

Sino-Australian relations complicated by BHP's attempted merger with Rio Tinto

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China recorded its largest-ever foreign investment on February 1 when it purchased 12 percent of the London-listed stocks of mining giant Rio Tinto or 9 percent of the company's total shares. The move by the state-owned Aluminum Corp of China (Chinalco), in coordination with US-owned Alcoa Inc, was aimed at preventing BHP Billiton, the Australian-based mining multinational, from successfully bidding for Rio with \$US147 billion in what would be the second-largest takeover in history.

Beijing's investment in a leading global mining company further highlights intensifying corporate conflict over control of raw material supplies and raises key questions about Australia's future relations with China.

Chinalco's \$14.1 billion investment in Rio is almost equal to the combined values of the three largest deals China made in recent years: Industrial Commercial Bank of China's (ICBC) \$5.6 billion investment in South Africa's Standard Bank last October, China Investment Corp's \$5 billion stake in Morgan Stanley in December and China National Petroleum Corporation (CNPC)'s \$4 billion investment in PetroKazakhstan in 2005.

In 2005, China National Offshore Oil Corp (CNOOC) failed to take over California-based oil company Unocal, due to the concerns within the Bush administration and the US Congress that Chinese government control of a major US oil corporation would undermine American "national interests". This time, Beijing has changed tack and is pursuing its foreign investment in raw materials through a partnership with Alcoa, the world's largest aluminum corporation.

Chinalco claims it has no desire in further increasing its stake in Rio, with company president Xiao Yaqing declaring that the decision was purely "commercial" and that his aluminum firm was not interested in the iron ore business. It is widely understood in international financial circles, however, that Chinalco was acting on behalf of the Chinese state and its interests in the steel industry.

Under Australian law, large-scale foreign investment must be considered by the Foreign Investment Review Board (FIRB) with the federal treasurer given final veto power.

Last Sunday Treasurer Wayne Swan announced a set of six "principles" for reviewing foreign investment in Australia. While the treasurer denied his rules were aimed at Chinalco, his criteria stated that no investment must be directly controlled by a foreign government or lead to the "undue concentration" in a particular industry or sector.

Senior government sources told *Australian Financial Review* last

week that Chinalco had been obliged to submit its investment to the FIRB—even though its 9 percent stake in Rio Tinto was below the 15 percent trigger for FIRB involvement.

Swan has repeatedly declared that if China attempts to take a larger stake in Rio Tinto, he will decide whether to approve it "on national interest considerations". The treasurer, however, knows that the definition of "national interest" for Australia's corporate elite is rather complex.

Although Swan's "guideline" may put more questions over Chinalco's investment in Rio Tinto, Canberra is unlikely to veto the deal. Prime Minister Kevin Rudd's government administers an economy heavily dependent on the export of minerals to China. Australia sends half its iron ore to China, exports that have been growing at 25 percent annually for the past five years.

Last year, Australian trade reached \$45 billion with China, which surpassed Japan as Australia's largest trading partner. The UBS Australia has estimated that this year, thanks to growing mineral exports, especially iron ore and coal, and increasing continuing price rises, the country will record its first trade surplus since 2002.

China is now the world's largest steel producer and consumes over one third of the world's iron ore. If BHP and Rio Tinto, two of the world's three largest corporate suppliers of that mineral, form a monopoly, it could force steel mills in China and elsewhere to pay much higher prices. In order to develop alternative supplies, Baosteel and other Chinese steel companies have been cultivating partnerships with other Australian iron ore producers, such as Fortescue Metal Group. But none of these suppliers can supplant BHP and Rio Tinto.

BHP's attempt to swallow Rio has worried not only Beijing but steel companies in Japan and Europe as well as their "antitrust" regulatory bodies. According to the *Wall Street Journal* on February 12, a BHP-Rio Tinto combine would be a \$350 billion behemoth just behind the Exxon Mobil Corporation; the world's largest corporation.

The newspaper pointed out such a monopoly would generate "nearly double the profit of Microsoft and 45 times the profit of Yahoo. It would create a company so geographically dispersed, and so politically influential that it would become almost a country unto itself." The new corporation would control 40 percent of the world's seaborne trade of iron ore and large chunks of other commodities such as coking coal, copper, aluminum and uranium.

The *Journal* noted that rising demand for raw materials by China

and India was forcing mining companies to expand production into “ever-more threatening political theaters like the Congo” and other parts of the globe. A BHP-Rio Tinto deal would provide “the capital base to pursue these massive new projects, without putting the company at mortal risk”.

