

CEDA (Committee for the Economic Development of Australia)

Foreign Investment and the Mining Industry

Victoria, River Room, Crown, Melbourne
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Speaker: Keynote Presentation - Doug Ritchie, Global Head of Strategy, Rio Tinto

Introduction

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Good afternoon and welcome,

Many of you know that emotions are running pretty high in Australia on the topic of foreign investment. It's an issue that is guaranteed to generate headlines. I understand that and that's why I appreciate the opportunity to address it in some detail today.

No one wants Australia to lose out, and no one wants Australia to lose control over its valuable natural resources. Those resources have helped underpin this country's economic success story and provided valuable jobs and income. It is fair to say that Australia would not be the rich, self-sufficient economy it is today without those key mineral resources.

That's why I think it is worth looking beyond the instant emotional responses, strong though they might be, and closely examining the facts around the development of Australia's resources. It seems to be the prudent thing to do at this time, if we need to make large decisions about the future.

There is no doubt that the world has changed and that China is set to play a major role in the global economy. Over the next five years, China is expected to consume more iron ore than Australia has exported throughout its history. So how Australia responds to China will, I believe, be crucial to the future wealth of this country.

Today I want to do three things: firstly, paint a picture of the current state of Australia's resources industry and the extent of direct foreign investment. Secondly, to look at the approach adopted by Australia in the past to foreign investment and what impact that has had. And, lastly, I want to examine the contentious subject of 'control' and just what that really means.

I think there are a few popular myths that accompany these three areas. I want to investigate these and see if they stack up. Hopefully I can provide you with a little clarity.

The Current State

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Turning firstly to the current state of Australia's mineral resources industry, there is no doubt about its huge importance to the economy, even with the recent downturn in commodity markets. Mining makes up some 8 per cent of the economy and resources have accounted for almost all of the growth in Australia's exports in the past five years.

Foreign capital is ubiquitous in the Australian resources industry, forming majority and minority interests in joint ventures, and in both listed and unlisted companies.

The major mining companies - BHPB, Rio Tinto, Anglo, Xstrata - are now majority foreign owned, and that ownership has allowed Australia access to the global capital it needs to develop its resources. The stock of foreign investment in Australia at 31 December 2007 totalled \$1.6 trillion. And mining companies, most of which are foreign owned or controlled, produced 8 per cent of our national GDP in 2008.

Foreign capital plays an even more pivotal role when it comes to the growth of the resources sector. For example, in 2006, foreign direct investment was equal to over 80 per cent of new private capital expenditure in the Australian mining sector. Without it we simply would not be able to support the growth of the industry.

One of those popular myths in circulation is that foreign investment sucks out wealth and jobs from a country. But research shows that for every dollar of income generated in Australia, 95 cents remains in Australia, and only five cents is sent overseas.

So the picture we have today is of a world class industry where foreign investment plays a crucial role. You would think that this would ensure Australia's position in the global resources market. However, it might surprise you to learn that Australia has actually been losing ground. Compared to the rest of the world, Australia's share of global resources output has been slipping.

Countries like Brazil, India, Indonesia and Russia are increasing their market share as they aggressively pursue business with Asia. For example, the value of Brazil and Argentina's soybean exports to China alone now exceeds Australia's total agricultural exports to China.

So the picture of Australia's resources sector is more complex than at first glance. Yes, it is a large, world class operator, supported by substantial amounts of foreign capital and equity. Its resources continue to offer huge growth prospects and potential wealth for this country, but global changes are seeing complex forces coming into play, including increased competition, that could reshape the current order.

The question is how Australia responds to this challenge.

Past Experience

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I want to turn now to the past.

Despite the populist fears that the “farm has been sold” to foreigners, the fact is that the “farm has been developed” by foreigners and their money. Foreign capital was originally applied to primary industries such as wool and gold, and has been there in some shape or form almost from the start of European settlement. One of the most important periods of development was the 1970s and 1980s. It was at this time that Japan turned to Australia for investment in resources. Today there are key Japanese investments across the resources sector.

What I think is worth examining more closely is how the period of the 70s and 80s bears a striking similarity to the period we are now entering with regards to China. Let me explain.

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Japan in the sixties and seventies was an Asian country undergoing rapid change. It had come a long way in thirty years and was embracing a market-based industrial economy. It had a high rate of growth and was generating a healthy current account surplus. Sound familiar?

But like China today, Japan lacked the domestic resources required for growth and the economy was heavily dependent on imports. The need to obtain security over supplies is heightened during these early phases of economic development because they are so metal intensive. So Japan turned to foreign investment to fill the gap.

As you might know, Japanese companies purchased an interest in iron ore through joint ventures at Robe River and at Mount Newman. Later Japanese interests participated in the Yandi and Mt Goldsworthy JVs. Today, almost half of Japan’s import requirement for iron ore is effectively supplied by its share of production in projects in Australia and Brazil. There is little controversy over this, and neither should there be. The investments have been of mutual benefit to both countries.

