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"Strengthening Australian Ties in the Chinese Iron & Steel Industry"

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Special Guest Speaker: Mr Robin H Chambers AO
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ROBIN H. CHAMBERS

BRIEF PERSONAL BIOGRAPHY

Robin Chambers is the Senior Partner of Chambers and Company, which is the Australian affiliate of Chadbourne and Parke, headquartered in New York.

He has an Arts degree and an Honours Law Degree from Melbourne University and a Law Degree from Duke University in the United States where he was an associate with Chadbourne and Parke, after graduating there.

On his return to Australia he was General Counsel of CRA Limited (which is now Rio Tinto Limited), for 14 years. After leaving CRA, he was appointed as the lead lawyer for the Chinese Government on the Channar Iron Ore joint venture in Western Australia, which was China's first major overseas investment. Today he is a Director of the Chinese Government's holding companies for that investment and sits on the joint venture policy committee.

He has been a director of more than twelve Chinese Government subsidiaries established in Australia and continues to act for Chinese steel producers. Over the past 20 years of his involvement in China, he has travelled to China more than 150 times.

He is Senior Vice-President of the Victorian branch of the Australia-China Business Council and is a director of the Australian Government's Australia-China Council.

Today, China is the biggest steel market in the world, and in 2003, China is expected to become the largest importer of iron ore globally, on the other hand, Australia is the largest exporter of iron ore. The synergies between the two countries' iron and steel industries are manifest. China is fast emerging as the saviour of the Australian mining industry with its rapidly expanding market to offset weak demand elsewhere in the world.

Australia's iron ore exports to China are dominated by the two largest iron ore producers, Hamersley Iron and BHP-Billiton, and you have heard from their respective chief executives earlier today.

While the current statistics are very impressive, it is the future trend which is most remarkable. The Chinese steel market became the world's largest market faster than all earlier predictions, and demand is expected to soar in the next decade.

Given steel's strategic importance, the Chinese Government is intent on re-making its steel industry to achieve international competitiveness.

In 2002, China's consumption volume of steel production exceeded 200 million tonnes for the first time in China's history. China's demand for steel has more than quadrupled since 1980.

China's consumption of steel production is predicted to exceed 250 million tonnes by 2005 and 300 million tonnes by 2010, according to the January 2003 China Metallurgical Newsletter.

China's steel production has increased from 150 million tonnes in 2001 to 180 million tonnes in 2002 and will exceed 200 million tonnes in 2003. A January 2003 industry report predicted that this figure will exceed 250 million tonnes before the year 2008.

Over the same period, China's imports of iron ore increased from 60 million tonnes in 2000 to 93.2 million tonnes in 2001, and 111.5 million tonnes in 2002. Imports are predicted to reach 130 million tonnes in 2003. (Over the same period, domestic iron ore production was 230 million tonnes in 2001 and 231 million tonnes in 2002. The estimate for 2003 is 250 million tonnes.) This massive increase in imports took many in the industry by surprise. Basically, it reflected China's demand for higher quality iron ore, the over-all poor quality from China's own iron ore sources and the pressure on China's steel industry to compete with imports following China's entry into the WTO.

You will have heard many reports on China's fabulous economic growth, especially over the past decade. GDP growth last year was 8.1 per cent and is expected to still exceed the level of 7 per cent for the current year.

Last year for the first time China became the largest destination for direct foreign investment, with an increase of USD54 billion in 2002. China's total contracted foreign investment is now USD837.31 billion, and actual foreign investment is USD451.6 billion.

One significant recent factor of China's iron ore industry was China's big swap from Australian iron ore imports to imports from Australia's competitors, especially Brazil, India and South Africa, over the past year.

In my address to you, I will endeavor to provide you with a brief picture of the Chinese iron and steel industry as it has special relevance to the Australian iron ore industry. It is noteworthy that last week when I was in China, the National President of the Chinese Iron and Steel Association was holding top level meetings to report on the future of China's steel industry which will set the scene for coming years. I will also talk about Australia's role and opportunities as the leading world producer of iron ore for China.

Let me now provide a brief overview of china's iron and steel industry.

As I have stated, China's predicted iron and steel imports provide an impressive opportunity for the Australian iron ore industry.

China's demand for steel is a reflection of the sustained massive growth of its economy. That demand is fed by a number of special factors. China's winning of the bid for the 2008 Olympic Games is reported to require millions of additional tonnes of steel. There is to be the construction of 22 new stadiums, a new Olympic Village and the renovation of 15 existing stadiums. Then there will be the public transport projects, growth in expressways, subways and light rail facilities and airport upgrades.

China's car production increased by 30 per cent in 2002, and will require China to upgrade its steel production to accommodate higher quality specialty steels. Currently much of that market is being met by imports, mainly from Japan and South Korea.

Building construction continues apace all over China. For anyone who has been to Shanghai to see the development of the Pudong precinct can only be amazed by that development. The Mayor of Pudong told me recently that there are eighty high-rise towers under construction currently in Pudong.

