# Foreign Investment: a Foundation for Australia's Prosperity

28 April 2009

**Submission to the Senate Standing Committee on Economics**

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# EXECUTIVE SUMMARY

## Background to the Senate Inquiry

Australia has a long history of making foreign investment work to drive the economy's growth. British capital supported the first stages of Australia's early development, and foreign investment from the United Kingdom, the United States, Japan and many other countries has been integral to Australia's development ever since.

As a country, our challenge is to continue to attract the capital we need to support increased economic growth and trade. This challenge is exacerbated by the global financial crisis, the erosion of traditional sources of capital, and the emergence of new sources. As a nation, we need to ensure that our investment review processes meet our needs for capital, while securing our national interest.

Today, Australia is facing new challenges in assessing foreign investment proposals. In the past couple of years, a small but increasing number of high-profile investment proposals have come from countries that have not traditionally invested in Australia to any significant extent. Even more importantly, several of these proposals have come from entities owned, in whole or in part, by governments, including sovereign wealth funds (SWFs) and state-owned enterprises (SOEs). These investments, in particular, have attracted a great deal of media attention and public debate.

As a result of the specific concerns raised about the increasing investment by government-owned entities in the Australian economy, the Senate has launched a formal Inquiry into Foreign Investment by State-owned Entities. The Inquiry specifically seeks to report on the Australian and international experience of SWFs and SOEs, particularly in the context of Australia's foreign investment arrangements.

## Foreign investment has driven Australia's development

Australia has benefited greatly from foreign investment into its economy over a long period of time. This is generally agreed by economists, the corporate sector, bureaucrats and politicians of all persuasions. Ted Evans, former Commonwealth Treasury Secretary, noted[1]:

> *"It is a fact that, for all of its modern history, Australia has borrowed from abroad – our prosperity has been built on foreign investment."*

As will be outlined in this submission, the investment relationships built on the back of foreign investment have enhanced Australia's trade relationships, as well. Rio Tinto's own experience at its Robe River joint venture confirms this. Participation of Japanese investment partners underpinned rapid growth of exports, especially to Japan, in excess of other Pilbara operations. This was achieved with no discernible impacts on market prices.

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[1] Ted Evans, 'Economic and nationalism and performance: Australia from the 1960s to the 1990s', 3 June 1999

Increased trade with investment partners strengthens not only Australia's economic relationships with investing countries, but also Australia's political and strategic relationships, increasing the likelihood of stable, broad-based relationships with key trading partners. Moreover, high levels of foreign investment have been achieved without "selling the farm" – Australia retains 95 cents in every dollar of GDP it creates.

Nonetheless, the issue of foreign investment has always been, and remains, contentious. Each new wave of foreign investment has brought new challenges. Investment by western countries such as the United Kingdom and the United States raised concerns as to whether Australia was losing control of its destiny to companies based overseas, and as to whether Australia's national culture and identity would be challenged. In the 1980s, investment by Japanese companies in mining, manufacturing, tourism and other ventures received close scrutiny and considerable public opposition. While the next wave of foreign investment is expected to come from China, it should be noted that until now, China's investments in Australia have been small and well below what we might expect given the extent of Australia's trading relationship.

Nowhere is foreign investment more important than in the highly capital intensive resource sector. The majority of the resource industry's investment has been funded from offshore. Indeed, the leading mining companies in Australia, including both BHP Billiton and Rio Tinto, are primarily funded from offshore, not Australia, and neither company is even close to being majority Australian owned. Other majors, including Xstrata and Anglo American, are entirely foreign owned. These foreign investments are not only critical for financing growth, but they also facilitate trade relationships. Moreover, it is clear that access to foreign investment for major resource companies and projects will be increasingly competitive in the future, as other resource rich regions begin to develop their resources.

Increased foreign investment in the resources sector quickly translates to increased wealth for all Australians. As discussed later in Section 2 of this report, modelling by Access Economics shows that even modest 'skewing' of investment towards Australia would increase the wealth of every Australian household by more than $2,000.

## The challenge: securing foreign investment capital to sustain growth

Looking forward, the challenge for Australia is to maintain access to the capital needed to sustain its economic growth in the face of rapidly changing global capital markets. Reserve Bank Governor Glenn Stevens recognised this when, describing conditions for Australia's success in the next economic expansion, he suggested that Australia must[2]:

> *"remain open for trade and investment, and have a capacity to deploy both our own and other people's capital carefully and profitably."*

On the one hand, as the current economic crisis deepens (or even if it stabilises quickly), capital to fund business investment will be critical to sustain economic growth. A share of this capital must continue to come from overseas. On the other hand, risk premiums required to secure capital are

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[2] Glenn Stevens, 'The Road to Recovery', Address to the Australian Institute of Company Directors, 21 April 2009

higher today than in the recent past, and some of the countries that have supplied capital to Australia over the past few years will be less able to do so in the years ahead (for example, the United States and the United Kingdom). It should be emphasised that this is a longer term trend, and the current crisis has simply accelerated that trend.

Lack of access to capital or a higher cost of capital has the potential to be seriously detrimental to Australia and the continued development of its resource sector. For instance, interest rates are likely to be higher, investment lower, and growth, employment and incomes lower. Already, capital constraints have contributed to the cancellation of US$200 billion of resource projects across the globe.

Looking to new sources of capital is therefore not an option – it is a necessity. Businesses and government are now realising this. Indeed, a significant portion of the capital necessary to support Australia's growing public sector debt is now coming from China.

As Australia and other developed nations increasingly look to emerging industrial countries (and particularly China) for this capital, inevitably they will be required to deal with investments by government-owned entities. To date, most of the foreign capital invested in Australia has been from privately-owned organisations[3], albeit of many different types, and with a degree of foreign government influence and support, at least in some instances.

Australia's experience in dealing with investments from foreign companies owned (in whole or in part) by foreign governments has been very positive. SingTel's investment in Optus, for example, has helped bring healthy competition to Australia's telecommunications industry. Investments by POSCO from Korea and Sinosteel from China, and others, have helped build Australia's resources industry.

Investment by SOEs and, to a much lesser extent, SWFs, is perceived by some to create concerns relating to transfer pricing, loss of national identity or culture, reduced competitiveness or national security. However, the extent of these concerns is frequently over-estimated, and all have been effectively addressed by Australia's foreign investment review regime over a long period. Indeed, it is arguable that Australia's ability to attract large quantities of foreign investment while mitigating any perceived downsides has been the foundation for the country's prosperity.

Internationally, there is also no evidence that investments by SWFs and SOEs have resulted in any of the negative characteristics sometimes associated with government investment. In fact, these investments have increased business growth and market competition.

It is logical to expect that, as the importance of SWFs and SOEs grows, the governments who manage them will be motivated to ensure they act and are seen to act as responsible, commercial investors that contribute to the success of the countries in which they invest. For example, policy changes driven by the Chinese government, together with external pressures such as those created by China's membership of the WTO, mean China's SOEs and SWFs are becoming increasingly commercial in their approach.

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[3] There does not appear to be any data on the actual level of investment by entities with foreign government ownership

## Towards a sustainable foreign investment regime

The challenge for Australia's foreign investment review process is to ensure that investments – whether linked to foreign governments or not – are made in a way that is consistent with Australia's national interest, without dissuading investment that will help Australia's economy create wealth and employment. The objectives of a foreign investment regime to be applied to investment proposals from foreign governments were outlined by the Treasurer Wayne Swan[4]:

> *"The key differences [in evaluating] investments associated with foreign governments concern independence, commerciality and corporate governance, and business behaviour.*
>
> *"The key is that investments are consistent with Australia's aim of maintaining a market-based system in which companies are responsive to shareholders and in which investment and sales decisions are driven by market forces rather than external strategic or political considerations."*

In February, 2008 the Commonwealth government outlined a set of six principles for screening investments linked to foreign governments[5].

Rio Tinto supports a principles-based approach, applied on a case-by-case basis using existing decision making processes, as the foundation for assessing such proposals. It has served Australia well.

Further, Rio Tinto believes that it is crucial that these principles must be applied in a way that creates a foreign investment regime that will be sustainable in a period where more capital flows are likely to come from government owned investors.

Specifically, Rio Tinto believes the principles should be applied in a way that:

- Asks three key questions when determining whether government ownership of a potential investor deserves close consideration. These questions are:
  1. To what extent is the investing company operated independently from government in order to pursue commercial interests?
  2. Will the investing company have real influence or control over the investee company?
  3. Does any influence or control have the potential to be exercised in a manner contrary to Australia's national interest?

  All of these "links in the chain" must hold for the outcome of a transaction to be potentially at odds with Australia's national interest.

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4 Wayne Swan, 'Speech to the Australia-China Business Council', 4 July 2008

5 Wayne Swan, 'Government improves transparency of foreign investment screening process', Press release, 17 February 2009

- Bases an assessment of whether an investment may hinder competition on the views of the Australian Competition and Consumer Commission (ACCC), to ensure a consistent approach and to avoid duplication of effort
- Applies the general investment principles without special consideration for particular industries. In particular, much of the debate around the special status of the resource industry can be considered within the existing framework – the principles can deal with any of these considerations. For example, considering issues such as “whether a resource is already developed” or is a “major part of the total resource” are inherently embodied in the third investment principle, which tests the extent to which an investment will hinder competition or lead to undue concentration or control. This application of general principles should not, however, usurp current licensing or other regulations that are applied today to investors independent of their origin

Ensuring the existing principles are applied consistently with these recommendations would ensure that the “case by case review” of investments is asking the questions that will ensure Australia’s national interest is being protected.

The stakes are high – if Australia gets it wrong in its approach to investment by SOEs, particularly in the resource sector, these entities can and will invest elsewhere. This means that the Australian economy will miss out on growth opportunities, and that Australian businesses will lose market share to global competitors. There is already evidence that China, Australia’s most important trading partner for several key commodities, has boosted its trade relationships in Africa and elsewhere on the back of significant resource investments. When Australia turned away from foreign investment in the 1970s, investment and economic growth suffered.

## Rio Tinto’s proposed transaction with Chinalco is an example of foreign investment consistent with Australia’s national interests

Rio Tinto’s proposed partnership with Chinalco, a Chinese SOE, is currently undergoing review by the Foreign Investment Review Board.

For Rio Tinto shareholders, the proposed transaction represents the optimum combination of new capital, raised at premium prices, with ongoing benefits through a pioneering strategic partnership.

The proposed transaction provides an example of the type of foreign investment that is consistent with Australia’s national interest. This transaction delivers substantial benefits for Australia:

- The US$19.5 billion capital injection provided by Chinalco will immediately strengthen Rio Tinto’s Australian businesses and the Australian economy
- The strategic partnership with Chinalco will position Rio Tinto’s Australian businesses for the future
- The strategic partnership will strengthen the broader economic relationship between Australia and China
- As control of all operations remains with Rio Tinto, the transaction effectively manages potential concerns arising from SOE investment

Given these benefits, Rio Tinto believes its proposed partnership with Chinalco is consistent with the principles used to assess foreign investment related to government owned investors.

Rio Tinto also believes that the proposed partnership illustrates the benefit of the three suggestions put forward in this submission. In particular, asking the three key questions described above clarifies that the transaction is consistent with the national interest because:

1. Based on Rio Tinto's experience with Chinalco, Chinalco operates as a commercially driven enterprise. As such, Chinalco is focussed on pursuing its commercial interests of maximising return on its investments and growth in the global markets in which it operates. The listing of Chalco on multiple stock exchanges is testimony to this intent.

2. The proposed transaction will not allow Chinalco to exercise control over Rio Tinto's assets. As described above, Rio Tinto retains control over all operational activities, including marketing. Chinalco will not make decisions regarding capital investments, product mix and production levels, pricing, contracting strategies, and marketing tactics and strategies.

3. Control over Rio Tinto's assets could not be used in ways contrary to the national interest. ACCC findings make clear that, even if control was assumed, Chinalco could not manipulate the price of bauxite, alumina or iron ore to the detriment of other Australian producers or the advantage of Chinese customers. In particular, for iron ore the ACCC finds that any accelerated investment will not allow Rio Tinto to unilaterally influence iron ore prices.

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# STRUCTURE OF THIS SUBMISSION

This submission is presented in seven sections, in addition to the Executive Summary. The sections are outlined below:

**Section 1:** Background to the issues being addressed at this Senate Enquiry, including Rio Tinto's interest and experience in these issues both as an investor and recipient of foreign investment funds.

**Section 2:** Highlighting the importance of foreign investment to Australia's economic development, including an overview of the benefits that foreign investment has brought to Australia.

**Section 3:** A discussion of the challenges that Australia faces in securing capital to finance its economic growth in the period ahead, and the need to engage with Chinese entities (and other new sources of capital).

**Section 4:** A discussion of how the need to deal with new sources of capital, including China, will lead to an increasing requirement to engage with SOEs and SWFs, and why Australia must be prepared to deal with this.

**Section 5:** An assessment of the perceived concerns regarding investment from SWFs and SOEs, the actual experience of these entities as investors in Australia and internationally, and the risk of overreacting to overstated concerns. Experience demonstrates that this investment has been very positive, both in Australia and internationally.

**Section 6:** Outlines a small number of proposals to ensure Australia's foreign investment review regime is sustainable in an era where more investment capital will come from SWFs and SOEs. The proposals aim to ensure the foreign investment review regime remains focussed on ensuring that Australia maintains an economic system driven by market-based decision-making in the interests of all stakeholders and the nation as a whole.

**Section 7:** Describes Rio Tinto's proposed partnership with Chinalco, and how it represents an example of the type of SWF/SOE investment that is consistent with the national interest.

This submission also includes an Appendix that contains additional detail of the specific arrangements regarding the proposed partnership with Chinalco.

# 1. BACKGROUND TO RIO TINTO'S INTEREST IN THIS ISSUE

As will be discussed in more detail later in this report, Australia is facing new challenges in assessing foreign investment proposals. In the past couple of years, a small, but increasing number of high-profile investment proposals have come from countries without a significant history of investing in Australia. Even more importantly, several of these proposals have come from entities owned, in whole or in part, by governments. These investments, in particular, have attracted a great deal of media attention and public debate. As a result, on 18 March 2009, the Australian Senate referred the following matters to the Standing Committee on Economics for inquiry and report by 17 June 2009:

a) the international experience of sovereign wealth funds and state-owned enterprises, their role in acquisitions of significant shareholdings of corporations, and the impact and outcomes of such acquisitions on business growth and competition; and

b) the Australian experience of foreign investment by sovereign wealth funds and state-owned companies in the context of Australia's foreign investment arrangements.

Rio Tinto has a keen interest in the matters under inquiry:

- Rio Tinto is reliant on international capital markets to fund much of its activity. In 2008, Rio Tinto's global capital expenditure amounted to $10 billion. Well functioning capital markets, prudently regulated are necessary to fund this investment. As a global resources company, Rio Tinto has raised equity and debt capital in Australia, the United States, the United Kingdom, Hong Kong, Singapore, Japan, Europe and elsewhere.
- Rio Tinto also has a strong role to play in Australia's continuing success. This is clearly demonstrated by the increased focus on its Australian operations over recent years – with approximately $30 billion dollars in investment in Australia since 1998. Significantly, Rio Tinto is the largest private sector employer of indigenous Australians who comprise around eight per cent of Rio Tinto's Australian workforce. This large investment 'footprint' establishes a clear link between Rio Tinto's performance and Australia's continued development. A report prepared for Rio Tinto by Access Economics indicates that Rio Tinto's direct value add to the Australian economy represents nearly one per cent of GDP[6].

Rio Tinto believes it is well positioned to assist the Committee:

- Rio Tinto has long experience as a provider of foreign investment capital, as Rio Tinto's operations span 90 countries.
- Rio Tinto has significant experience as the beneficiary of foreign investment as well. In Australia, this experience includes long standing joint venture arrangements with investors from Japan, China, and elsewhere. Foreign investment has underpinned the development of Rio Tinto's well known Pilbara iron ore assets, and many other important projects.

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[6] Access Economics, 'The Economic Contribution of Rio Tinto in Australia', June 2008

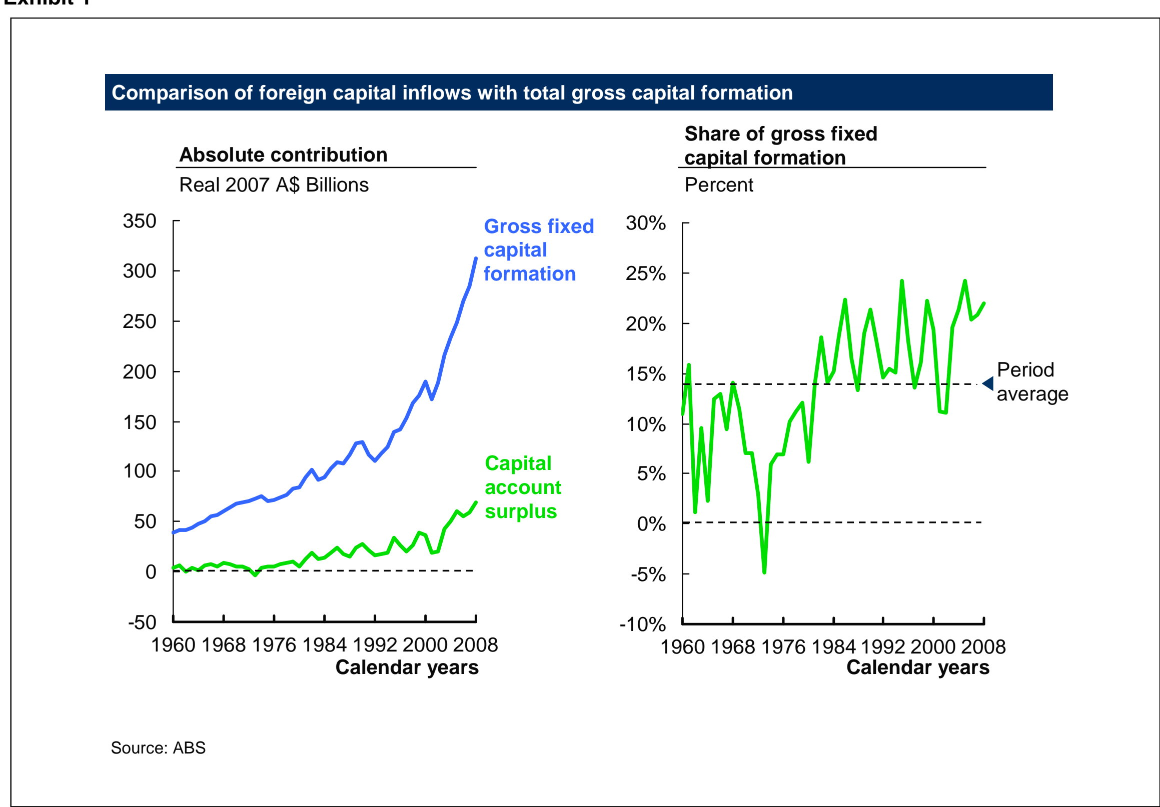
Rio Tinto's proposed partnership with Chinalco, a Chinese SOE, is currently before the Foreign Investment Review Board, prior to a decision by the Treasurer. In formulating this partnership, Rio Tinto has carefully considered issues of Australia's national interest with regard to this partnership, and is well placed to assist the Inquiry to understand the details of this proposed transaction.