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Now let’s look at China today. It currently imports over half of its iron ore needs. It is no wonder that it is considering ways to diversify and secure investment in resources. It has already begun to do so, through the Channar joint venture (over 20 years ago) and other more recent equity investments. But even if you take into account Chinalco’s proposed partnership with Rio Tinto, China’s share of iron ore production in Australia would still only account for around 13 per cent of its needs.

From the outset Japanese investment in the Australian resources sector has almost always been via minority stakes. China has pursued the same strategy, but has extended to larger stakes in certain situations. Despite what you might think, Chinese

investors have settled for fewer rights than previous Japanese joint venture partners, but I will get to that later.

Another feature common to both countries at the initial stage of development is the presence of a centralised body, or group of bodies, that target industry development, guide and promote investment including access to finance.

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It seems that many have forgotten the name of MITI - Japan's powerful Ministry of Trade and Industry. But it wasn't that long ago that MITI held immense influence and effectively ran much of Japanese industrial policy, directing investment internally and externally.

At the time, many voices in Australia were warning of the rise of Japan and the power of MITI. The press was full of concern about Japanese investment here and coined the phrase "Japan Inc". The media devoted many column inches to discussing the motives of the Japanese and the apparent lack of transparency or separation between government and private enterprise. There were warnings that Japan could buy Australia many times over.

The fact is that the dire predictions failed to materialise. I think it's because we misunderstood what was happening. The transition from a centrally planned to a commercial economy is a major endeavour and has been a common feature of the Asian region. Japan used a range of structures and methods to ensure a smooth transition. Bodies such as MITI are most relevant for dealing with rapidly expanding economies coming off a low base. But, once the economy achieves greater maturity, they are no longer relevant.

There is no reason to suspect China is not embarking on a parallel course. The similarities are striking and I think helps us to cut through some of the more excessive myths regarding China today.

Learning from Japan

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If we accept that there are similarities between Japanese investment in the 70s and 80s, with the current Chinese situation, then there may be some useful lessons we can take away.

In particular, it is worth considering what the cost of forgoing the investment might be. ABS data shows that foreign direct investment by Asian countries is directly linked to export opportunities for Australia. But what happens if that investment is turned away or delayed?

There is considerable evidence that the investment and other benefits it entails ends up elsewhere.

During the early 1980s, industrial relations in the resources industry markedly deteriorated. Stoppages and other actions reduced the reliability of supply. Government actions in taxes, royalties and indirect charges (e.g. rail freights) exacerbated this. Japan, amongst other customers, chose to facilitate the development of 'more reliable' capacity in other countries.

It was at this time that the Japanese chose to invest in iron ore in Brazil. This saw Australia's share of global iron ore exports decline by two per cent between 1985 and 1987. In today's figures that equates to some 18 million lost tonnes each year. Coking coal from the Bowen Basin was a similar story.

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Today the global competition is even greater. China has huge needs for the future and will buy and develop other assets that are in competition with Australia if we fail to attract their investment. And it is already happening - China has announced at least \$33 billion in acquisition and development initiatives in African resources over the past few years. Then there is Latin America.

What the period of Japanese investment suggests is that the fears associated with direct foreign investment from Asian countries will trigger temporary hysteria, which will subside. More importantly, it shows that where conditions are not conducive to that investment it will go elsewhere and relatively diminish Australia's share of the global resources pie.

Out of Control

Now, I want to come to the issue of control. It is perhaps the most contentious subject in the current debate.

An anecdote. A few years ago during iron ore price negotiations with the Japanese, a Rio Tinto marketing executive received a pointed gift from the Japanese negotiating team. The gift was a doll without a face. The pointed message of the faceless doll was that the Rio negotiator had "no face" in Japan because of his strident and successful efforts in obtaining higher iron ore prices.

The gift signalled how tough Rio had played the negotiations. And remember this was the response from the country that is a joint venture participant with Rio Tinto in one of Australia's biggest iron ore operations, at Robe River.

Has the presence of a major customer like Japan as a joint owner in Australian resource projects such as iron ore and coal resulted in reduced prices for these products? These examples would suggest not. And I would suggest that it is a myth that a commercially operating entity will not do its utmost to maximise prices for its product.

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Speculation that the Chinese, through their proposed investment in Rio Tinto, are running some kind of Machiavellian scheme to drive down prices simply has no foundation. Once again by turning to the experience with Japan a few decades ago, it is instructive to note that Japanese interests in resource joint ventures were generally granted greater rights than that being proposed by Chinalco today. And no one would suggest there has been anything but healthy pricing markets between Japan and Australia.

The typical joint ventures with Japan tended to involve higher levels of board and management representation. They also involved greater minority protection, frequently with the Japanese having veto powers, and few limitations on the disposal of their interest. This compares with the Chinalco deal where there are no management rights and only minority board representation, only very limited veto powers and strong rules governing pre-emption on any disposal.