In the 2006-07 financial year, BHP sold one-fifth of its global production to China—including 49 percent of its iron ore. But the Australian company mines less iron ore than its main rivals—Brazil’s Vale and Rio Tinto.

In recent years, Vale has become the main player in annual iron ore price negotiations with Asian steel mills. Over the past four years, the negotiated price benchmark for iron ore has more than doubled and on February 19 it rose by another 65 percent.

While Rio followed the benchmark, BHP has been trying to undercut Vale, which controls 40 percent of the world’s iron ore exports, by offering lower shipping costs. The most obvious expansion for BHP is to take control of Rio and its large operations in the key iron ore region of Pilbara in Western Australia.

Last year, BHP CEO Marius Kloppers told Rio shareholders that the merged companies would save at least \$3.7 billion per year but the Rio Tinto board rejected the bid on the grounds that the Australian company had “undervalued” its assets.

On February 7, BHP launched another “hostile” bid of 3.4 BHP shares for each Rio share or about \$106 per share. Rio Tinto again rejected the offer. Investors now expect BHP to pay at least \$117 per Rio share—the price paid by Chinalco just a few days ago.

BusinessWeek pointed out on February 13 that under the current proposal, Rio shareholders would end up holding 44 percent of the merged company. “But if BHP is forced to raise its bid, its own shareholders could end up with less than 50 percent of the combined company. Similarly a cash sweetener, which could add \$15 billion to the price of the deal, would burden BHP with debt, just as it looks to reduce costs by eliminating duplicate operations.”

Intervention by the Chinese government to buy a larger stake in Rio Tinto cannot be ruled out. Rio Tinto’s iron ore profit rose 18 percent in 2007—to \$2.25 billion or one-third of its total earnings—thanks largely to the rising demands from emerging economies. Between 2000 and 2007, Rio’s sales to China tripled. In 2006, it shipped 43 percent of its iron ore to China and over the next few years, plans to massively expand its annual global output of iron ore from 145 million tonnes to 600 million tonnes. BHP has unveiled similar large-scale expansion plans.

For the Chinese government, which is struggling to curb inflation and social unrest, the continuing price increases in imported raw materials will further compound the crisis.

Last year, Beijing established a \$200 billion China Investment Corporation, not simply to seek higher returns on the country’s huge \$1.5 trillion foreign currency reserves. Greater state investment in foreign energy and mining assets is at the centre of Beijing’s efforts to secure stable supplies of raw materials. These moves are seen by a number of great-power rivals in the West, as a threat to their economic and geopolitical interests.

A BHP observer told the British-based *Independent* newspaper on February 10: “You can see parallels here with Russia and its

creation of Gazprom. Look at the way Gazprom acquired assets, building the group into the biggest gas producer in Europe. But it took Europe a long time to work out what was going on in Russia and then, hey presto, suddenly it was there on our doorstep. Is China doing the same in mining?”

The rise of China has placed Australia in a precarious position. While Australia’s corporate elite is making huge profits from China’s rapidly growing economy, the Bush administration has branded Beijing a “strategic competitor” and sought to establish a string of military bases and alliances, including Australia, to contain it. Canberra is also uneasy about China’s increased presence in its “backyard”, the South Pacific, which has been a major factor behind Australia’s active interventions in East Timor and Solomon Islands.

On February 9, the Melbourne-based *Age* commented that Prime Minister Rudd faced a “tough balancing act”. The newspaper pointed out that while Rudd was being promoted as a popular Western leader in China for his fluent Mandarin and high-level connections, he might have to “make a difficult decision” over Chinalco that would disappoint Beijing.

“[F]rom the PM down this week, government ministers have united in a common chorus: any foreign investment will be judged according to law and decided on national interest, they say. But in an age of growing Chinese power, where precisely does Australia’s national interest lie?” the newspaper asked.

“Rudd is well attuned to the controversy about China’s aggressive resource diplomacy,” the newspaper continued. “During a meeting with George Bush last year, he handed some gifts to the US President—two books, one biography of Australia’s wartime prime minister John Curtin, the other, an investigation into China’s careful efforts to extend its global reach”.

Rudd’s gifts are a clear message to Washington: that the Labor government will maintain its commitment to the US alliance in order to advance Australia’s interests in the Asia-Pacific, but does not want the US coming into conflict with China.



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