# 2. CONTEXT: FOREIGN INVESTMENT IS CENTRAL TO AUSTRALIA'S ECONOMIC DEVELOPMENT

Productive investment is key to economic growth. Investment in capital goods such as plant, equipment and buildings directly drives GDP growth as it occurs, but this investment also increases productive capacity, delivering a permanently higher level of economic activity in the future. In recent years, investment has been increasingly important as the engine of growth in the Australian economy. Over the past five years, two thirds of the growth in Australia's GDP has been due to investment. Capital investment by households and business now contributes 25 per cent of GDP.

Australia has always relied on foreign capital to contribute to this investment. Since 1960, the rest of the world has contributed 14 per cent of Australia's total capital investment (Exhibit 1). Not only has the need for foreign capital grown, the sources of Australia's foreign capital have evolved over time. From the earliest stage of colonial development, Australia looked to the UK and then to the US for its capital. Much of Australia's current industrial base was underpinned by foreign investment from these nations. By the 1970s and 1980s, these countries' contributions had begun to wane as the contribution of Japan and other Asian nations grew.

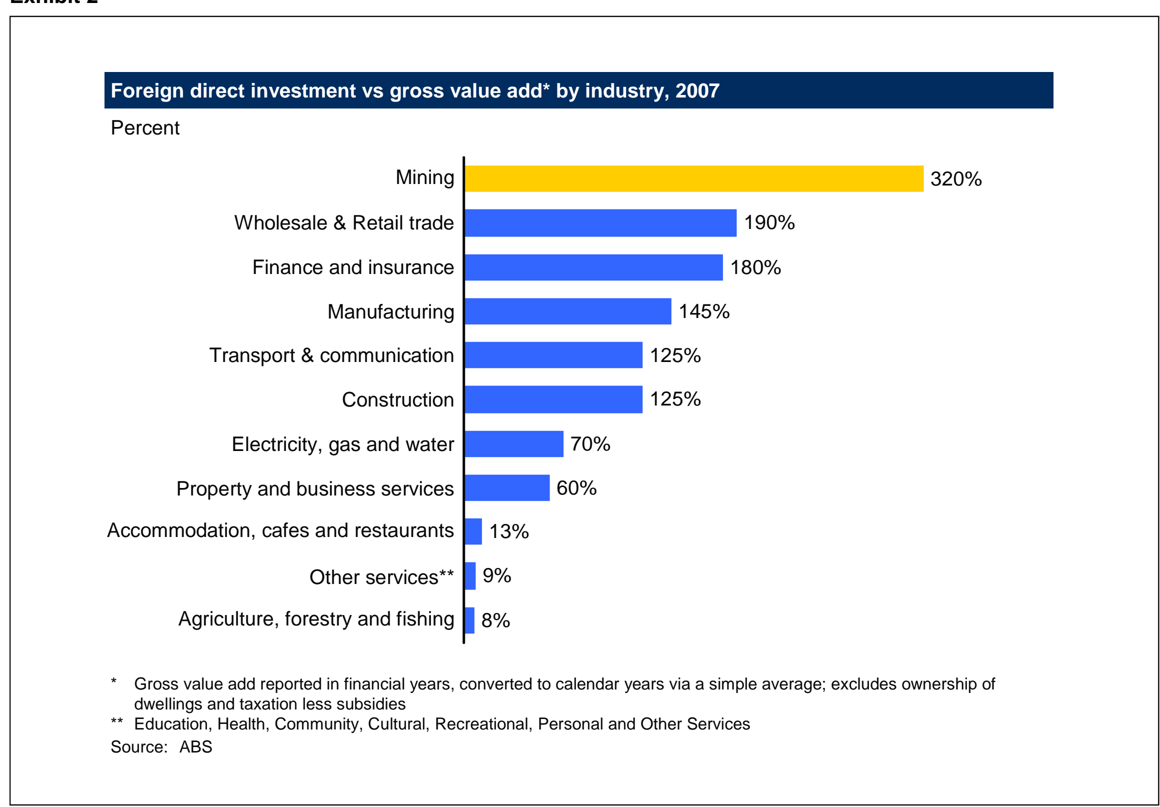
**Exhibit 1**




Source: ABS

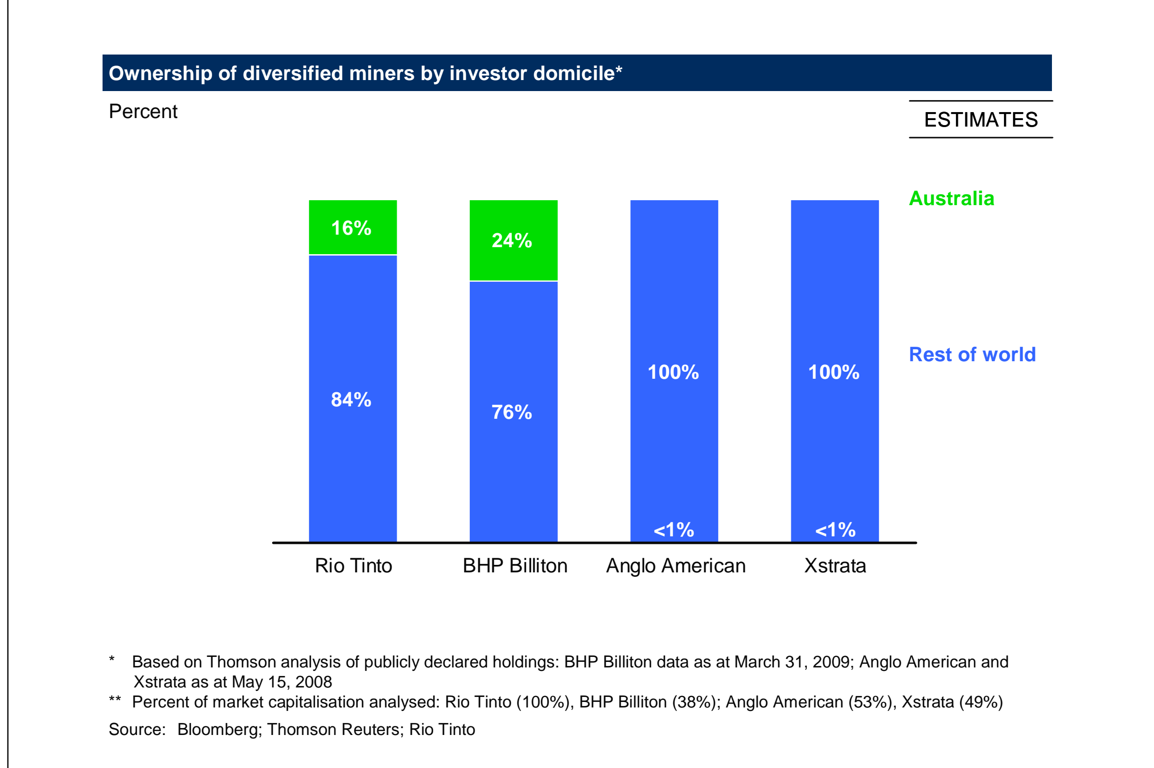
The mining industry has been particularly reliant on access to international capital. In fact, the mining industry is more reliant on foreign investment than any other industry, measured relative to value-added to the economy (Exhibit 2). ABS statistics show that the majority of the Australian mining industry has been funded by offshore investors. Investments by Kaiser Steel Corporation and Cleveland Cliffs Iron Company, for example, drove the early development of the Pilbara's iron ore assets. Rio Tinto and Australia continue to benefit from these investments today.

**Exhibit 2**




However, examination of the ownership within the mining sector suggests this figure may understate the importance of foreign investment. The leading mining companies operating in Australia, including Rio Tinto and BHP Billiton, are primarily funded from offshore, not Australia - they are no longer majority Australian owned (Exhibit 3). Outside of this group, many leading sector-specific players are also foreign owned. As a result, most of Australia's production capacity is controlled by majority foreign owned companies (Exhibit 4).

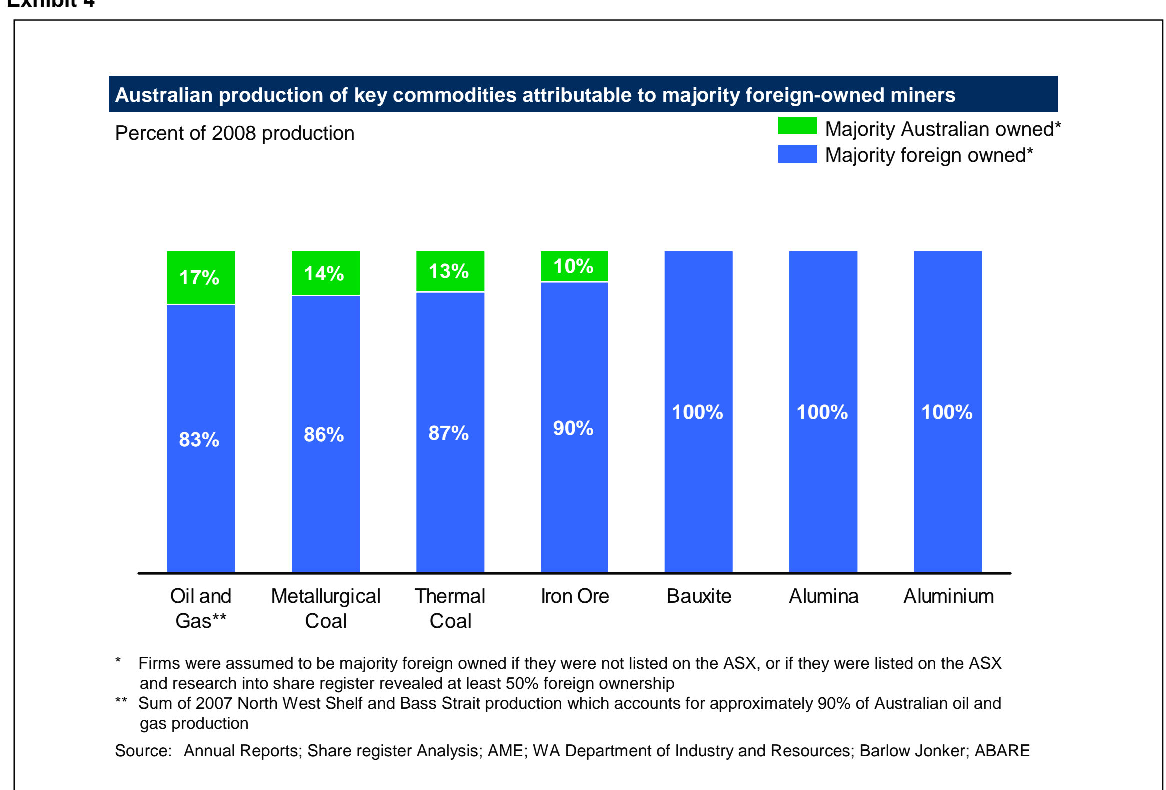
**Exhibit 3**




* Based on Thomson analysis of publicly declared holdings: BHP Billiton data as at March 31, 2009; Anglo American and Xstrata as at May 15, 2008
** Percent of market capitalisation analysed: Rio Tinto (100%), BHP Billiton (38%); Anglo American (53%), Xstrata (49%)

Source: Bloomberg; Thomson Reuters; Rio Tinto

**Exhibit 4**




* Firms were assumed to be majority foreign owned if they were not listed on the ASX, or if they were listed on the ASX and research into share register revealed at least 50% foreign ownership
** Sum of 2007 North West Shelf and Bass Strait production which accounts for approximately 90% of Australian oil and gas production

Source: Annual Reports; Share register Analysis; AME; WA Department of Industry and Resources; Barlow Jonker; ABARE

This reliance on foreign investment will continue. Current ABARE estimates of resource industry projects under development exceed $160 billion over the next five years. While many of these projects have been delayed due to the current financial crisis, most are still planned to move ahead if funding is available. Traditionally, foreign capital would have provided the majority of this investment. Any shortfall in this contribution will be difficult to replace from domestic sources. By comparison, data from Bloomberg show that over the past five years, the share of total funds raised in Australia's capital markets attributable to mining has averaged around $7 billion per annum[7].

Australia's access to foreign investment capital has brought about three main benefits to Australia:

- Australia has experienced significant direct economic benefits from foreign investment, and additional benefits from foreign direct investment. Foreign investment in productive assets offers a short term stimulus and a long term increase in Australia's economic potential, creating additional enduring wealth and jobs.
- Australia's experience, and Rio Tinto's experience, suggests that foreign investment links directly to increased trade.
- Trade and investment relationships have created favourable security and foreign policy outcomes for Australia.

Economists agree that foreign investment brings substantial direct economic benefits. A recent paper for CEDA[8] summarises the key benefits of foreign investment. For recipient countries they include:

- **Foreign investment increases the 'pool' of savings**, meaning economic growth is not limited by the availability of domestic funds. Were countries with low saving rates - like Australia - to rely solely on domestic funds, competition for funds would increase interest rates. Worthwhile projects that might otherwise proceed would not be funded.
- **Foreign investment encourages specialisation.** All firms have a unique set of skills. An Australian firm may find a possible project in Australia unattractive if it does not fit its skill set. Foreign investment allows foreign firms with the right skills to ensure these projects proceed. This process allows Australia to focus its own capital resources on exploiting its particular skills.
- **Foreign investment creates spillovers.** Empirical research shows foreign investment brings technologies and expertise that flow from investee firms to the host economy more broadly. This is particularly powerful in developing nations, but it also brings benefits to more developed economies, including Australia.
- **Foreign investment can increase taxation revenue.** Foreign investors must pay tax to the government of the nation hosting their investments. When foreign investment allows additional projects to proceed, tax revenues increase. The ATO rigorously polices arrangements between Australian subsidiaries and foreign parents to ensure that foreign investors contribute their appropriate share of taxation revenues.

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[7] This figure likely overestimates the true potential of domestic capital, as it includes participation by foreign investors in Australian capital markets, and rollovers of debt facilities that do not necessarily constitute new capital investment

[8] Committee for Economic Development of Australia, 'The contribution of foreign direct investment and the mining industry to the welfare of Australians', *Information Paper Number 92,* November 2008

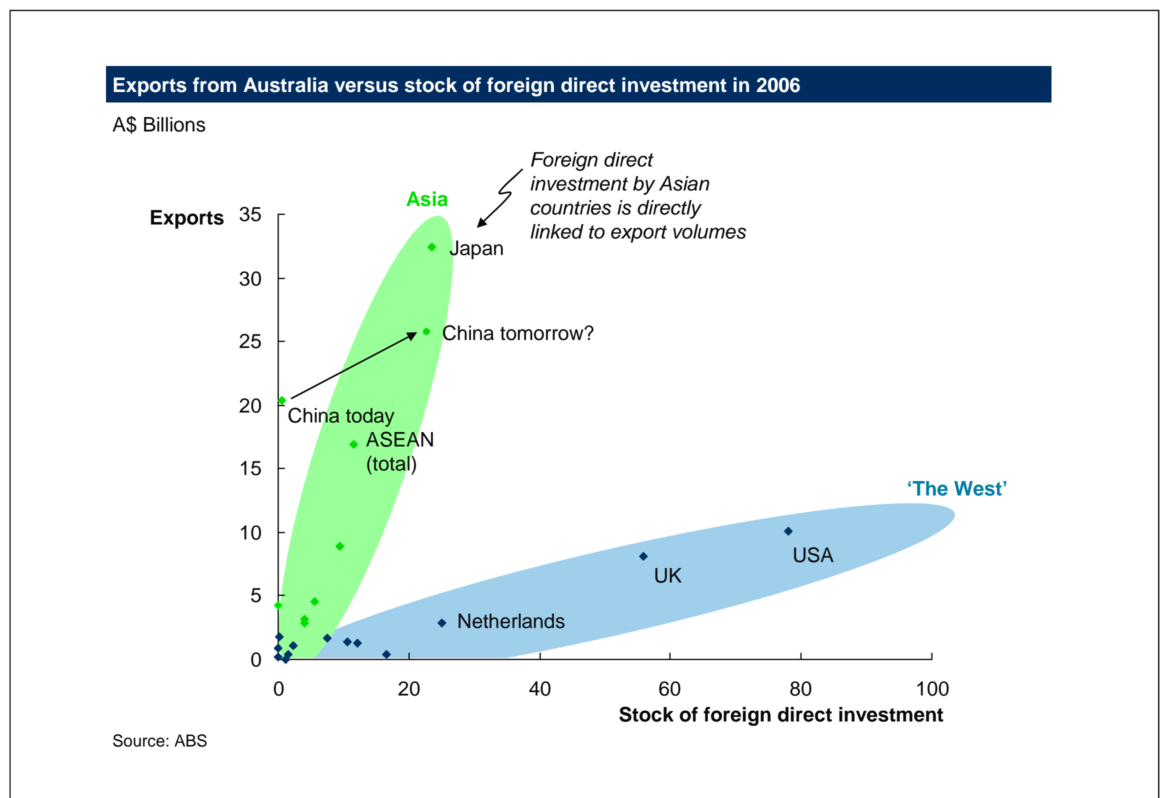
In addition, a broader range of benefits accrue across the whole global economy, including:

- **Foreign investment facilitates portfolio management**, allowing investors to diversify their exposure across different national economies profitably.
- **Foreign investment increases global standards of living.** By assisting each nation to specialise in what it does most productively, foreign investment facilitates the most efficient use of global resources - labour, capital and natural resources.

In combination, these factors act to stimulate short term growth, increase the potential of the Australian economy, and so create wealth and employment for Australians.

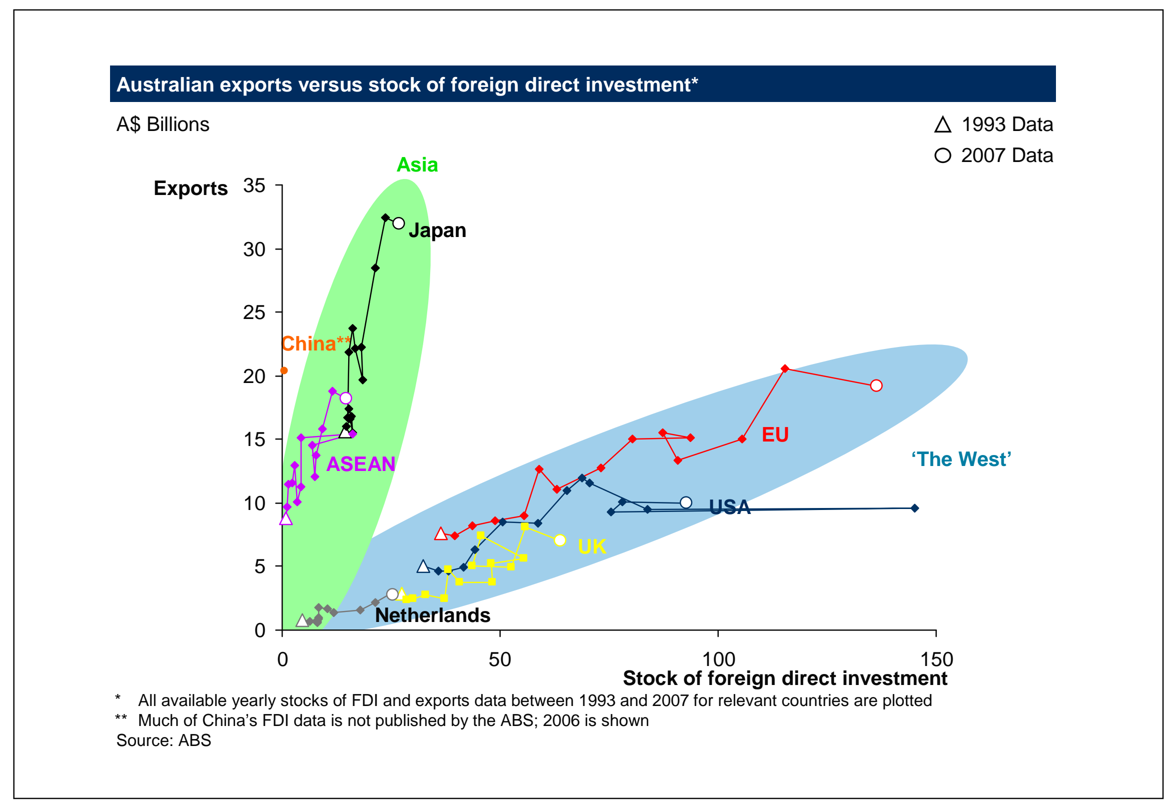
Australia's position as a successful trading nation has been underpinned by its foreign investment relationships. Australia's principal trading partners are also important contributors of foreign investment (Exhibit 5). Investment relationships with Asian nations have been particularly effective at driving export sales.