When it comes to marketing arrangements the differences are also stark. The agreements put in place with Japan frequently included off-take rights, long term supply contracts, exclusive agency arrangements and greater control to the minority partner. This compares with the proposed deal with Chinalco in which all marketing activities will be undertaken by Rio Tinto with the decision making retained by Rio Tinto personnel. Chinalco will not make decisions regarding product mix and production levels, pricing, contracting strategies or marketing tactics and strategies. It is hardly a position of deep influence. And even if there were similar rights as those granted to the Japanese, there is no evidence that those rights have had any impact on prices.

Rio Tinto has a lot of experience dealing with joint ventures. With more than 40 currently operating, we have a pretty clear idea of what's required to make these relationships work and have identified three key issues critical to their success.

Firstly, appoint senior Rio Tinto representation to governing bodies; secondly, develop internal structures that safeguard Rio Tinto's rights, manage the formal contractual structures and ensure the scope of the arrangements is aligned with the transaction agreements; thirdly, develop appropriate protocols for managing sensitive information.

Now some people seem to think that 600 pages is a lot for an agreement with Chinalco and that it somehow hides insidious details. The fact is the opposite – and those who understand these types of deals realise that a detailed agreement is critical to making them work and is built on Rio's long experience of working partnerships.

Most Australian resource joint venture agreements run into hundreds of pages – what's different about those we propose with Chinalco is that we took an unprecedented step and posted all of the details on the joint ventures agreements on the ASX. As a result we've had to educate even very experienced Australian commentators and analysts on how to understand them – they've never seen this sort of detail before!

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One argument put around is that it is different today, because the Chinese are investing through state owned enterprises. Well, you just have to look at the experience of countries such as Singapore to realise that this is not something new. Temasek

Holdings is a successful state owned enterprise that few would argue operates on anything but a commercial basis and it holds significant stakes in major corporations such as Merrill Lynch, Barclays Bank and SingTel, the owner of Optus here in Australia. There is no question of inappropriate influence there, and nor should there be.

Interestingly, many state owned enterprises are now listed companies, with growing levels of foreign ownership. A recent McKinsey report forecast that by 2012 the Chinese government would have almost zero percent interest in these companies.

Despite this, there are no documented cases of investments by state owned enterprises causing significant problems for a host country. The OECD has identified that sovereign wealth funds have been reliable, long-term, commercially-driven investors and a force for global financial stability in times of recent financial turmoil.

So a question we should ask is, if we discourage investment by an entire class of Chinese companies, what impact will this have on Australia? Particularly if there is no evidence that this is likely to lead to reduced commodity prices or lower national wealth. On the contrary, the evidence is that it will boost the national wealth, promote exports and create jobs.

So, having given that lengthy outline of the elements of the agreement with Chinalco, I want now to be very short and very precise on the issue of control:

Upon completion of this transaction Rio Tinto will have exactly – repeat- exactly the same control over our assets, over our business products and over our marketing as we do today. We will make investment decisions, price our products and engage with our people in exactly the same way as we do today, albeit with a greater insight into the Chinese market than we do today.

Flexible window

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The question now is how we handle the particular opportunity afforded today by the rise of China. China is emerging as a principal driver of global growth and a major, and probably **the** major, supplier of capital over the next several decades.

I believe there is currently a window of opportunity for Australia to position itself uniquely for a mutually rewarding relationship that could define the next few decades. By forging a deeper engagement with China, including allowing substantial inflows of capital, we could generate enduring export markets at a time when alternative markets are thin on the ground.

We could also gain a long-lasting relative advantage in securing capital on competitive terms, which could underpin Australia's recovery from the current downturn and its longer term growth prospects. Importantly, we could also increase Australia's standing and influence with the country set to emerge as an economic and strategic super power.

These are big opportunities, and the potential benefits are enormous. It seems sensible to assess investment proposals from state-owned enterprises using a principles-based approach, applied on a case-by-case basis. However, it is crucial that these principles are applied in a way that understands more capital flows are likely to come from government owned investors.

It may seem obvious, but it is worth pointing it out - mining companies do not own the land from which they extract minerals. They are granted leases and licences to operate by governments, both federal and state. No matter what might occur, the people of Australia will always have ultimate control over their country's valuable resources. For example, we have strong taxation rules, transfer pricing rules and other strong regulatory protections. And if they ever have significant and real concerns, the people are free through their lawmakers to adjust the rules, laws and regulations governing those resources.

China's appetite for resources has driven a substantial increase in Australia's terms of trade, which has benefited us all. A recent economic study shows that there were approximately 116,000 extra jobs created in Australia in 2007 alone due to the terms of trade benefit caused by China.

The opportunity now is to build on that and ensure we all share in the wealth.

Thank you.