China is focused on become a "world manufacturing center", which must increase its demand for a value-added product.

The challenge for the Chinese steel industry will be to provide serious competition for high quality steel imports as China's increasingly sophisticated economy demands more than crude steel production. That expansion must move into stainless, galvanized and coated steel products, amongst others.

Shanghai Baosteel's joint venture with Thyssen Krupp in 1999 for production of stainless steel is only one of many foreign joint ventures to facilitate the transformation of China's steel production to be able to match foreign competition.

All of this is good news for the Australian iron ore industry, which is able to provide higher quality iron ore than is available from China's own iron ore resources.

In order to develop a more competitive international steel industry, China has implemented a number of steps over recent years. Many of these steps are quite draconian, and have brought about major changes in the structure and operation of China's iron and steel industry. All of this has happened over a relatively short time frame, which makes their significance even more remarkable.

In the mid-1990s, the Ministry of Metallurgical Industry, which until then had been responsible for all imports and exports of iron and steel, gradually lost its exclusivity for imported iron ore for use in China's steel industry. Instead, the Chinese steel companies were gradually permitted to make their own arrangements to import their iron ore needs.

Of even greater significance, the Ministry of Metallurgical Industry as the responsible Ministry has disappeared entirely to be replaced by the Chinese Iron and Steel Association. Thousands of senior officials who once held power over China's iron and steel industry lost their jobs and the former Ministry was down graded and then disappeared.

The China Iron and Steel Industry and Trade Group Corporation, commonly known as the China Steel Group, which was a corporatized entity under the former Ministry of

Metallurgical Industry, has survived and retained its role as a major trader of iron ore imports, and has its own steel production interests, but today it shares that activity with a growing number of major Chinese steel producers.

The trend today is towards the creation of mega iron and steel producers which can readily compete more effectively with the international competition. The January 2003 China Metallurgical newsletter stated and I quote: -

> "China will step up restructuring and associations to rationalize the organization and systems of its enterprises. It will nurture and develop a number of corporations and groups with international competitive edge, so that their strength can be brought into play."

Several years ago Shanghai Baosteel absorbed Shanghai Steel Mills, No'.s 1, 3 and 5, to become China's largest steel producer. Its production was estimated at around 18 million tonnes last year. Undoubtedly, Baosteel will not stop at that level but will be expand to compete more readily with international competition.

When compared with Europe's USINOR conglomerate at 40 million tonnes and POSCO from South Korea and Nippon Steel in Japan at 25 million tonnes each, Baosteel as China's largest producer has some way to go before reaching those levels.

Last week Tangshan Steel told me that they will absorb the other steel companies in Hebei Province, which will take their total annual production from 5 million to 10 million tonnes, and part of Capital Steel's Beijing production in China reported to being transferred to Tangshan as well.

Another feature is the development of private investment in steel plants. While still a recent development, this is consistent with growth patterns in other industries in China where privately owned enterprises have achieved significant market share.

As to the question whether China will encourage or even permit substantial foreign investment into Chinese State-owned Enterprises in the steel business, I believe that the answer is that it will have a chance. China will be looking for new technologies and logistical and management expertise from foreign investors. The foreign capital will often be an added incentive. China is doing this in other industries, and it can be expected that it will follow the same policies for the Chinese steel industry. Overall, China is undergoing a major economic restructuring which is changing the landscape in many industries in China.

This re-structuring is not without some costs. Capital Steel in Beijing has around 100,000 employees to produce around 7 million tonnes of steel, which in the West might employ only ten to twenty thousand workers. Its role in social welfare and operating hospitals, schools, etc., makes the rationalization of such a major company difficult.

In different parts of China, the loss of steel companies would not only affect local employment, but also regional economic power and wealth. In the 1960s, the policy was to promote regional self sufficiency. As a result, small inefficient operations were created all over China. The task now being confronted by the Central Government is to close obsolete and under-performing plants, which it is doing.

One important objective of the rationalization has been to secure the profitability of the industry. With fewer and larger producers at a global scale, the steel industry is returning to profitability. For 2001, it was reported that the industry profitability was zero, while in 2002, the profitability has increased to RMB25 billion.

Notwithstanding this consolidation into larger producers, the point is made in China that many of the smaller mills can still be profitable because of comparatively low labor and other costs. They have a different economic model from Western steel plants.

For the future profitability of China's steel industry there continue to be many challenges.

One is the industry over-supply globally, together with international trade protection such as we have seen from the United States recently.

Another is the urgent demand for high-tech, value-added product.

A third is the increasing shortage of available resources against future production growth.

What does all this mean for the Australian iron ore industry?

The Australian production is dominated by the two major producers, Hamersley Iron and BHP Billiton.

Australia's iron ore exports to China have increased from 24 million tonnes in 1999 to 32 million tonnes in 2000 and 37 million tonnes in 2001.