**Exhibit 5**



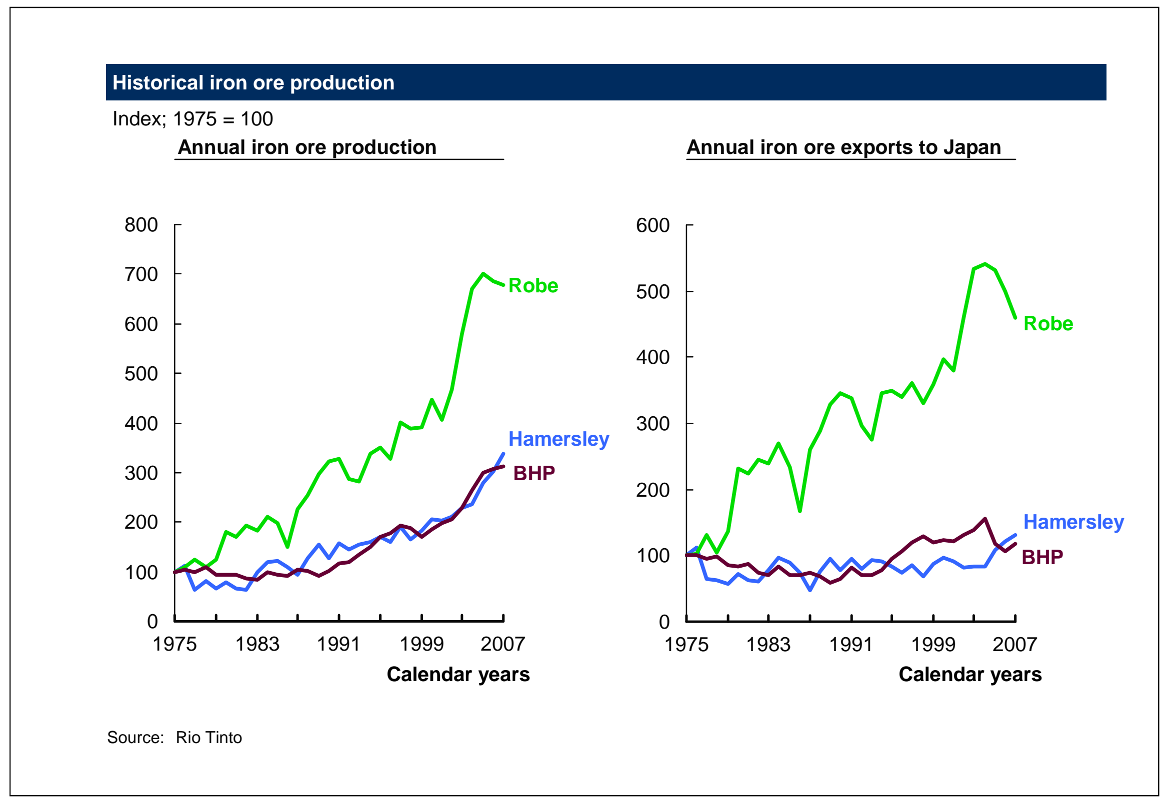
Importantly, these investment and trade relationships have grown together (Exhibit 6). China is the noticeable exception to this rule today, but these data suggest that continued growth of Australia's trade with China will be accelerated by developing a parallel investment relationship.

**Exhibit 6**




Robe River's experience in the Pilbara is an example of how foreign investment boosts trade with investor countries. Rio Tinto's Robe River operations are 47 per cent owned by a combination of Japanese firms. These relationships have underpinned rapid growth in Robe River's production volumes, especially those to the Japanese market. This growth has far outstripped that of other Pilbara operations, both Rio Tinto's other mines and BHP Billiton's (Exhibit 7).

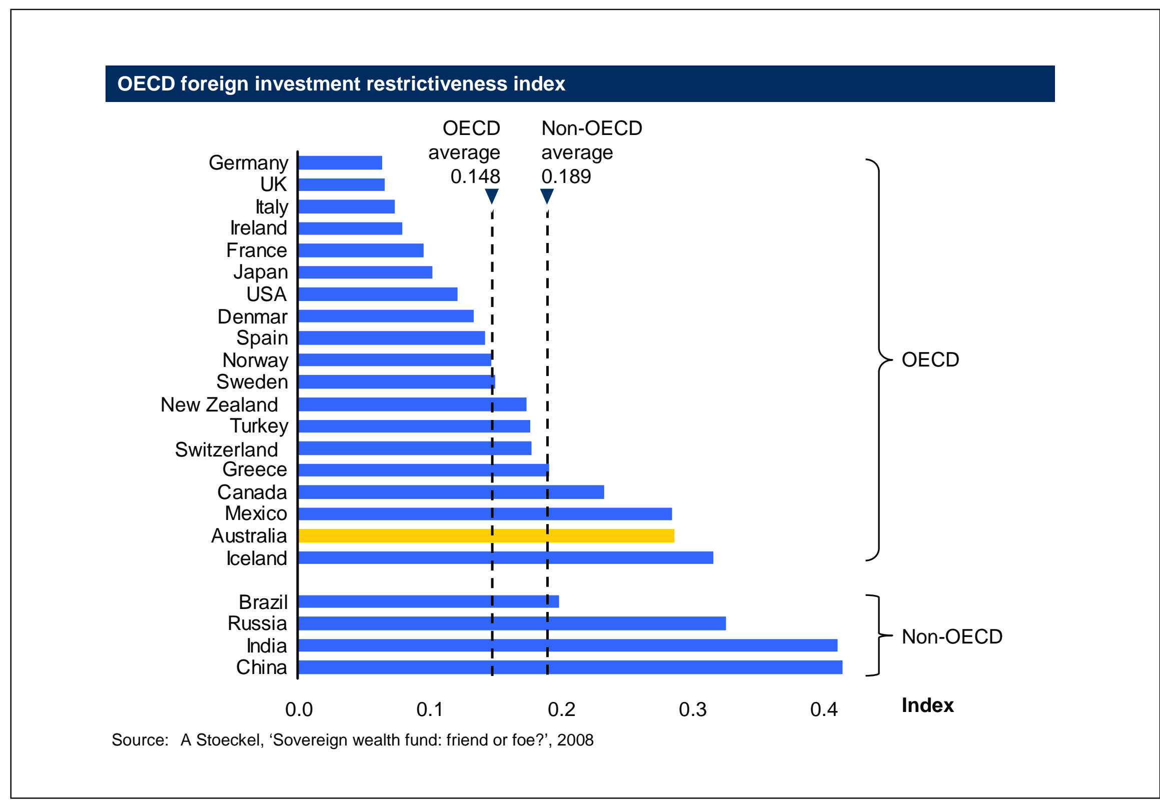
**Exhibit 7**




This growth, it should be noted, did not have an impact on market prices. Japanese purchasers, including Rio Tinto's partners, participated in the same benchmark pricing process as other iron ore customers across the world. A comparison of iron ore prices with other commodities over the corresponding period shows similar price trends.

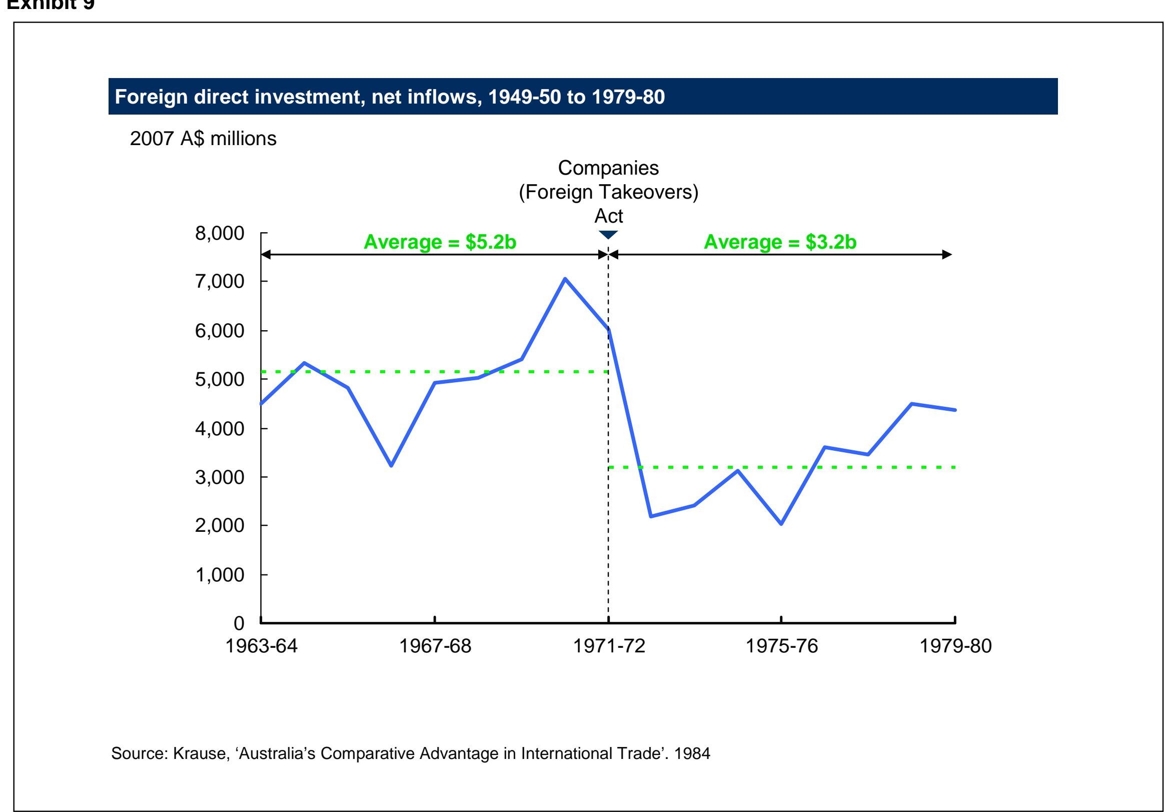
Trade and investment relationships also reduce security risks. Countries with strong trade and investment linkages tend to develop broader economic and political relationships that form the stable foundation necessary for trade. These relationships, and the inter-dependence they bring about, increase the integration of countries in a way that provides a strong economic incentive for countries to maintain harmonious relations.

**Exhibit 8**




Source: A Stoeckel, 'Sovereign wealth fund: friend or foe?', 2008

**Exhibit 9**




Source: Krause, 'Australia's Comparative Advantage in International Trade'. 1984

Australia’s foreign investment regime has given us the best of both worlds. Australia’s review process is one of the most rigorous in the world (Exhibit 8), applied in a way that has allowed capital to enter and fund critical investment.

Australia's experience during the 1970s is a reminder of the cost of discouraging foreign investment. As described in the recent CEDA report[9], legislation passed by the McMahon government in 1972 triggered a period of increasing restrictions on foreign investment, and the flow of capital into Australia was sharply reduced as a result (Exhibit 9). Among many effects, these restrictions lead to a significant reduction in minerals exploration. For example, private petroleum exploration expenditure fell by two thirds over the four years between financial year 1972 and financial year 1976. Total exploration expenditure in the decade beginning in financial year 1971 was 40 per cent of its value in the following decade when restrictions were eased.

Modelling by Access Economics, and included in the CEDA report[10], suggests that, even small diversions of investment capital have meaningful impacts on the Australian economy. This modelling calculated the economy wide impact of the increased capital expenditure in the Australian resources sector as a result of increased foreign investment.

Relative to a reference case, this analysis showed that even modest ‘skewing’ of foreign investment toward Australia over the next 20 years in three key resources sectors (iron ore, metallurgical coal and bauxite) could:

- increase household consumption by between $2,005 and $2,825
- increase per capita GNP by between $2,848 and $3,965

Three effects were responsible:

- Economic activity is increased directly by growth in investment. Increased capital expenditure, or investment, increases economic activity through higher demand for construction services, which is an important sector in the economy in terms of employment (as well as the importation of machinery and equipment). Importantly, this investment also creates productive capacity to deliver higher levels of economic activity in the future.
- More importantly, increased output of iron ore, metallurgical coal and bauxite and the subsequent increase in exports of those products directly improves economic activity and welfare (through higher wages paid as well as taxes and royalties collected).
- Apart from the direct increases in economic activity, there are flow on effects as a consequence of increased demand in those sectors that supply goods and services to construction and mining.

For the most part, as a nation, Australia has recognised the value of foreign investment, and successes in attracting investment are applauded. To give two examples:

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[9] Committee for Economic Development of Australia, ‘The contribution of foreign direct investment and the mining industry to the welfare of Australian’s, *Information Paper Number 92,* November 2008

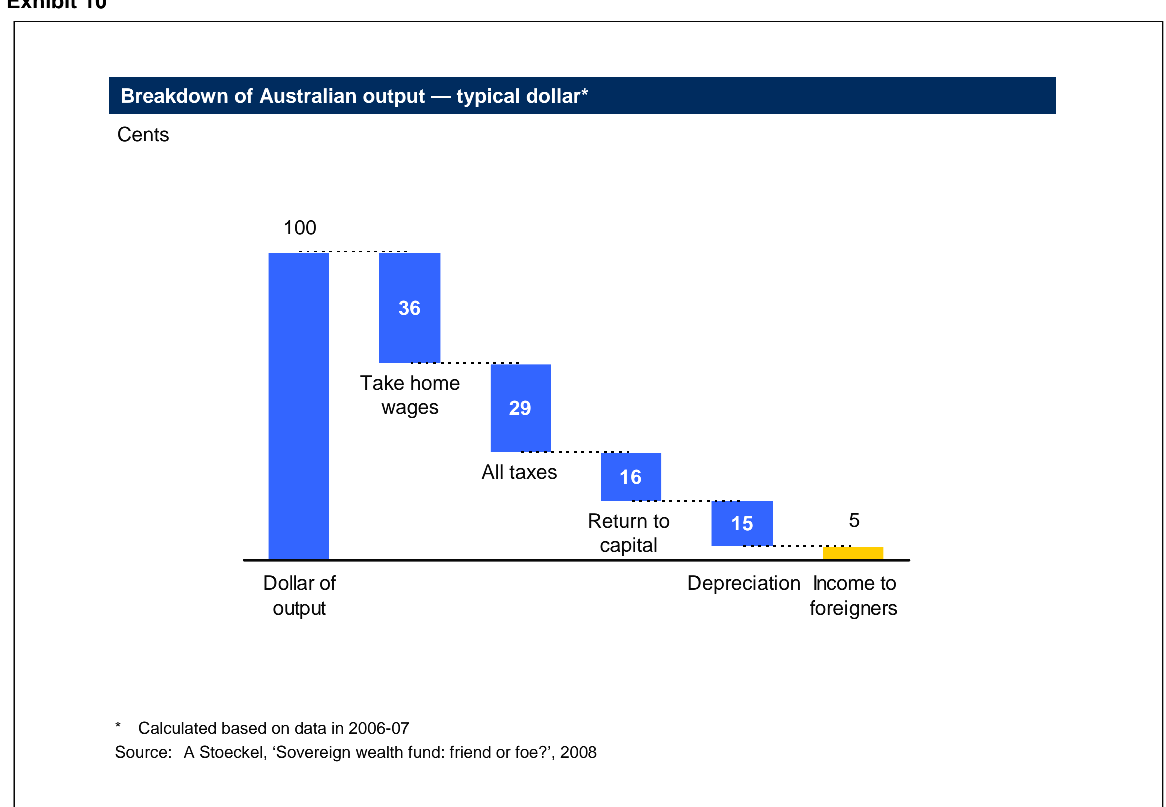
[10] *Ibid.*

- Toyota's recent decision to assemble the Camry hybrid-electric vehicle attracted a great deal of fanfare and favourable press[11]
- Australia's emerging LNG industry, much of which is funded by foreign investment, has secured widespread government and business support[12]

Australia has captured the benefits of foreign investment without "selling the farm". Foreign controlled entities operating here do so subject to Australia's well developed framework of legislation and regulation that ensures community standards in areas such as environmental responsibility and workplace safety are maintained. Enterprises in the minerals sector are granted mining rights subject to a comprehensive body of federal and state regulation ensuring that their operations deliver substantial benefits to the Australian community.

Despite significant foreign investment in the Australian economy over a long period of time, Australia retains 95 cents of every dollar of GDP it generates (Exhibit 10). We should never lose sight of the fact that the economic growth generated by foreign investment benefits all Australians, whether directly, in terms of job creation, or indirectly, in terms of contribution to economic strength, as measured by our terms of trade. This allows all Australians to benefit from a strong exchange rate by importing goods we want and need at lower cost.

