

Market review

Competitive environment

Rio Tinto is a major producer in all the metals and minerals markets in which it operates. It is generally among the top five global producers by volume in each such market. It has market shares for different commodities ranging from five per cent to 40 per cent.

Most of Rio Tinto's competitors are private sector companies which are publicly quoted. Several are, like Rio Tinto, diversified in terms of commodity exposure, but others are focused on particular commodities. Metal and mineral markets are highly competitive particularly since commodity prices are subject to price declines in real terms as a result of productivity gains, increasing technical sophistication, better management and advances in information technology.

High quality, long life mineral resources, the basis of attractive financial returns, are relatively scarce. Nevertheless, Rio Tinto holds interests in some of the world's largest deposits.

Economic overview

Between 2004 and 2007 the world economy grew at an average rate of around five per cent a year on a purchasing power parity basis (source: IMF). This favourable economic environment generated strong year on year growth in demand for commodities. Although the mining industry responded by raising levels of investment, there were significant lags in bringing on new capacity. Consequently, growth in demand for certain commodities outpaced growth in supply, causing prices for those commodities to increase.

Most of the growth in demand during this period was attributable to China, which experienced rapid economic growth as it entered a phase of mass urbanisation and industrialisation. China's GDP expanded by 13 per cent in 2007 (source: Chinese National Statistics) and its consumption of copper and aluminium increased by 35 per cent and 43 per cent, respectively, according to the World Bureau of Metal Statistics.

Spot commodity prices eased slightly in the latter part of 2007 but during the first half of 2008 the global economy continued to grow at a rate above the long term average. At the same time, metal and mineral production levels were limited by a series of disruptions and constraints on the supply of certain inputs. In part as a consequence of these factors, Australian iron ore benchmark prices for the 2008-9 marketing year were increased by 80 to 98 per cent compared to previous levels, coking coal benchmark prices

increased by 211 per cent and thermal coal benchmark prices increased by 99 per cent. The West Texas Intermediate oil benchmark price peaked at US\$147 per barrel in mid July 2008 and during the same month, copper prices reached a record level of almost US\$9,000 per tonne.

During the third quarter of 2008, however, global economic conditions began to deteriorate, in part as a result of turbulence in the financial markets stemming from the sub-prime mortgage crisis in the US. In particular, the bankruptcy of Lehman Brothers, the US investment bank, in September 2008, contributed to an acceleration of economic deterioration. Following the bankruptcy, risk premiums expanded significantly and lending and general access to financing contracted. Governments around the world took action to restore confidence in financial markets and improve liquidity, including purchasing distressed assets, providing loan guarantees and through direct capital injections.

Despite these measures, financial turbulence continued during 2008 and contributed to a decline in global economic growth and the emergence of recessionary conditions in certain countries. In particular, the US, UK, Eurozone and Japan all experienced declines in GDP during the second half of 2008 and China's economy grew at a slower rate in 2008 than in prior years. Slowing growth in China and certain other developing countries reflected the fact that those economies were much more dependent on external demand than was previously expected and is a result of the absolute fall in exports relative to expectations. In the case of China the lagged impact of previous policy tightening, declines in equity markets and a correction in a slightly overheating property market have also contributed to the deceleration in growth. Activity in the housing and automotive sectors has fallen alongside a fall in consumer confidence.

The deterioration in global economic conditions since the third quarter of 2008 has had a significant impact on demand for, and prices of, metals and minerals. Previous conditions of market shortages have been transformed into excess supply. Combined primary base metals stocks on the London Metals Exchange doubled during the second half of 2008, to their highest level since the mid-1990s. This trend has been most notable in the case of aluminium. For metals such as copper, where supply growth has been more limited, there has been a much lower rise in visible stocks.

Prior to the economic downturn, metals

prices were well in excess of the marginal costs of production, reflecting strong demand and constraints in supply. As a result of declining demand stemming from the deterioration in global economic conditions, the LME base metals price index (a basket of the main LME traded base metals) finished the year 60 per cent below its March 2008 peak. Spot aluminium and nickel prices finished 2008 at around US\$1,500 per tonne and US\$11,000 per tonne, respectively, their lowest since 2003. Spot copper prices ended 2008 at approximately half of their level at the beginning of the year and their lowest since 2005.

The majority of Rio Tinto's iron ore and coal production is sold at annual contracted prices rather than on the spot market. Accordingly, Rio Tinto is experiencing significant deterioration in the pricing environment for these commodities.

However, it reduced production of iron ore towards the end of the year as a result of declining demand associated with lower steel production in Europe and Asia.

The impact of the deterioration in economic conditions on industrial minerals prices has been less significant. Gold prices have increased, reflecting weak growth in supply as well as gold's attractiveness to some investors in times of increased financial uncertainty.

Adverse economic developments during 2008 have led to a shift in focus from maximising output to capital management and cost saving. Despite this, Rio Tinto also believes that recent developments have highlighted the value of pursuing a strategy of investing in Tier 1 mining assets, which are generally able to generate positive margins over the whole of the economic cycle.

Trend information

Demand for the Group's products is closely aligned with global GDP. Changes in the GDP of developing countries will generally have a greater impact on demand for commodities such as iron ore and coal, which are significant inputs in the development and improvement of infrastructure. Conversely, changes in the GDP of developed countries will have a greater impact on industrial minerals, which have many applications in consumer products. Copper is used in a wide range of applications and demand for it has tended to grow in line with or slightly faster than global GDP. Trends in production of the Group's minerals and metals, gross sales revenue and underlying earnings are set out in the Performance section of this 2008 *Annual report*.