Australia lost market share in the same period. That was in part due to constraints in Australia's capacity to increase exports quickly to meet the new demand. Logistical problems exist, especially as I understand, with port facilities in Western Australia.

Imports into China from Brazil increased by 21.3 per cent in 2002, from India by 33 per cent in 2002, and from South Africa by 15 per cent in 2002. Australia's exports were recorded to have increased by only 12.5 per cent in the same period. Taken over a three-year period from 1999 to 2001, Australia's exports to China rose only 16 per cent while Brazil's exports increased by 66 per cent and India's exports increased by 54 per cent.

What will occur this year will depend in part on factors such as rising shipping rates, which will likely increase with any oil crisis resulting from a war with Iraq. That will favor the Australian producers, provided they can overcome their logistical problems. Differences in the quality of iron ore, especially from the high quality ore available from Brazil, will always be a competitive factor.

I mentioned previously the Chinese Government's initiative toward creating mega-steel mills to compete with international competition. That process can only be expected to continue. It is something we can see occurring across a range of industries in China as China re-structures to meet the demands of a market economy.

What is noteworthy is the contrasting strategies being followed by China and Japan. Currently, Hamersley and BHP Billiton are negotiating with the leading Japanese steel mills to fix the prices and volumes for the 2002-3 contract year. The Japanese producers have effectively managed the pricing arrangements by collective bargaining against the Australian and other world producers. The Japanese steel mill price sets the industry benchmark. Chinese prices follow suit, subject only to any special discounts and rebates which are a feature of the Chinese market.

On the Chinese side, until the mid-1990s, the Ministry of Metallurgical Industry had the monopoly on Chinese iron ore imports and Hamersley Iron and BHP Billiton had to deal with the Ministry of Metallurgical Industry and its corporatized entity The Chinese Steel Group. That was very important. For the Channar joint venture which the Ministry of Metallurgical Industry entered into in 1987, the Ministry guaranteed the total market in China for its total production. That was agreed at a time when the Ministry controlled the market. Today, China Steel Group does not enjoy that monopoly and has to compete with Hamersley Iron and BHP Billiton, dealing directly with Chinese customers.

With only two major Australian producers, an increasing number of major Chinese steel customers, have lost negotiating strength against the Australian suppliers. Moreover, the Chinese steel companies have their own independence and competitiveness with each other in the Chinese markets, so that prospects for their collaborating are less likely than might have been the case in the past. It will be interesting to see if China continues to allow this situation to develop long term if it should perceive that China is paying more for its iron ore imports.

Finally, my profile introduction mentions my experience as the lead lawyer for the Chinese side in the Channar joint venture between Hamersley Iron and the Ministry. That was regarded as the model joint venture for China's own overseas joint ventures. Its unique feature was to exchange equity for market guarantees. That model was consciously followed by the Chinese Government in negotiation Australia LNG's 25 billion dollar LNG sales contract with China, which has been receiving so much publicity recently when the China National Offshore Oil Company was granted around 5 per cent equity in part of the North-west shelf operations. Shanghai Baosteel's recent iron ore joint venture with Hamersley Iron has also followed that model with some variations.

Future resources investment in Australia by China can only be expected to do the same, not only for the iron ore industry. China is pursuing a policy of upstream investment by investing in overseas resources.

Based on my own contacts in China, I am aware that both Hamersley Iron and BHP Billiton are competing to lock in Chinese steel companies as secure customers by offering equity in new mines in return for long-term sales contracts. The Chinese producers are very keen to become involved as well as they also want a security of supply beyond mere long-term sales contracts. In such cases, the Chinese are offering guaranteed sales in return for an equity share.

With its Channar joint venture in 1987 Hamersley Iron established valuable contacts and a considerable reputation which secured its leading position as a preferred supplier to the Chinese steel industry. That also secured guaranteed sales of 10 million tonnes a year committed by the Chinese side. Hamersley Iron has similarly secured a future 10 million tonnes of sales a year with its Baosteel joint venture. It has also established a special relationship with Capital Steel which has invested in Hamersley's HIsmelt technology. Those three partners provide Hamersley Iron was a very powerful marketing base on which to build its future sales profile in China.

Insofar as I am aware, BHP Billiton has not established any similar partnering relationships with Chinese mills with equity components, although both Hamersley Iron and BHP Billiton have utilised non-equity contributions to engender special connections with selective Chinese producers at different levels.

All of this can only serve to entrench Australia’s premier position as a supplier to China’s very impressive steel industry expansion.

With the massive increase in demand in China for iron ore supplies, an apparent seller's market has developed which will underpin the development of further Australian mines by Hamersley Iron and BHP Billiton. A major difficulty will be the lack of new projects available for Chinese investment. There remains an excellent opportunity for small players in the Australian industry to team up with Chinese companies to secure valuable market share in China.

Mr R H Chambers AO
24-25 February 2003