**Exhibit 10**




[11] For example: Richard Blackburn, 'Toyota to build Hybrid Camry in Australia', *Sydney Morning Herald*, 10 June 2008

[12] For example: Queensland Minster for Infrastructure and Planning, '5,000 Jobs Proposed in LNG Project', press release, 8 April 2009

# 3. THE CHALLENGE: ACCESSING CAPITAL FROM RAPIDLY CHANGING GLOBAL MARKETS

If the benefits of foreign investment are to continue, Australia's response to the changes catalysed by the global financial crisis must include a strategic approach to attracting new sources of capital. There are three reasons for this:

- The critical economic contribution from business investment is under threat as traditional sources of funding dry up
- China is assuming a new role in the global economy, and is likely to become the most important source of foreign capital for countries running current account deficits in the medium to long term
- Australia faces increased competition to secure its fair share of the benefits of foreign investment

## Lack of access to capital threatens Australian business investment

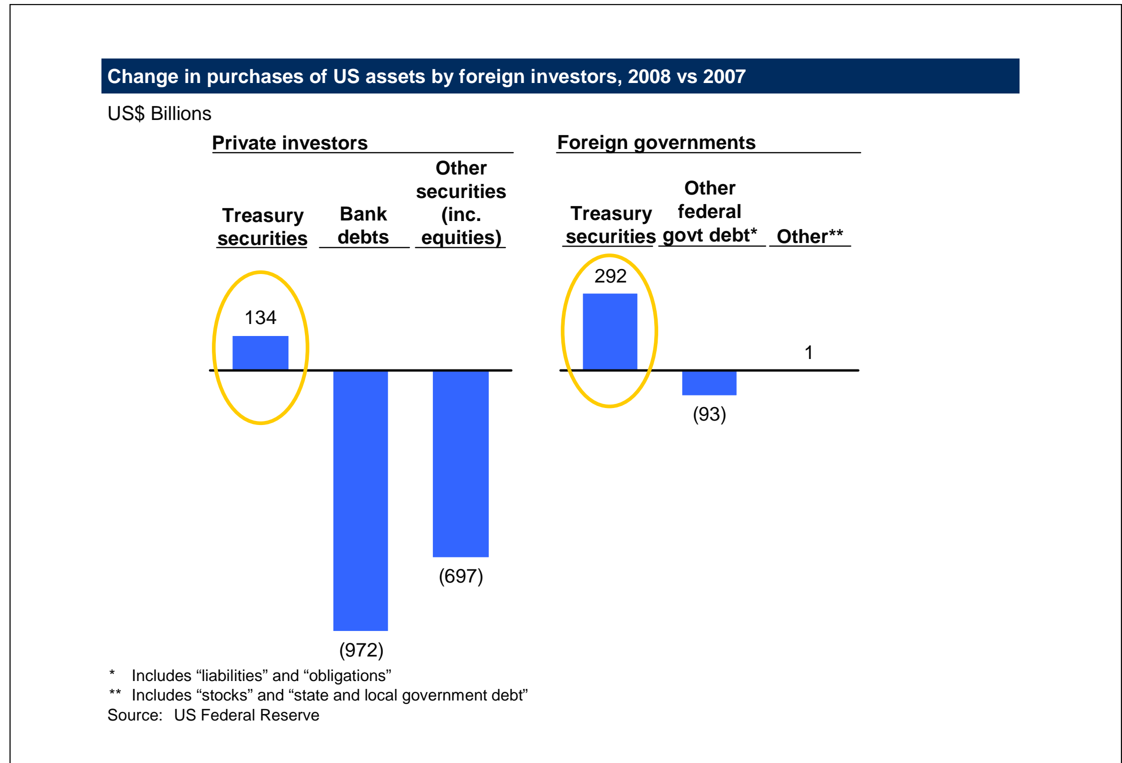
The implications of the global financial crisis for Australian business investment are profound. First, the global financial crisis has accelerated trends in the flows of global capital and in the balance of the global economy, reducing the flow of capital from Australia’s traditional sources. Second, there are strong signs that lack of access to global capital and rising costs are having a strong impact on investment, and that in the absence of new sources of capital this can only get worse. Third, if insufficient capital is available to reflate asset values toward fundamental values, corporates tend not to invest in productive capacity.

At least three important trends threaten Australia's traditional sources of capital:

- **Localisation:** Investors around the world are repatriating their capital to their local markets. This repatriation can be seen in data from the Bank of International Settlements, showing that previous strong growth in cross-border holdings by banks has sharply reversed. This reversal represents an unwinding of global funding relationships. This movement has contributed to the difficulties being experienced by local banks and other financial institutions when attempting to roll over funding arrangements with international banks.

- **Flight to safety:** Investors are rebalancing their portfolios towards the safest assets. This behaviour is natural in times of increased uncertainty in financial markets. However, for those who are not seen as "safe havens" funding grows more difficult to find. Recent data from the US Federal Reserve Board illustrate this effect. The reserve currency status of the US dollar means US treasury debt is seen as a "safe haven" investment. Compared with 2007, in 2008 both domestic and offshore investors increased their holdings in US Treasury bonds while reducing their holdings of other, more risky investments (Exhibit 11)

**Exhibit 11**




- **Repricing:** In part driven by the flight to safety discussed above, capital has become more expensive, especially for higher risk uses. Capital market performance has improved since the most intense phase of the global financial crisis in late 2008, but capital today is still significantly more expensive than at any time in the past decade. Reductions in the P/E ratios across the Australian equity market mean each dollar of business profits buys less equity capital than previously. In addition, increased corporate bond spreads mean interest rates on debt capital have increased substantially. This is especially the case for corporate debt assessed to be higher risk.

This drying up of traditional sources of capital is being accompanied by growth in new sources, particularly in Asia. As will be discussed in more detail below, Australia's challenge is to ensure that it has good access to these new sources of foreign investment.

Although these trends have emerged most starkly in the past 6-12 months, there is a strong likelihood that they will influence the cost and availability of capital for years to come.

There are strong signs that lack of access to global capital, as well as simply rising costs, are having a strong impact on investment. To give three examples:

- Recent press reports suggest that the Federal Government's planned infrastructure fund is having trouble securing sufficient private sector funds to proceed with its target project list[13].
- Balance sheet data suggests that companies are choosing to raise equity to deleverage before investing in new growth projects. This behaviour can be seen in both the United States and Australia.
- Resource industry analysts suggest more than US$200 billion of new mining projects have been delayed or cancelled in response to the ongoing global recession.[14] In many cases, lack of capital has been a major contributing factor in these decisions. In the absence of new sources of capital, improvement in these trends will take considerable time.

In these circumstances, access to sustainable sources of capital inflows is the best way of ensuring investment in productive capacity can begin quickly. It does not matter whether these inflows occur through acquisition of existing assets or by investment in new capacity. Acquisitions free up the capital of the sellers, which can then be used for other purposes. In addition, acquisitions act to reflate asset values to a point that further encourages organic growth.

## China's potential new role as Australia's premier source of capital

As these changes unfold, China's emerging role is becoming clearer. It is commonly agreed that rapidly expanding domestic markets will result in China becoming a principal driver of global GDP growth. China is also emerging as a principal pillar of the global financial system, based on its accumulated reserves and the reduction in current account surpluses in some other countries.

Part of China's new role will be as a major - and possibly the major - source of global capital. Evidence of this new role includes:

- Unlike most Western economies, China is forecast to maintain large current account surpluses, providing continued growth in capital available to invest. The capacity of key sources of capital in recent years to continue to supply funds is falling or has disappeared. Japan and Germany, for example, are suffering from dramatic economic slowdowns; Middle East economies can no longer rely on high oil prices to fund their investment.
- China's outbound foreign investment has increased rapidly in recent years - far more rapidly than that of traditional capital suppliers (Exhibit 12).
- There are indications that China is moving its large foreign exchange reserves from risk-free investments, like US Treasury bonds, into a wider range of assets (Exhibit 13). This change will lead Chinese enterprises increasingly to seek foreign investment opportunities in Australia and other countries, particularly in sectors that are critical to its economic performance.

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[13] Adele Ferguson and Jennifer Hewett, 'Nation building funding crisis as private sector fails to find cash', *The Australian*, 19 March 2009

[14] Credit Suisse, 'Capex capitulation #2', *Metals and Mining*, 13 March 2009

**Exhibit 12**

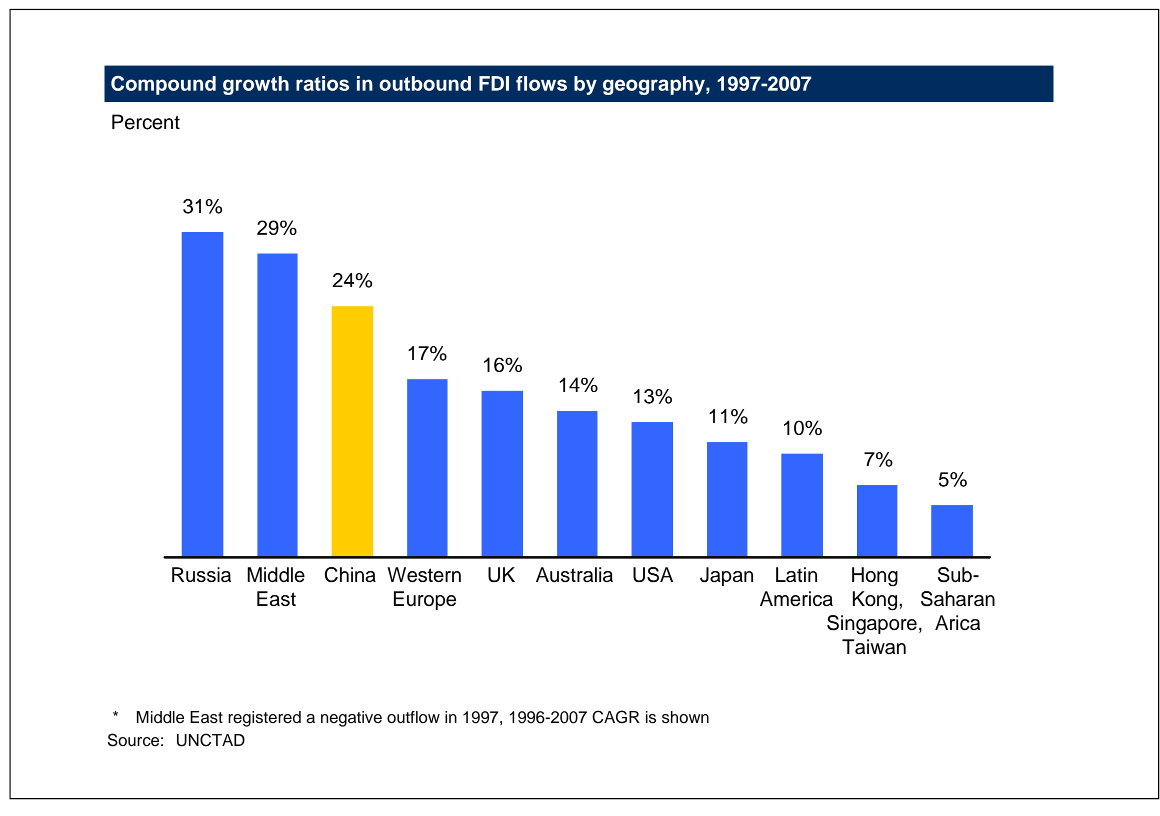
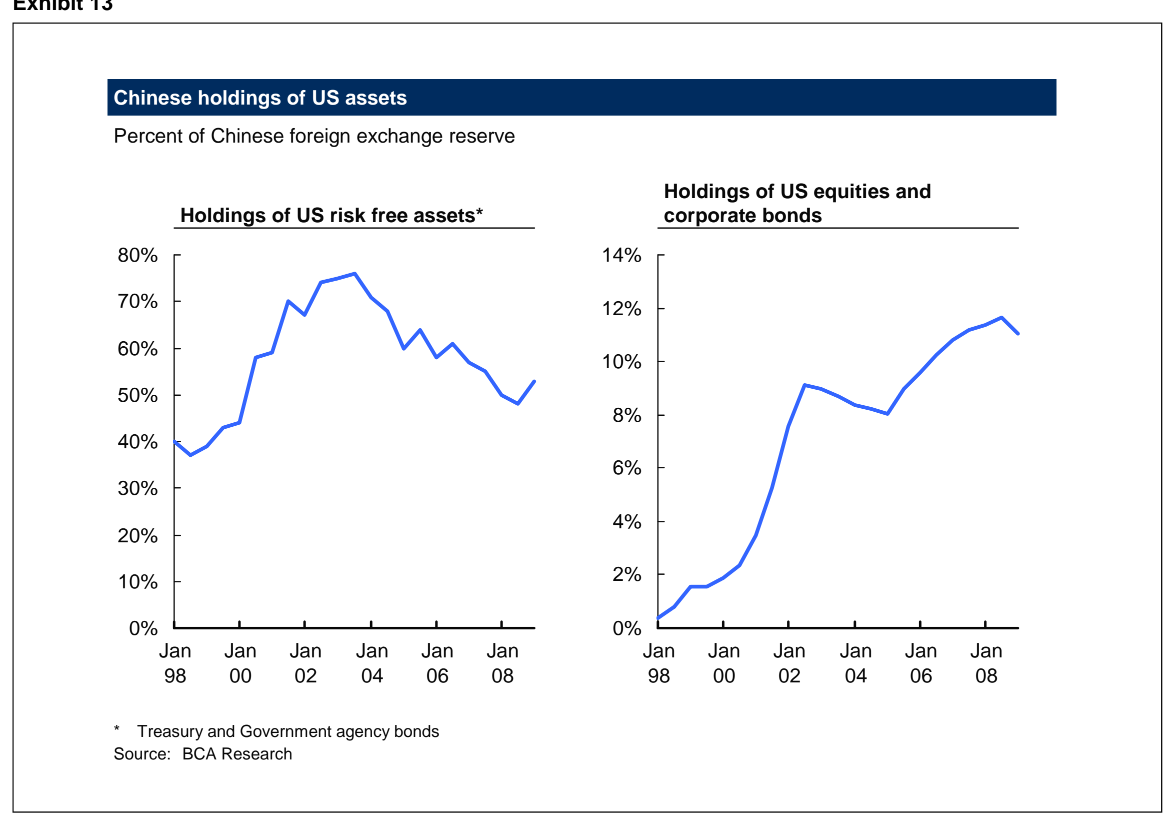



**Exhibit 13**



Few economies can be counted as a sustainable source of capital. Of those that can, China is arguably the most important.

All these changes taken together mean that, in the decades ahead, Chinese investment will be critical to Australia's ongoing economic development, particularly in the resources sector. Like Japan before it, China is short of the resources necessary to support economic development, and is long on capital generated by its export earnings (Exhibit 14). Just as in the case of Japan, this creates opportunities for resource exporting countries like Australia.

**Exhibit 14**

**Import share of commodity consumption**

**A high demand for key mineral resources to fuel growth…**

Import share of commodity consumption, percent

| | China, 2007 | Japan, 1985 |
|---|---|---|
| Oil | 49 | 100 |
| Natural Gas | 2 | 95 |
| Thermal Coal | 1 | 67 |
| Coking Coal | 2 | 94 |
| Iron Ore | 39 | 100 |
| Copper | 55 | 95 |
| Bauxite | 43 | 100 |

**…can be met using cash generated from an export-oriented economy**

Current account surplus, US$ Billions (2008)

300
250
200
150
100
50
0
-50
1977 1982 1987 1992 1997 2002 2007
China
Japan

Source: ABARE; International Energy Agency; USGS; World Bank

## Increasing competition for global capital

Australia now competes with a wider range of countries for increasingly scarce investment funds.

Evidence of increased competition for available capital is widespread. The global financial crisis has created new sources of demand for capital. Among them:

- Recapitalisation of the financial sector in the United States and the United Kingdom. This is not only government driven 'bail outs' of collapsing firms but also some traditional capital raisings from relatively stronger institutions.
- In combination with the bailouts above, government fiscal stimulus packages, as well as reduced taxation revenues, have led the governments of many developed nations to run considerable budget deficits. These deficits must be funded, typically by bond offerings, a task which is made more difficult by their unusual size and coincident timing.

- Businesses are choosing to strengthen their balance sheets to survive the current economic downturn.
- We can reasonably expect that gross foreign investment by countries such as the United States and the United Kingdom will fall in the coming years, as increased risk aversion (relative to the global financial crisis era) 'settles in'.

# 4. FINDING NEW SOURCES OF CAPITAL: GOVERNMENT OWNED INVESTORS AND THEIR GROWING ROLE

As Australia competes for investment capital from countries such as China, it will need to address the growing role of government owned investors – SOEs and SWFs.

SOEs are not a new phenomenon. It is sometimes forgotten that many governments have used state owned enterprises to provide services that the private sector was unable or unwilling to provide or legally prevented from providing. These businesses sometimes provided public infrastructure, but government businesses were active in other sectors, too. For example, European governments, in particular France and Great Britain, have a long tradition of participation in the aerospace sectors[15]. Australian government owned businesses in the banking, insurance, gaming, airline, telecommunications and other sectors.

Globally, SWFs also have a long history. Governments with access to pools of capital have often sought to use investment funds to deploy that capital to pursue a range of policy goals, often to manage funds to stabilise budget revenues or to provide for future generations. Singapore's Temasek Holdings, created in 1974, is an early example of a sovereign wealth fund.

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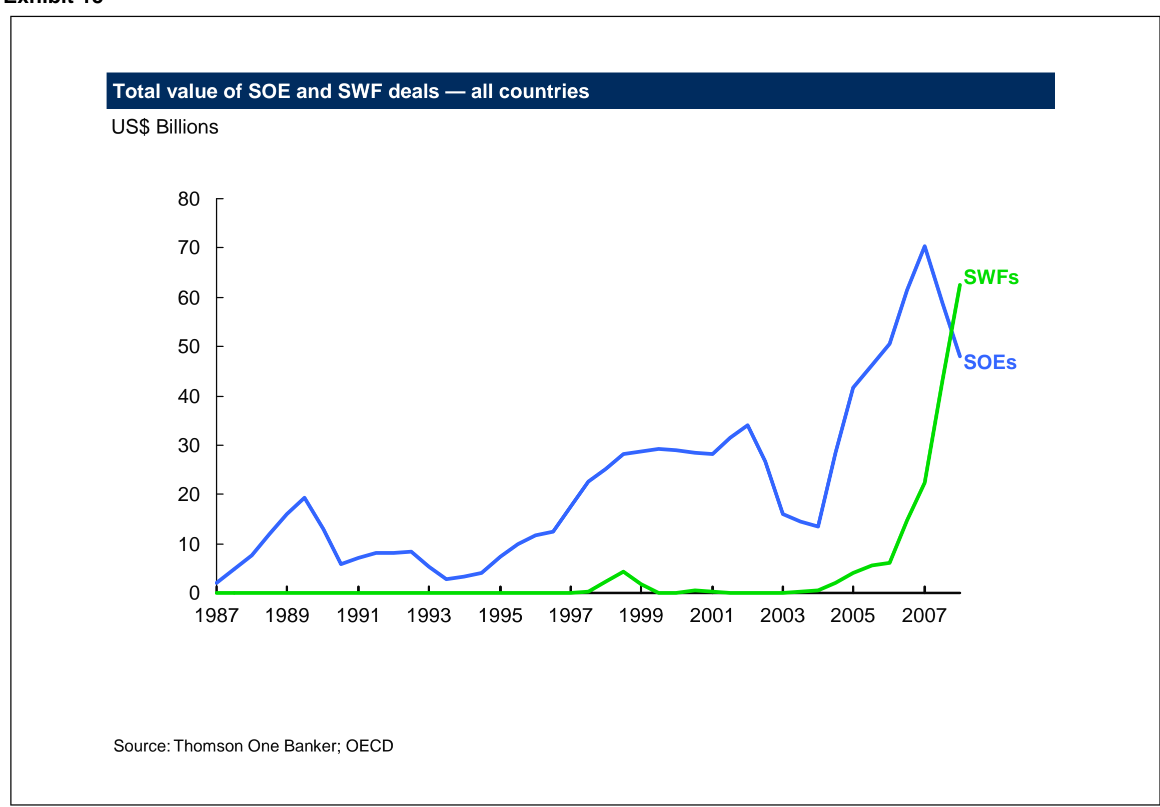
[15] Aerospatiale, now part of Airbus' parent company EADS, was created in 1970 from the merger of three French state-owned companies. Similarly, British Aerospace, now part of BAe Systems, was formed in 1977 as a result of the nationalisation and merger of British aerospace companies

The role of SOEs and SWFs in global capital markets has increased in recent years (Exhibit 15). Some have built a strong, diverse track record of investment both globally and in Australia (Exhibits 16 and 17). This track record is distinguished not only by its geographic and sectoral diversity, but by the performance of the foreign investors themselves. Empirical studies show state owned foreign investors perform as well as other foreign firms[16]. The same studies show this performance is achieved without the use of government influence or information.

**Exhibit 15**




It should be recognised that, though growing strongly, investments by SOEs and SWFs represent only a small fraction of total global capital flows. JP Morgan estimates SWFs share of total global financial assets is around two per cent[17].

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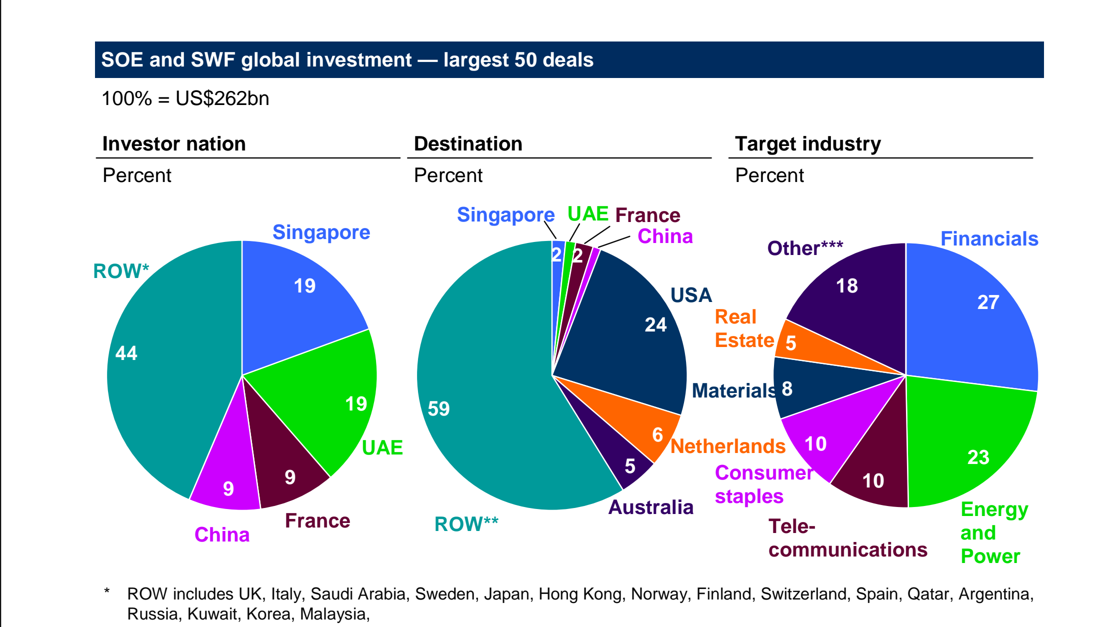
[16] Peter Drysdale and Christopher Findlay, 'Chinese Foreign Direct Investment in Australia: Policy Issues for the Resource Sector', *Crawford School Seminar Paper*, 4 September 2008

[17] David G. Fernandez and Bernhard Eschweiler, 'Sovereign Wealth Funds: A Bottom-up Primer, JPMorgan Research, 22 May 2008

**Exhibit 16**



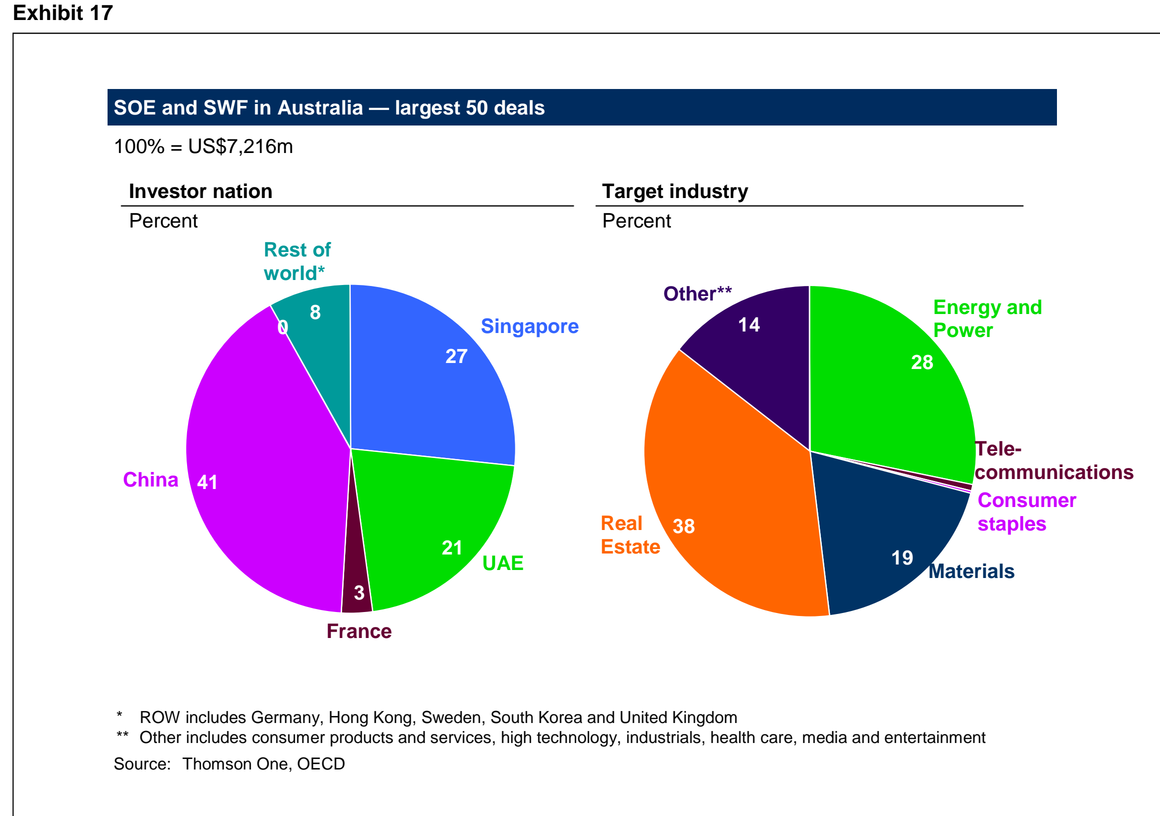

* ROW includes UK, Italy, Saudi Arabia, Sweden, Japan, Hong Kong, Norway, Finland, Switzerland, Spain, Qatar, Argentina, Russia, Kuwait, Korea, Malaysia,

** ROW includes UK, Italy, Saudi Arabia, Sweden, Japan, Hong Kong, Norway, Finland, Switzerland, Spain, Qatar, Argentina, Russia, Kuwait, Korea, Malaysia, Canada, Germany, Taiwan, Nigeria, Pakistan, Belarus, South Africa, Serbia and Montenegro, Denmark, South Korea, Indonesia, Thailand, Bahamas

*** Other includes consumer products and services, high technology, health care, media and entertainment

Source: Thomson One, OECD

**Exhibit 17**




* ROW includes Germany, Hong Kong, Sweden, South Korea and United Kingdom

** Other includes consumer products and services, high technology, industrials, health care, media and entertainment

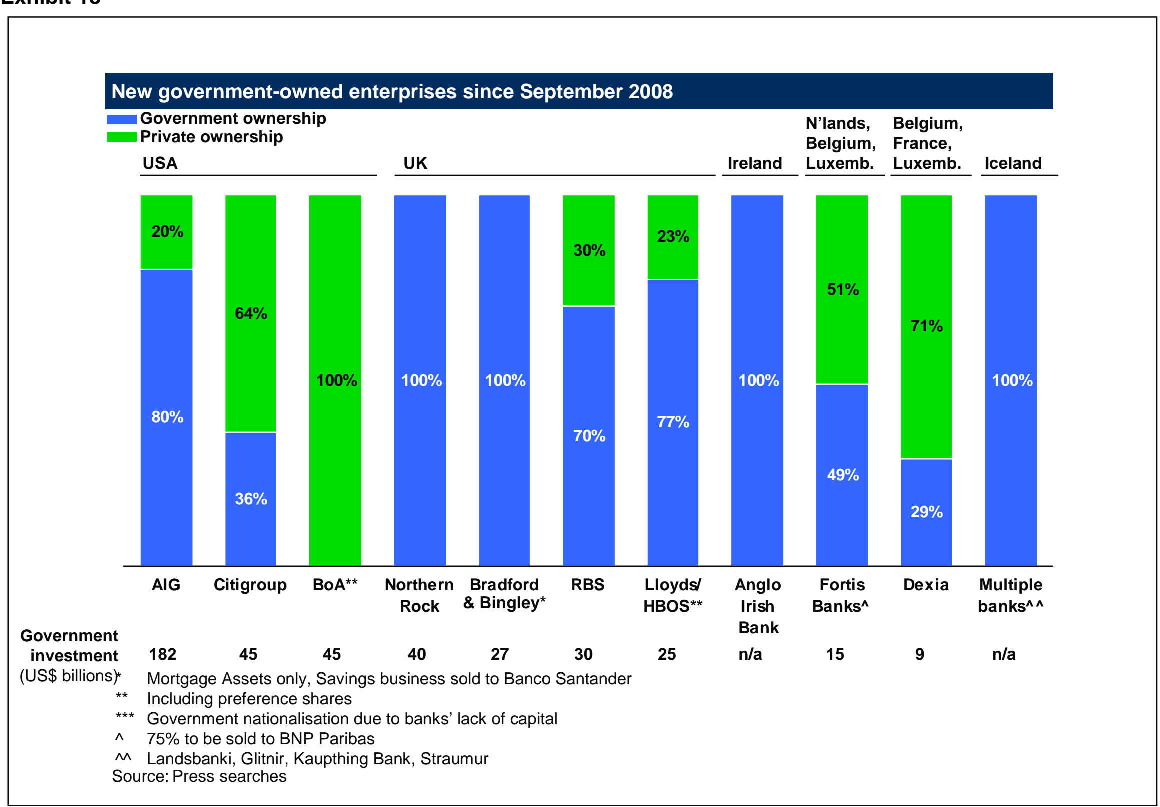
Source: Thomson One, OECD

It is worth noting that government "bail outs" of collapsing companies are resulting in the number of SOEs and SWFs growing all the time. Since September 2008, at least 14 financial institutions have become either wholly or partly government owned (Exhibit 18). Future government recovery packages may result in this number increasing, and include firms from other industries.

Australia has a long history of accepting investments from government owned and government linked investors.

During the 1970s and 1980s, Japanese firms investing in Australia had substantial links to the Japanese government, through key departments such as the Ministry of International Trade and Industry. These firms' activities were 'directed' by governments in many different ways, including the provision of subsidised finance, control over export licences and access to imported technologies, and government coordinated marketing support. These links allowed the Japanese government to influence, among other things, where and in what industries these firms invested. Despite concerns raised by these links at the time, Australia's foreign investment policies successfully managed these investments in the national interest.

**Exhibit 18**




More recently, government owned entities have invested in Australia. To give four examples:

- In 1982 Korean steel maker POSCO invested in Mt Thorley Coal mine. At this time, POSCO was government owned.
- Singtel, 55% owned by the Singaporean government through Temasek Holdings, owns 100% of Optus.

- Rio Tinto's own Channar operation was underpinned by an initial 40% investment in 1987 by CMIEC, the Chinese Ministry of Metallurgical Industry's trading arm. This interest is now held by Sinosteel, an SOE.
- In 2004, BHP Billiton entered into the Wheelarra Joint Venture, with four Chinese steel mills taking a combined 40% interest in the Jimblebar mine. These mills had a mixture of private and government ownership.

In fact, Australia's foreign investment regime has adapted to cope with, and successfully manage, investment from companies with a range of governance structures and government influence.

The challenge today is to continue to adapt Australia's regulatory regime to support potentially significant investments from SOEs and SWFs. To do so successfully, it is important to understand that:

- Government owned investors are surprisingly diverse, requiring customised approaches
- Dealing with China will mean dealing with government owned investors
- Chinese government owned investors are increasingly commercial in their orientation

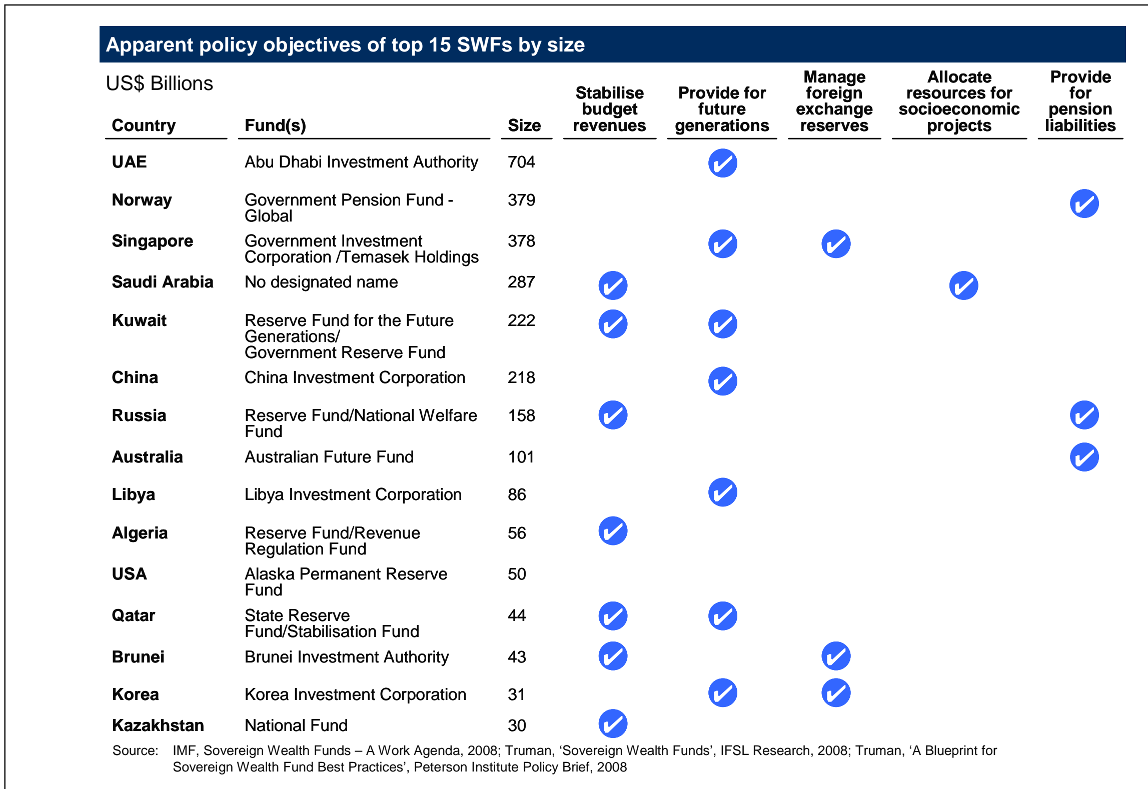
## SOEs and SWFs are surprisingly diverse, requiring customised approaches

At times there is a temptation to treat SOEs and SWFs as a homogenous group. In fact, these broad classifications hide significant differences.

Most obviously, they have different functions and objectives. The primary function of SWFs is funds management on behalf of government as a whole, or a specific sub-group of a nation (e.g. retirees). As such, they are usually financially oriented, portfolio investors. Policy objectives for creating and operating SWFs are diverse and include stabilising budget revenues, saving to provide for future generations, managing foreign exchange reserve assets, allocating resources for funding priority socioeconomic projects, and providing for pension liabilities on government balance sheets. Major SWFs cover the spectrum of policy goals (Exhibit 19).

SOEs, on the other hand, operate specific enterprises. Their investments, both domestically and overseas, are usually in businesses related to their own. Most often they seek opportunities both to leverage their existing capabilities and develop new ones.

**Exhibit 19**



**Apparent policy objectives of top 15 SWFs by size**

US$ Billions

| Country | Fund(s) | Size | Stabilise budget revenues | Provide for future generations | Manage foreign exchange reserves | Allocate resources for socioeconomic projects | Provide for pension liabilities |
|---|---|---|---|---|---|---|---|
| **UAE** | Abu Dhabi Investment Authority | 704 | | ✓ | | | |
| **Norway** | Government Pension Fund - Global | 379 | | | | | ✓ |
| **Singapore** | Government Investment Corporation /Temasek Holdings | 378 | | ✓ | ✓ | | |
| **Saudi Arabia** | No designated name | 287 | ✓ | | | ✓ | |
| **Kuwait** | Reserve Fund for the Future Generations/ Government Reserve Fund | 222 | ✓ | ✓ | | | |
| **China** | China Investment Corporation | 218 | | ✓ | | | |
| **Russia** | Reserve Fund/National Welfare Fund | 158 | ✓ | | | | ✓ |
| **Australia** | Australian Future Fund | 101 | | | | | ✓ |
| **Libya** | Libya Investment Corporation | 86 | | ✓ | | | |
| **Algeria** | Reserve Fund/Revenue Regulation Fund | 56 | ✓ | | | | |
| **USA** | Alaska Permanent Reserve Fund | 50 | | | | | |
| **Qatar** | State Reserve Fund/Stabilisation Fund | 44 | ✓ | ✓ | | | |
| **Brunei** | Brunei Investment Authority | 43 | ✓ | | ✓ | | |
| **Korea** | Korea Investment Corporation | 31 | | ✓ | ✓ | | |
| **Kazakhstan** | National Fund | 30 | ✓ | | | | |

Source: IMF, Sovereign Wealth Funds – A Work Agenda, 2008; Truman, 'Sovereign Wealth Funds', IFSL Research, 2008; Truman, 'A Blueprint for Sovereign Wealth Fund Best Practices', Peterson Institute Policy Brief, 2008

It is a misleading oversimplification to portray SOEs and SWFs simply as agents of government. An IMF survey of SWFs found considerable variation in independence from government[18]. Among the IMF's findings were that:

- While roughly one third of SWFs had a board with a majority of government officials, one third had no government representatives on their board at all
- Though accountability to the legislature of the SWF's home country is common, 21 per cent of SWFs are not accountable to their legislature, and a further five per cent are accountable only through the distribution of their annual report

This diversity increases the difficulty in forming a 'one size fits all' approach to government owned investors. However, the challenge of dealing with diversity must be met - foreign investment by SOEs and SWFs is going to play an ongoing and increasing role in Australia.

## Dealing with China will mean dealing with government owned investors

The recent sharp rise in interest in overseas investment by SOEs and SWFs is closely linked to the increased prominence of Chinese government owned investors.

SOEs were initially dominant in China's economy. In the early decades of the Peoples' Republic, SOEs were the overwhelmingly dominant form of economic enterprise. That began to change in 1978

[18] International Working Group of Sovereign Wealth Funds, 'Current Institutional and Operational Practices', September 2008

with the institution of the economic reforms of Deng Xiaoping. Since the early 1990s, however, policy reforms have meant the nature, role and significance of SOEs in the Chinese economy has changed radically.

These reforms reflected a recognition that, in spite of the relatively hostile regulatory environment in which they then operated, growth in the Chinese economy was being driven by private sector enterprises.[19] It also became clear that SOEs' broad role in delivering a wide range of social welfare benefits was incompatible with their primary function as economic enterprises and that this incompatibility was damaging China's growth prospects and seriously weakening its financial system.

SOEs and SWFs are, however, still at the forefront of China's 'going global' strategy. The OECD describes China's 'going-global' strategy as the encouragement of globalisation of enterprises, through enlarging global markets, securing natural resources, attaining higher technologies, and enhancing the brand value of Chinese enterprises.[20]

It is not surprising that China should be pursuing such a strategy at this stage in its economic development. In many ways it is overdue. Until now, China's foreign investment in countries such as Australia has been minimal, and well below what we might have expected given the size of our trading relationship. 'Going global' will deliver benefits to China through providing a more sustainable growth path that will deliver higher living standards. For the global economy it means a China more closely engaged with the rest of the world and, most importantly in current circumstances, a fresh source of capital.

Further, it is to be expected that China's interest in Australia should be focussed on the resource industry. First and foremost, Australia's resources sector is a world class industry that has presented very attractive investment opportunities to investors from all over the world as the figures quoted earlier illustrate. Second, it is a natural complement to China's broader trade relationship with Australia. Third, development of its own resource industries to underpin its growth ambitions is a major priority for China.

Australia and the rest of the world should, however, expect the interests of Chinese companies to broaden. Chinese investment transactions now occur across a wide range of industry sectors and geographies. For example:

- Lenovo's acquisition of IBM's personal computer business instantly created a global Chinese personal computer business
- Chinese car manufacturers have acquired UK manufacturers to acquire new brands and technologies
- Chinese manufacturing companies have acquired foreign competitors to gain access to new markets, as well as to underpin globalised supply chains and consolidate manufacturing facilities

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[19] Ross Garnaut, Ligang Song, Yang Yao and Xiaolu Wang, 'Private Enterprise in China', *Asia Pacific Press at ANU and China Center for Economic Research at Peking University*, 2001

[20] OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, 'State Owned Enterprises in China: Reviewing the Evidence', January 2009

- Chinese banks and insurance companies have used foreign investment to add products and gain access to critical skills[21]

## China's SOEs and SWFs are increasingly commercial in their orientation

The Chinese government has recognised that China's SOEs and SWFs must be able to compete with other global firms. This means a more commercial orientation is required if their 'going global' strategy is to succeed.

As a result, the Chinese government has adopted specific policy initiatives to make SOEs and SWFs increasingly commercial in their mode of operation and in the pressures they face. This means they increasingly compete with private companies in their markets and, not coincidentally, their own motives and goals increasingly match those of the private sector.

China's accession to the WTO has also provided an incentive for this move to a commercial orientation. WTO membership requires a commitment to maintain a market based economy. The impetus that this commitment provides for reform was one of the reasons the Chinese government sought WTO accession[22]. SOEs must become more commercial to be consistent with this commitment.

Examples of these policy actions include:

- Government officials have begun to hold state-owned companies more accountable for successes and failures. From 1994 to 2005, 3,685 state companies failed
- Responsibility for pension and health care provision is being transferred from state companies to the state
- Both public and private sector companies face the same approval processes for cross-border M&A and other global activities[23]
- Listings of SOEs on stock exchanges have been used to introduce more transparent ownership and more efficient supervisory mechanisms (Exhibit 20)[24]

Included in this reform program is a focus on greatly reducing the number of SOEs. According to the OECD, SOEs' share of production in China has fallen from 78 per cent in 1978 to around 30 per cent today.

Nevertheless, this consolidation of SOEs still has a long way to go, making any attempt by government to 'control' these businesses very difficult. China's steel manufacturing industry, for example, has around 1,800 firms; the largest five control only 18 per cent of volumes. By comparison, in Japan's steel industry the largest five firms control around 80 per cent of volumes.

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[21] Thomas Luedi, 'China's track record in M&A', *The McKinsey Quarterly*, Number 3 2008

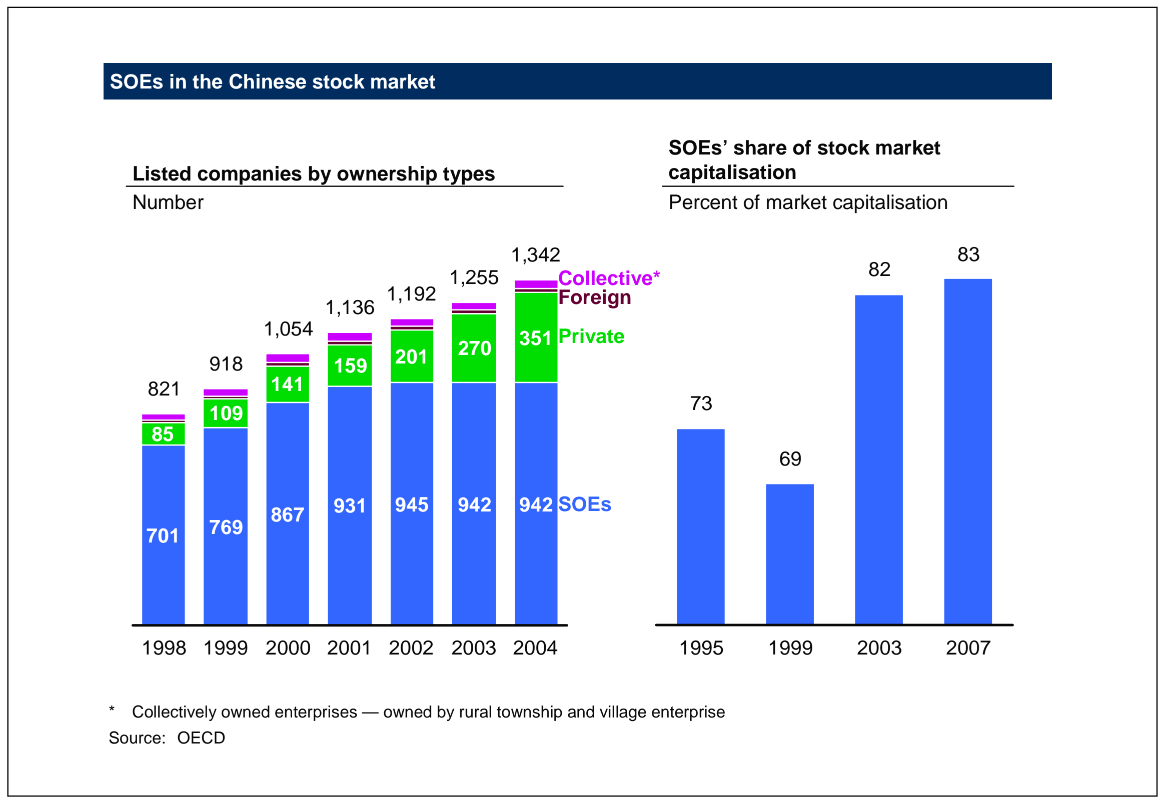
[22] C Bajona and T Chu, 'China's WTO accession and its effects on state-owned enterprises', *East West Centre Working Paper, Economic Series*, April 2004

[23] Jonathan R. Woetzel, 'Reassessing China's state-owned enterprises', *The McKinsey Quarterly*, July 2008

[24] OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, 'State Owned Enterprises in China: Reviewing the Evidence', January 2009

China's SOEs and SWFs are also becoming much more diverse. Research by McKinsey & Company highlights this.[25] SOEs now range from large quasi-governmental institutions to companies which, though still state owned, function like modern private sector concerns. These companies compete head-to-head with multinationals in global markets and many are global organisations themselves.

**Exhibit 20**




25 Andrew Grant, 'Revitalising State Owned Enterprises', *The McKinsey Quarterly*, Number 3 2008

Finally, SOEs and SWFs are rapidly becoming more independent from government. There are a growing number of examples where the actions of Chinese SOEs are inconsistent with close coordination and control by the Chinese Government. For example:

- In recent years Chinese oil companies in Africa have bid against each other for assets, sold oil on world markets rather than to China when prices have been favourable, and generally ignored the wishes of China's Ministry of Foreign Affairs.[26]
- In recent iron ore price negotiations there has been a lack of coordination between Baosteel, the traditional leader, and the China Iron and Steel Association (CISA). These differences included a decision by CISA to bypass negotiations and deal directly with selected companies[27]

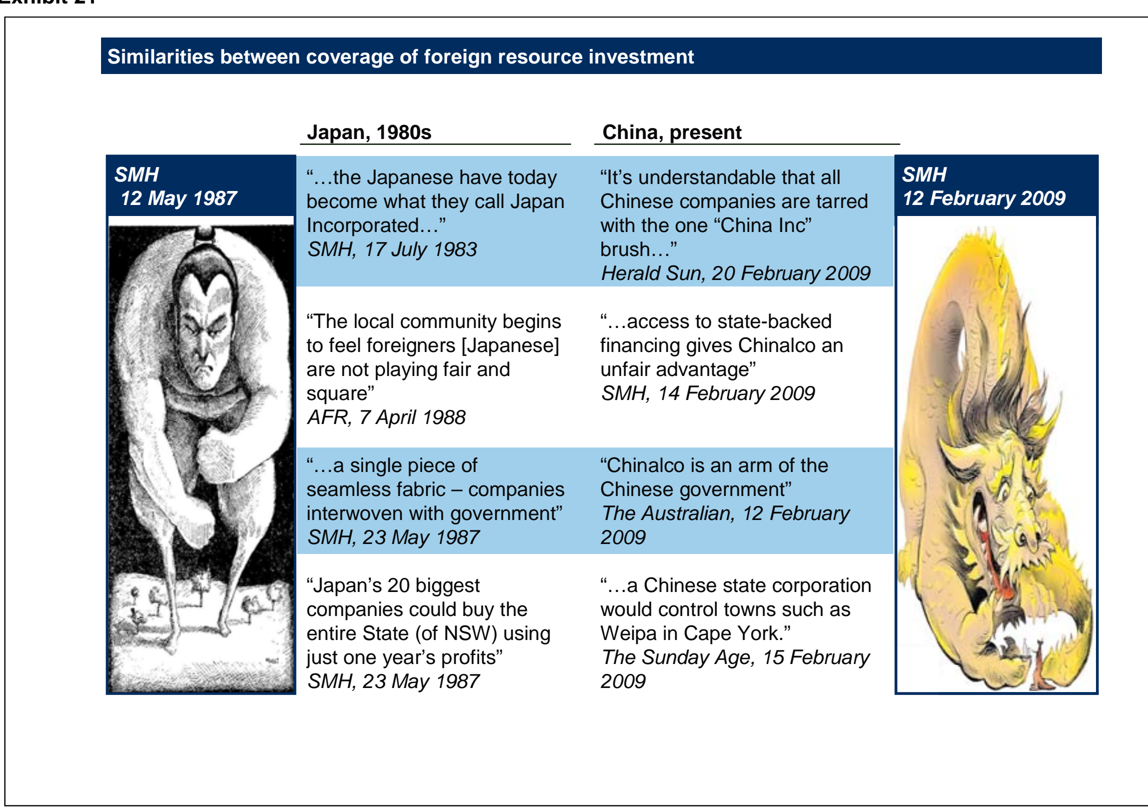
[26] John Garnaut, 'Why Canberra must not meddle in the Rio-Chinalco deal', *Sydney Morning Herald*, February 16 2009

[27] John Garnaut, 'China's iron ore confusion is good news for Australia', *Sydney Morning Herald*, April 13 2009

# 5. ARTICULATED CONCERNS ARE OFTEN OVERSTATED

The increasing prominence of SOEs and SWFs, particularly from China, has raised concerns parallel to those about 'Japan Inc' in the 1970s and 80s. An examination of contemporary media coverage of both issues shows a combination of thoughtful pieces and more emotive treatment. In particular, the more emotive articles demonstrate disturbing similarities (Exhibit 21).

**Exhibit 21**



**Similarities between coverage of foreign resource investment**

| | Japan, 1980s | China, present | |
|---|---|---|---|
| ***SMH* 12 May 1987** | "…the Japanese have today become what they call Japan Incorporated…" *SMH, 17 July 1983* | "It's understandable that all Chinese companies are tarred with the one "China Inc" brush…" *Herald Sun, 20 February 2009* | ***SMH* 12 February 2009** |
| | "The local community begins to feel foreigners [Japanese] are not playing fair and square" *AFR, 7 April 1988* | "…access to state-backed financing gives Chinalco an unfair advantage" *SMH, 14 February 2009* | |
| | "…a single piece of seamless fabric – companies interwoven with government" *SMH, 23 May 1987* | "Chinalco is an arm of the Chinese government" *The Australian, 12 February 2009* | |
| | "Japan's 20 biggest companies could buy the entire State (of NSW) using just one year's profits" *SMH, 23 May 1987* | "…a Chinese state corporation would control towns such as Weipa in Cape York." *The Sunday Age, 15 February 2009* | |

A dispassionate analysis of Australia's experience with Japanese investment concludes that it has proved to be very positive for Australia. It has resulted in significant economic growth, without any of the concerns proving to be well founded.

Today, separating the emotion from the facts regarding SWFs and SOEs suggests that:

- Concerns regarding SOE and SWF investments are usually overstated, including those regarding Chinese SOEs and SWFs
- Arbitrarily rejecting investments from SOEs and SWFs is much riskier for Australia's broader economic prosperity than developing and applying foreign investment review processes that manage any potential issues

## Concerns regarding SOE and SWF investments are usually overstated

Investment by SOEs and SWFs creates special concerns, which spring from the perceived conflicts between Australia's national interests and the interests of the SOE or SWF's government owner. Though they can be described in different ways, these concerns are typically articulated as falling into one of five categories:

- Undue use of influence, usually to artificially lower prices for Australian produced goods and services
- Inappropriate transfer pricing, allowing goods to be sold to an affiliate of an SOE or SWF at other than commercial terms
- National security issues related to access to key assets or resources
- Reduced competitiveness for Australian companies, and consequent displacement by foreign firms
- Loss of national identity and culture

The evidence suggests, however, that these concerns are overstated.

As government owned investors could have objectives other than profit maximisation, undue use of influence to alter prices may be a concern. Yet Australia already has at its disposal the means to protect against these issues, through application of ACCC reviews and the Trade Practices Act.

Some economists have noted that investments in the resource industry pose particular risks that may require special arrangements. For example, in the case of scarce resources like mineral deposits, it has been suggested that an investor who is also a customer may have an incentive to extract resources faster than may be optimal. However, these concerns hinge on the potential for actions by Australian producers to drive down commodity prices through increasing production. Though deserving of examination, this is not the case for major Australian commodities. For example, in its review of the proposed Chinalco partnership with Rio Tinto, the ACCC found that Rio Tinto would not have the ability to influence global iron ore prices through unilateral capacity expansion decisions. Increased Australian production of iron ore would result in greater market share for Australia, but would not reduce iron ore prices. This analysis would hold true for other key commodities as well.

Moreover, these concerns do not always reflect other factors that a potential investor customer would need to consider, including: the prospect that falling iron ore prices would lead to a fall in steel price; that any gains from lower prices would be more than offset by the declining value of its investment; or that (in an extreme case where an investor is clearly acting as an agent for government) lower commodity prices could marginalise many high cost operations in its home country.

Transfer pricing issues can best be addressed directly through appropriate taxation laws, and their rigorous enforcement. As these issues commonly arise, these mechanisms are already in place. Rio Tinto’s experience confirms that the ATO actively examines transfer pricing arrangements for all companies operating in Australia.

National security issues should be effectively managed through assessing the risks on a case by case basis. The current foreign investment review process already addresses issues of national security. The recent Minmetals/OzMinerals transaction is an example of this process at work. Finally, in assessing national security risks, the potential positives from increased engagement through foreign investment should not be overlooked.

Reduced competitiveness for local firms is always a concern in a dynamic global economy. Some fear more competitive foreign firms will displace smaller local companies, if foreign investment is encouraged. For example, it is argued that SOEs have a lower cost of capital that Australian companies, and therefore Australian companies should be protected. In general, protecting local firms from competition is not the way to raise living standards for Australians. In fact, as discussed earlier, the evidence is that foreign investment produces more competitive local firms through enhanced trading relationships, and extensive ‘spillovers’ of technologies and business practices. In addition, allowing Australian firms to access low cost capital enhances, not detracts from, their competitiveness.

Some argue that foreign investment leads to loss of sovereignty and national identity. Yet Australia retains sovereignty over business activities taking place within its borders, including those conducted by SOEs and SWFs. Fears foreign investment will erode Australia’s national identify are also largely unfounded. Australia’s long history of foreign investment has not eroded its distinctive national identity. Changes in the source or form of that investment are unlikely to place its identity further at risk.

Investments by Chinese SOEs and SWFs often generate distinctive concerns. On the basis of the evidence, these concerns are often overstated.

While the structure of the Chinese economy is very different from that in Australia, Japan or the United States, including in respect of the role of government, these differences are substantially less than they were in 1978 and are continuing to contract.

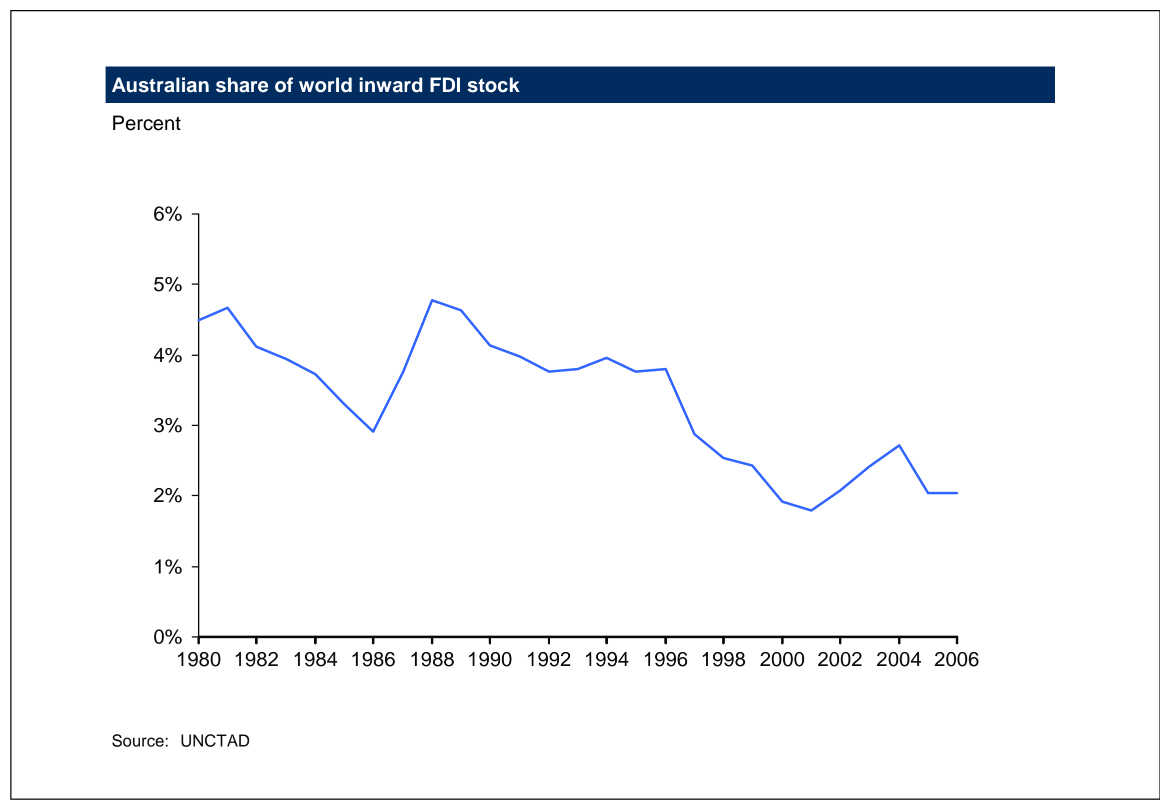
In addition, a Chinese enterprise operating in Australia would be subject to the same legislative and regulatory regime as any other enterprise and there is no reason to believe that these regimes would be less effective because of the nationality or government affiliation of the enterprise owner. The firm in which the Chinese enterprise is investing will similarly continue to be subject to legislative and regulatory requirements in Australia.

## Arbitrarily restricting foreign investment is risky for the Australian economy

Failing to facilitate investments from SOEs and SWFs could be much riskier for Australia's broader economic prosperity than the relatively manageable risks of engagement.

Australia's experience illustrates the dangers of not adapting to the new global environment. Australia's share of the world's foreign direct investment has been falling (Exhibit 22), reflecting increased investment in competitor countries.

**Exhibit 22**

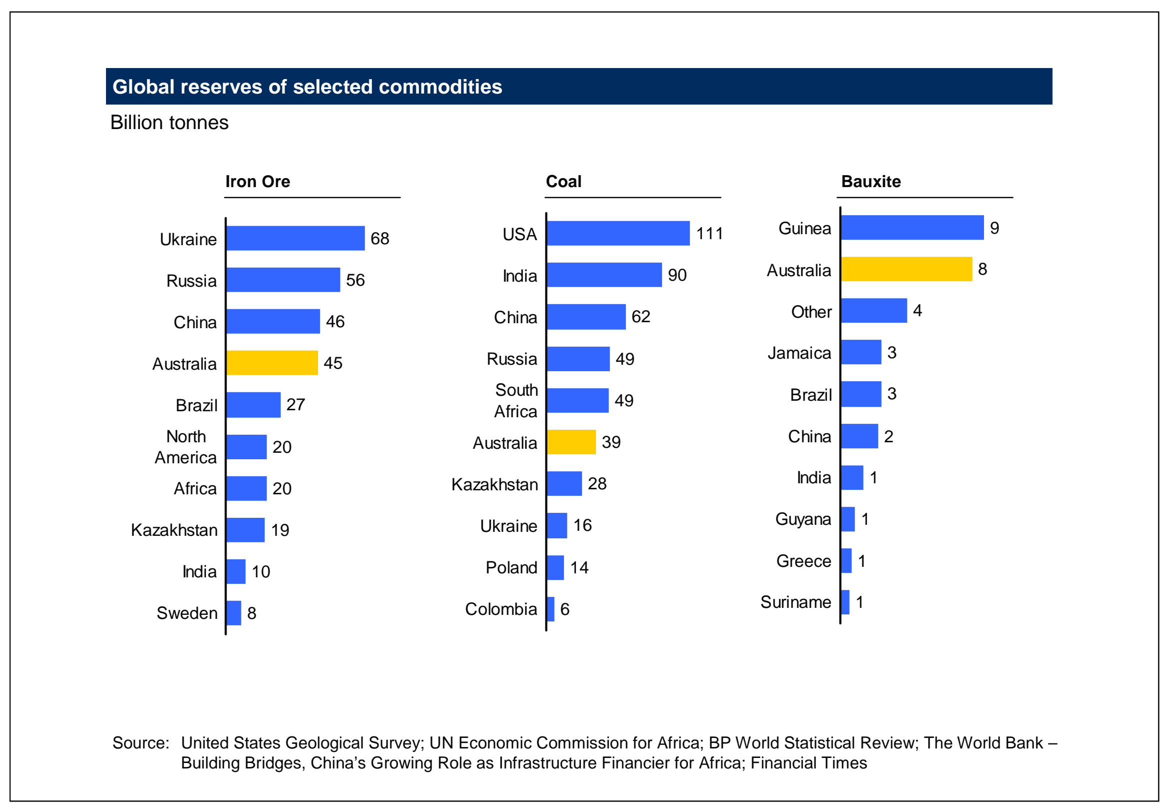



Rio Tinto's experience in the resources sector reflects this. Other countries have mineral resources comparable with Australia's own and will compete for investment funds (Exhibit 23). For example, in iron ore, Russia, Ukraine and China all have more extensive reserves than Australia.

In some cases, these mineral deposits are being developed more rapidly than Australia's. As a result, in key commodities, other countries have been gaining share at Australia's expense (Exhibit 24).

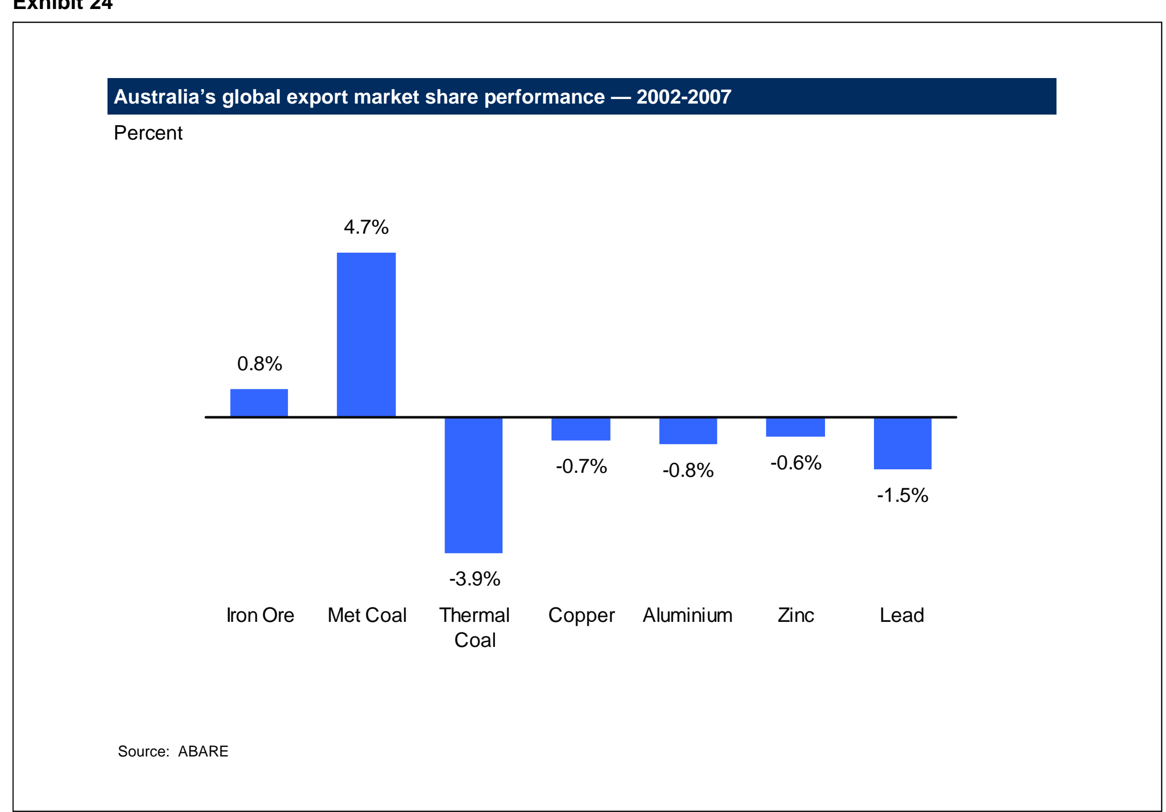
This trade impact extends beyond specific investments to the broader economy. Australia has lost out as other nations have been quicker to capitalise on this potential. Since 1990, exports from Africa to China have grown 80 per cent faster than Australia's. South America, too, has rapidly grown exports to China. Since beginning in 1995, for example, soy bean exports from Brazil and Argentina to China have grown to be a US$7 billion business.

**Exhibit 23**




Source: United States Geological Survey; UN Economic Commission for Africa; BP World Statistical Review; The World Bank – Building Bridges, China's Growing Role as Infrastructure Financier for Africa; Financial Times

**Exhibit 24**




Source: ABARE

# 6. TOWARDS A SUSTAINABLE FOREIGN INVESTMENT REGIME THAT ADVANCES THE NATIONAL INTEREST

Australian foreign investment policy must now face the reality that government owned investors will be key providers of vital foreign capital, and that many of these will be from China.

Australian policy makers have the task of ensuring that Australian policy allows appropriate engagement with all foreign investors. While caution in developing these investment relationships is prudent, the assessment of the benefits and risks should be made in an objective, fact-based way. The choices that now confront Australia are too important to get wrong.

Australia is a developed, sovereign nation with a rich set of tools for ensuring that commercial activity, including by foreign-owned entities, does not damage the wider interests of the Australian community. These tools include:

- Competition law that polices anti-competitive practices and mergers
- A tax code that covers transfer pricing
- Environmental standards and regulatory entities to monitor business practices
- Workplace laws and codes, including those covering health and safety, together with mechanisms of enforcement
- Laws to protect the interests of indigenous peoples, especially in remote areas
- Laws governing land use, including highly developed and detailed codes covering the extractive industries
- A robust national identity, itself the product of many different cultures

Moreover, Australia already has a mature and relatively sophisticated foreign investment regime. In fact, OECD research indicates Australia more closely examines foreign investments than many other OECD countries.

Rio Tinto agrees with the Treasurer when he says that

> *“the key is that investments are consistent with Australia’s aim of maintaining a market-based system in which companies are responsive to shareholders and in which investment and sales decisions are driven by market forces rather than external strategic or political considerations."*

In February 2008, the Treasurer identified principles that must be considered when evaluating investments associated with foreign governments. They are:

- Are an investor's operations independent from the relevant foreign government?

- Will an investor be subject to and adhere to the law, and observe common standards of business behaviour?
- Will an investment hinder competition or lead to undue concentration or control in the industry or sectors concerned?
- Will an investment impact on Australian Government revenue or other policies?
- Will an investment impact on Australia's national security?
- Will an investment impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community?

Rio Tinto considers Australia's current foreign investment regime mature and sophisticated, consistent with the Treasurer's goals. Rio Tinto sees the basic approach outlined by these policies – that of principles-based, case-by-case assessment – as the bedrock on which this regime is built. This basic foundation should remain in place. Moving to a 'one size fits all' or 'checklist' approach for government owned investors is inappropriate. This is especially so given the rapid evolution and diversity of these investors as described in Section 5.

As a result, Rio Tinto does not see a case for an overhaul of existing policies or processes.

Nonetheless, Australia's foreign investment review principles must be sustainable in a period where more capital flows are likely to come from government owned investors.

To ensure this is the case, Rio Tinto believes the principles should be applied in a way which:

- Asks three key questions when determining whether government ownership of a potential investor deserves closer consideration. These questions are:

  1. To what extent is the investing company operated independently from government in order to pursue commercial interests?

  2. Will the investing company have real influence or control over the investee company?

  3. Does any influence or control have the potential to be exercised against Australia's national interest?

  All of these 'links in the chain' must hold for the outcome of a transaction to potentially be at odds with Australia's national interest.

- Bases an assessment of whether an investment may hinder competition on the views of the Australian Competition and Consumer Commission, to ensure a consistent approach and avoid duplication of effort.
- Applies the general investment principles without special consideration for particular industries. In particular, much of the debate around the special status of the resource industry can be considered within the existing framework – the principles can deal with any of these considerations. For example, considering issues such as 'whether a resource is already developed' or is a 'major part of the total resource' are inherently embodied in the third

investment principle, which tests the extent to which an investment will hinder competition or lead to undue concentration or control.

Each of these points will now be described in turn.

## Consider three key questions regarding government ownership of investors

As discussed in Section 5 above, government owned investors have the potential to generate concerns not present in the case of other investors. Generally, these concerns arise from perceived conflicts between Australia's national interests and that of the government owner of the SOE or SWF in question.

As a result, assessing the extent to which these conflicts of interests occur and can be acted upon is crucial to the review of a foreign investment proposal.

Currently, assessment of these conflicts can focus on one aspect of control only. That is:

1. **To what extent is the investing company operated independently from government in order to pursue commercial interests?**

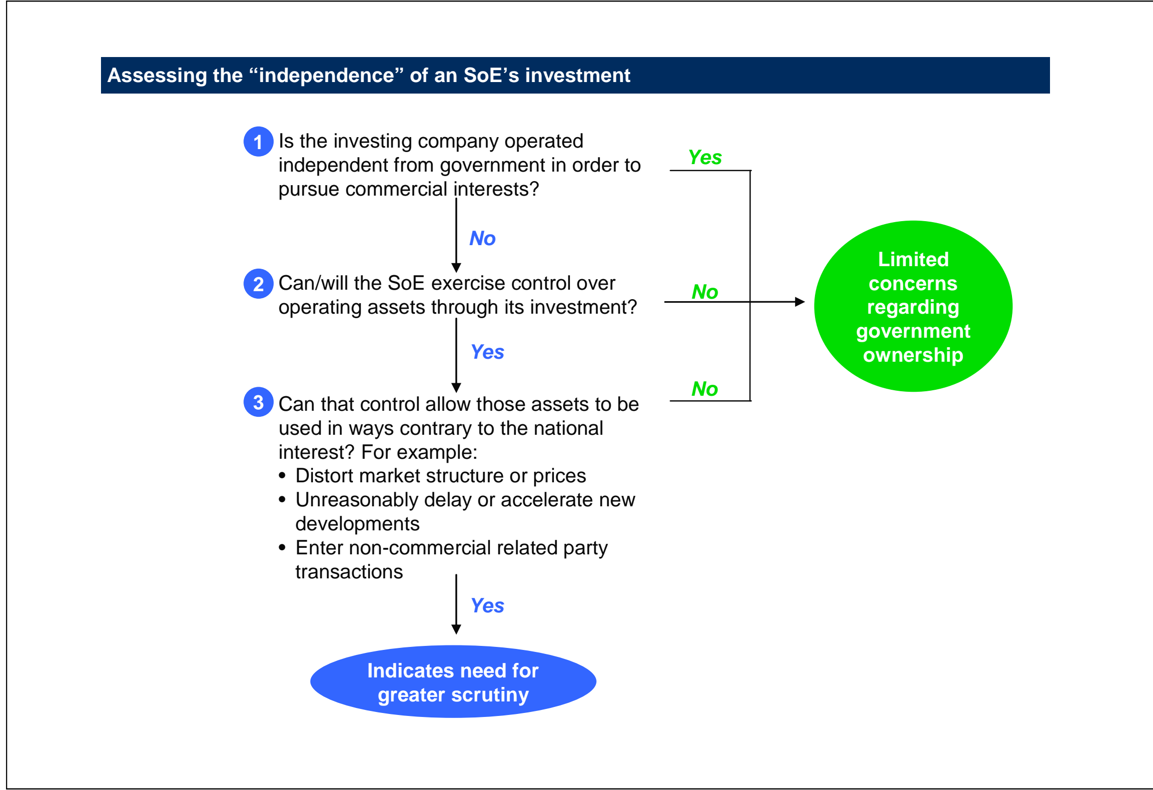
This focus can understate the importance of two equally relevant questions:

2. **Can the SOE exercise control over operating assets through its investment?** For the answer to this question to be yes, the investor company would have to be able to control key business decisions including capital investments, product mix and production levels, pricing, contracting strategies, and marketing tactics and strategies

3. **Can that control allow those assets to be used in ways contrary to the national interest?** For the answer to this question to be yes, for example, operation of the assets in question would have to be able to distort market prices or structures, or to allow related party transactions to occur at other than arm's length terms

All three questions must be considered if the potential for conflicts of interest between governments to generate a risk to Australia's national interest is to be completely assessed (Exhibit 25). Only if all links in this chain of reasoning hold can investment by a government owned entity potentially lead to an outcome contrary to the national interest. If not then the risk of conflicts of interest damaging the national interest is very substantially reduced, if not eliminated.

**Exhibit 25**




These questions recognise the reality that independence from government, or lack thereof, in and of itself is not a sufficient test to assess the potential for outcomes against the national interest.

These questions must be assessed with regard to:

- Specifics of the transaction, including the arrangements established to control management decisions
- Track record of both investor and investee organisations including management of previous relationships with co-investors and joint venture partners
- Australia's practical experience of successfully managing joint ventures with customers and/or other parties with potential conflicts of interests
- Stated and/or demonstrated intent for the government owned investor to increase its independence from its government owner, for example through sale of government shares, or through listing on stock exchanges

The questions are not intended to establish a 'red or green light' test for foreign investment proposals. Instead, these three questions would act to flag particular transactions for greater scrutiny.

## Base assessment of an investments competition impacts on the views of the ACCC

Rio Tinto agrees that that investments by government owned investors should not result in a substantial hindering of competition (the third principle described above).

Rio Tinto notes, however, that this principle involves similar if not identical considerations to the investment reviews of the ACCC.

Rio Tinto proposes that assessments of investments with respect to this principle be based on the views of the ACCC. There are three reasons for this:

- Transactions with the potential to substantially lessen competition will be addressed by the ACCC in any case, and duplication of effort leading to potentially different outcomes is wasteful and creates uncertainty.
- The ACCC is acknowledged as the expert in this field by the Australian Government.
- The ACCC's existing procedures and methodologies are well developed and well known. Investors' experience with these procedures will act to reduce the uncertainty associated with new investment.

Rio Tinto does not propose that the assessment of the competition impacts of investments be delegated to the ACCC. Nevertheless, recognising the value of the ACCC's view in these matters seems appropriate.

## Apply the same general principles to investment in all industries

Rio Tinto proposes that identical investment principles and the associated investment review processes should be applied to all industries. A well established case-by case approach using well designed principles is more likely to lead to appropriate regulatory outcomes. The alternative of restricting foreign investments in certain industries is likely to be arbitrary, inequitable and damaging.

In particular, many of the issues alleged to flow from the special status of the resource industry can be dealt with in the existing framework. The general foreign investment principles have the flexibility and regulatory clout required. For example, considering issues such as “whether a resource is already developed” or is a “major part of the total resource” are inherently embodied in the third investment principle, concerning the hindering of competition or undue concentration or control.

This proposal does not imply that Rio Tinto wishes to remove existing industry regulations that govern investments of any type, for example those regarding banking or broadcasting licences. Rio Tinto notes, however, that these valuable regulations do not draw a distinction between Australian and foreign investors in those industries, and are, therefore, consistent with this recommendation.

# 7. RIO TINTO'S PROPOSED PARTNERSHIP WITH CHINALCO IS CONSISTENT WITH AUSTRALIA'S NATIONAL INTEREST

Rio Tinto's proposed partnership with Chinalco is clearly relevant to the issues before this Inquiry. This transaction is currently undergoing review by the Foreign Investment Review Board, prior to a decision by the Treasurer.

Rio Tinto believes that this proposal is consistent with the national interest, and is an example of the type of foreign investment transaction that should be approved by the foreign investment approval process.

This Section explains the reasons for Rio Tinto's view. It begins by summarising the proposed transaction, including:

- The key features of the transaction
- Rio Tinto's strategic rationale for the transaction
- The specific arrangements that ensure Chinalco's investments do not transfer operational or strategic control from Rio Tinto

This Section continues by describing the reasons that Rio Tinto believes the proposed partnership is in the national interest. These are:

- The US$19.5 billion capital injection provided by Chinalco will immediately strengthen Rio Tinto's Australian businesses and the Australian economy
- The strategic partnership with Chinalco will position Rio Tinto's Australian businesses for the future
- The partnership will strengthen the broader economic relationship between Australia and China
- As control of all operations remains with Rio Tinto, the transaction effectively manages issues of independence from government

This Section concludes by describing how the transaction is consistent with the six principles to be considered when evaluating investments associated with foreign governments.

## Key features of the transaction

The transaction involves three elements.

First, the issue to Chinalco of **subordinated convertible bonds** for US$7.2 billion. These bonds can be converted by Chinalco into shares in the Rio Tinto parent entities, and if done so, would result in Chinalco's interest in Rio Tinto rising from 9.3 per cent currently to approximately 18 per cent. Upon issue of these bonds, Chinalco would be invited to nominate two non-executive directors for

appointment to the Boards of Rio Tinto plc and Rio Tinto Limited. One of these nominees must qualify formally as independent of Chinalco. Chinalco and Rio Tinto will enter into a Relationship Agreement, which will ensure that Rio Tinto is capable of carrying on its business independently of Chinalco as a significant shareholder.

Second, the acquisition by Chinalco of **minority economic interests in respect of certain Rio Tinto aluminium, iron ore and copper businesses** for US$12.3 billion. Only investments in aluminium and iron ore affect Australian assets. An overarching Strategic Alliance would be established by Rio Tinto and Chinalco in relation to the iron ore, aluminium and copper businesses respectively in which Chinalco is acquiring an economic interest.

Third, Rio Tinto and Chinalco intend to **pursue other cooperative arrangements and new business opportunities** in Australia and globally. These include:

- A joint venture for exploration in mainland China
- An arrangement in relation to joint development of Rio Tinto's Simandou iron ore project in Guinea
- A project development fund, using an initial capital contribution from Chinalco, to undertake project opportunities
- Reasonable assistance by Chinalco to develop Rio Tinto's relationship with Chinese financial institutions

## Rio Tinto's strategic rationale

The proposed transaction offers a comprehensive and attractive financial solution on terms that do not constrain Rio Tinto's strategic or operational flexibility in the future.

The proposed transaction will generate cash proceeds of US$19.5 billion upon completion. This cash injection will immediately strengthen Rio Tinto's balance sheet and provide resilience in uncertain economic times. It will also give Rio Tinto the flexibility necessary to undertake value enhancing growth as markets recover.

The partnership with Chinalco is also expected to offer the following strategic benefits to Rio Tinto:

- The proposed transaction creates a broad partnership with a leading Chinese industrial corporation that will further enhance Rio Tinto's strong relationships with China. The benefits of this relationship include the following:
    - Rio Tinto believes that China's industrialisation will continue to drive the demand for commodities for the foreseeable future. A strong relationship with Chinalco will provide deeper insights into this key market and the relationship will offer Rio Tinto a unique competitive advantage.
    - The proposed transaction creates an opportunity for joint ventures and project development in emerging economies. The two groups bring complementary skills including Chinalco's

capabilities to deliver infrastructure projects, and Rio Tinto's leadership in operational excellence and sustainable development.

- o Rio Tinto will enter into a landmark joint venture for exploration in China in partnership with Chinalco.

- The Chinalco relationship will facilitate access for Rio Tinto to funding for project development from Chinese financial institutions, at a time when global capital is scarce.
- The proposed transaction will not result in any change of control in Rio Tinto or the assets in which Chinalco is investing. Rio Tinto retains responsibility for carrying on day to day management and operation of its businesses independently of Chinalco.

In summary, this transaction uniquely positions Rio Tinto to lead the resources industry into the next decade.

## Specific arrangements regarding control of Rio Tinto assets

As discussed in Section 5, issues of control are clearly of importance when considering investments by SOEs. As a result, it is important to understand the arrangements concerning control made by Rio Tinto and Chinalco as part of the proposed transactions.

Importantly, the proposed transaction will not result in Chinalco acquiring control of:

- Rio Tinto
- any of Rio Tinto’s businesses, including any Australian business
- Rio Tinto’s marketing operations

In addition, the proposed transaction will not result in any material dilution of Australian ownership of Rio Tinto.

Appendix 1 to this submission provides a more detailed description of the arrangements regarding the control of Rio Tinto assets. This appendix is itself based on of the detailed agreements Rio Tinto has posted on its website and with the ASX for further examination.

In summary, however, these arrangements mean:

- Chinalco will not acquire positive or negative control of Rio Tinto at the parent company level. Specifically:
  - o Neither Chinalco’s potential 18 per cent interest in Rio Tinto, assuming all of the convertible bonds convert, nor Chinalco’s nomination shareholding of two new non-executive board members will allow control over Rio Tinto. Chinalco and its nominees will not be able to veto any decision of the Rio Tinto Boards.
  - o Dealings with Chinalco by Rio Tinto will be at arms length terms, and a conflicts policy will ensure Chinalco directors do not vote on, or receive information regarding matters where there will be a conflict of interest.

  - Rio Tinto will continue to be a listed company, subject to current disclosure and governance obligations, and there will be no change to Rio Tinto's demonstrated commitment to best practice employment, sustainable development and other commercial practices.

- **There will be no change of control of Rio Tinto's Strategic Alliance assets or interests.** Chinalco receives an economic interest only in these assets. Rio Tinto will retain operational control, and also retain control of all committees and boards controlling strategic alliance assets. Further, Chinalco will have no veto over expansions, of asset disposals, nor can Chinalco "sole risk" other expansions, or exercise pre-emptive rights over any of Rio Tinto's interests.
- **There will be no change of control of Rio Tinto marketing.** Chinalco will have neither the incentive nor ability to exert downward pressure on commodity prices or otherwise control marketing efforts. Chinalco is not a customer of Rio Tinto, other than small alumina purchases and does not purchase iron ore at all. Chinalco operates independently from the Chinese government, and so has every incentive to maximise the value of its investment and so no incentive to depress commodity prices. In any event, Chinalco will have no control over marketing of Rio Tinto products. The principal purpose of the joint marketing company arrangements is to enable Rio Tinto to benefit from Chinalco's capabilities to grow share in the important Chinese market. These are similar to standard industry arrangements with proven track records of delivering value to shareholders.

## No material dilution of existing Australian ownership

The Proposal will not result in a material dilution of Australian ownership of the Rio Tinto group.

Rio Tinto estimates that Australian ownership of the Rio Tinto group is currently approximately 16.25 per cent. The effect of the proposed transaction, assuming Chinalco converts all of the convertible bonds, would be to reduce Australian ownership of the group to approximately 15 per cent, a reduction of only around 1 per cent.

The proportion of the Rio Tinto group held through Australian listed Rio Tinto Limited has not significantly declined since the formation of the Rio Tinto DLC in 1995. The economic interest in the DLC held through the Rio Tinto Limited side of the Group was 23.3 per cent in 1995, and is now 22.25 per cent.

## The proposed transaction is consistent with the national interest

The specific features of the proposed transaction deliver substantial benefits to the Australian economy. These include:

- The capital injection provided by Chinalco will immediately strengthen Rio Tinto's businesses in Australia and the Australian economy. The strategic partnership with Chinalco will position Rio Tinto's businesses in Australia for the future.
- The proposed transaction will strengthen the broader economic relationship between Australia and China.

- The transaction has been carefully structured to ensure that Rio Tinto retains full control of its assets. There is no transfer of control and, therefore, no scope for a change of control to damage Australia's national interest.

It is for these reasons Rio Tinto believes that the proposed transaction is consistent with the national interest.

## Stronger Australian businesses, and a stronger Australian economy

As described in Section 1, Rio Tinto's Australian businesses are an important part of the Australian economy and are major contributors to Australian employment.

Rio Tinto's key operations in Australia include:

- Iron ore mines (and related rail, port and power infrastructure) in the Pilbara in Western Australia;
- Thermal and metallurgical coal operations in Queensland and New South Wales and Queensland
- Bauxite mines, alumina refineries and aluminium smelters in Queensland, New South Wales, Tasmania and the Northern Territory
- The Argyle diamond mine in Western Australia
- The Northparkes copper mine in New South Wales
- The Ranger uranium mine in the Northern Territory

Like all other businesses, Rio Tinto and its Australian operations have also been significantly affected by the global economic crisis. Rio Tinto's response to this has included reductions in capital expenditure and employment to conserve cash prudently. These responses have affected projects across Rio Tinto's operations, including Australia.

The balance sheet strength provided by the proposed transaction will put Rio Tinto in a stronger position to continue with capital investment programs in Australia and elsewhere. In the case of a prolonged downturn, a stronger balance sheet will reduce the risk of further reductions in capital expenditure and employment.

Strengthening Rio Tinto and the ability of its Australian businesses to compete will also benefit the broader mining services sector. Economic research into 'clusters' across a range of industries has demonstrated that the presence of multiple strong competitors leads to the development of globally successful supporting businesses (services, other suppliers and allied educational and other institutions).

The Australian mining sector has benefited significantly from having two major global mining companies with very significant businesses in Australia.  It is no coincidence that Australia has produced a number of mining service providers that are now competing successfully in global markets, including Dyno Nobel, Orica, Leighton, Barminco and Downer EDI United.

## The strategic partnership positions Rio Tinto's Australian businesses for future success

The strategic benefits of the transaction described above are of enormous value for Rio Tinto as a whole.

Two benefits in particular will act to position Rio Tinto's Australian businesses for future success: growth in Rio Tinto and Australia's share of sales to China; and access for Rio Tinto to funding of project development from Chinese financial institutions.

The Chinese market accounts for one third of global demand and two thirds of global demand growth in industrial metals. Of Rio Tinto's three principal products, China consumes over a third of the world's aluminium, over a quarter of the world's copper and over half of the world's seaborne iron ore.

China has been and will continue to be the key growth market for the commodities Rio Tinto produces.

Rio Tinto was one of the first resource companies to recognise the potential in China by being the first to export iron ore to China in 1973, by establishing the first iron ore joint venture with a Chinese party in 1987 (the Channar joint venture), and by being the first to recognise and respond to the structural upturn in the Chinese economic growth profile that has powered the global economy over recent years. The strategic partnership with Chinalco is a continuation of this relationship with China.

Chinalco is uniquely placed to understand the Chinese commodity markets, including the new demand and supply fundamentals of those markets. Chinalco's understanding of Chinese government policies, actions and approval processes will provide a valuable insight for Rio Tinto. These insights, and Chinalco's relationships in China, will lead to strengthened market access for Rio Tinto. As a result, Rio Tinto believes that the strategic partnership will enable it to capture a greater share of Chinese commodity demand, which will in turn lead to increased Australian exports and will boost employment and economic growth in Australia.

In addition, as discussed in Section 3, access to capital for new projects has become increasingly challenging, and has been a contributing factor in the cancellation or delay of more than US$200 billion of mining projects.

If Australian miners are able to access capital in this period, however, they will benefit from lower building costs during the current downturn, and from having capacity in place to take advantage of the next cyclical upswing.

The relationships between Rio Tinto and Chinese financial institutions, facilitated by Chinalco, represent a new channel to secure investment capital, and an important advantage for Rio Tinto's Australian businesses.

## A broader economic relationship between Australia and China

Section 2 described the broader trade benefits that investment brings for the Australian economy. In addition, Section 2 showed how investment by Asian economies was typically more effective in developing trade than that from traditional Western sources.

The proposed transaction clearly has the potential to assist in the development of a broader relationship with China. It represents a significant vote of confidence by a major Chinese corporation in the Australian resources sector and the Australian economy at a critical time.

## The circumstances of the transaction ensure Rio Tinto's assets cannot be controlled and used against Australia's national interests

The arrangements agreed by Chinalco and Rio Tinto, described above, ensure that Rio Tinto's operations cannot be used by the Chinese government in any manner contrary to Australia's national interests.

This can most clearly be seen by evaluating the three questions Rio Tinto regards as key to assessing the first of the foreign investment review principles, as discussed in Section 6. Specifically:

- **Based on Rio Tinto's experience with Chinalco, Chinalco operates as a commercially driven enterprise**. As such, Chinalco is focussed on pursuing its commercial interests of maximising return on its investments and growth in the global markets in which it operates. The listing of Chalco on multiple stock exchanges is testimony to this intent.
- **The proposed transaction will not allow Chinalco to exercise control over Rio Tinto's assets.** As described above, Rio Tinto retains control over all operational activities, including marketing. Chinalco will not make decisions regarding capital investments, product mix and production levels, pricing, contracting strategies, and marketing tactics and strategies.
- **Control over Rio Tinto's assets could not be used in ways contrary to the national interest**. ACCC findings make clear that, even if control was assumed, Chinalco could not manipulate the price of bauxite, alumina or iron ore to the detriment of other Australian producers or the advantage of Chinese customers. In particular, for iron ore the ACCC finds that any accelerated investment will not allow Rio Tinto to unilaterally influence iron ore prices.

In addition, as described above, the proposed arrangements between Rio Tinto and Chinalco will ensure all related party transactions are at arm's length. And finally, Rio Tinto's operations will continue to be governed by the laws and regulations of Australia, as they are today.

## The proposed partnership is consistent with the six principles

As discussed in Section 6, Rio Tinto supports the use of the six principles to assess foreign investment related to government owned investors.

Given the national interest benefits described above, and the specific arrangements of the transaction, Rio Tinto believes the proposed partnership with Chinalco is consistent with all six principles. Specifically:

- **The investor's operations will be independent from the Chinese government.** As discussed above, Chinalco will not be controlled by the Chinese government; furthermore the provisions of the transaction ensure Rio Tinto's operations will remain under Rio Tinto's control
- **The investor will be subject to and adhere to the law, and observe common standards of business behaviour.** Chinalco's investments represent minority economic interests in respect of some of Rio Tinto's Australian operations. These operations will continue to be subject to Australian laws and regulations. Rio Tinto's policy of high standards of business behaviour will remain in place
- **The investment will not hinder competition or lead to undue concentration or control in the industry or sectors concerned.** The ACCC has found that Chinalco's investment in Rio Tinto's iron ore business raises no competition concerns, including in the iron ore, bauxite and alumina markets. The competition authority in Germany has also found no competition concerns
- **The investment will not negatively impact on Australian Government revenue or other policies.** The proposed transaction will support growth in Rio Tinto's Australian businesses and in the Australian economy more generally, increasing Government revenue. Rio Tinto's business decisions will continue to be made on a commercial basis. All of Rio Tinto's businesses will continue to comply with the environmental safety and other policies of the Australian Government
- **The investment will not negatively impact on Australia's national security.** Rio Tinto will continue to comply with existing laws (e.g. in relation to the export of uranium). This investment will also assist to strengthen the trade and investment relationships between Australia and China, improving regional geopolitical relationships
- **The investment will not negatively impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.** In fact, as described above, the combination of capital investment and strategic benefits of the proposed transaction will act to strengthen Rio Tinto's Australian businesses, facilitating their continued success and the success of the broader Australian community

# Appendix 1: Details of the specific arrangements regarding retention of control of Rio Tinto assets

As discussed in Section 8, the proposed strategic partnership between Rio Tinto and Chinalco will not result in Chinalco acquiring control of:

- Rio Tinto
- any of Rio Tinto's businesses, including any Australian business
- Rio Tinto's marketing operations

This is the result of specific arrangements agreed by Rio Tinto and Chinalco as part of the negotiations surrounding the transaction.

This appendix provides more detail on these specific arrangements.

More detail can be found in the agreements governing the transaction, available on the Rio Tinto website or on the ASX.

## No change in control of Rio Tinto

Chinalco will not acquire positive or negative control of Rio Tinto at the parent company level:

- If all of the convertible bonds are converted, Chinalco will hold an economic interest of only 18 per cent of Rio Tinto group equity (currently it holds 9.3 per cent)
- Chinalco may nominate two new non-executive board members, one of whom must be independent of Chinalco. The Rio Tinto Boards currently comprise 13 directors. The Chinalco nominees must be approved by the Nominations Committee, and by shareholders at the next Annual General Meeting
- Dealings with Chinalco must be on arm's length terms. A conflicts policy will ensure Chinalco directors do not vote on, or receive information in relation to, matters where there will be a conflict of interest (as determined by a committee comprising the chairman, the chief executive and the finance director)
- Chinalco and its board nominees will not be able to veto any decision of the Rio Tinto Boards
- As a listed company, Rio Tinto will continue to be subject to continuous disclosure and corporate governance obligations and to the usual disciplines of the market place. This will ensure continuing transparency and accountability

Rio Tinto has taken a leading role in Australia in relation to employee safety, community development (including Indigenous employment) and sustainable development and the environment. The proposed transaction, if implemented, will not alter Rio Tinto's

demonstrated commitment in these areas. Chinalco supports Rio Tinto's continued compliance with Rio Tinto's code of practice in respect of employment, sustainable development, and commercial practices ('The Way We Work'), ensuring ongoing reputational and operating benefits for Rio Tinto and Chinalco.

The Rio Tinto Group will continue to be managed as it is today independently of Chinalco and in the best interests of all shareholders.

## No change of control of Rio Tinto's Strategic Alliance assets or interests

Chinalco will not acquire positive or negative control of any of the proposed Strategic Alliances or any of the assets concerned.

- **Chinalco will receive an economic interest only**. In the case of the Australian strategic assets, Chinalco will not be acquiring an interest in the assets or shares; instead it will be acquiring synthetic instruments ('Tracking Notes') which give a return based on the cash generated by the strategic assets. Chinalco will not receive product in kind and all production will continue to be owned and sold by Rio Tinto companies (in which Chinalco has a 'synthetic' economic interest only)
- **Rio Tinto retains operational control.** A 100 per cent Rio Tinto owned company will be appointed as manager to operate each of the strategic assets and will have day-to-day operational control
- **Rio Tinto retains control of Strategic Alliance Committees and Boards of holding companies**. Chinalco will be represented on Strategic Alliance Committees and boards of the holding companies of strategic assets, but in each case Rio Tinto will retain decision making control because:
    - Voting is based on economic interests (with Rio Tinto having more than a 50 per cent economic interest in each strategic asset except Yarwun. In the case of Yarwun the Rio Tinto appointed Chairman will have a casting vote)[28]; and
    - All decisions are made on the basis of a simple majority vote, subject to very limited minority protection rights
    - The limited minority protection matters that require both Chinalco and Rio Tinto approval are:
        - Related party transactions, other than those on arm's length or usual Rio Tinto group terms
        - Winding up of a holding company within a Strategic Alliance

[28] In the case of the Boards of the Weipa and Yarwun holding companies, and the bauxite marketing company, there will be a review every five years which will determine whether the Chairman should be a nominee of Chinalco or Rio Tinto. Critically, for so long as Rio Tinto holds a 50% or greater interest, it will retain the right to appoint the Chairman unless otherwise agreed

  - Certain limited types of amendments to key Strategic Alliance Agreements, which go to marketing/management fee structures, or are otherwise adverse to Chinalco
  - In the case of Yarwun and Boyne/GPS only, sale or permanent closure of all or a substantial part of underlying operations/assets and financing of expenditure at underlying asset level, or granting of security by Rio Tinto or Chinalco over its interests in the Alliance

  This is a much more limited list of minority protection matters than would be found in most joint venture agreements. For example, it does not include any requirement or entitlement for Chinalco to approve annual programs and budgets, mine plans, capital investments or operating policies.

  The existence of these minority protection rights will not prevent Rio Tinto exercising operational and strategic control of the Alliances and the underlying assets.

- **No veto over expansions**. Chinalco does not have a veto over any expansion decision. Chinalco and Rio Tinto will each be required to contribute their economic interest share of the cost of any capital investment up to a defined amount[29]. Above that amount, Chinalco may elect not to fund its share of capital investment, but if it decides not to fund its share, its interest will be diluted accordingly. Chinalco has no ability to "sole risk" an expansion or otherwise cause an expansion to proceed without Rio Tinto approval
- **No veto over disposal of assets.** Chinalco does not have a veto over disposals of assets within a Strategic Alliance (other than disposal of all or substantially all of the Yarwun, Boyne or GPS underlying assets, as noted above)
- Chinalco does not have pre-emptive rights over any of Rio Tinto's interests in Strategic Alliances, other than in relation to Yarwun. Any exercise by Chinalco of pre-emptive rights in relation to Yarwun would be subject to any necessary FIRB and other regulatory approvals

As a result of the above, Chinalco will not be able to exercise 'strategic' or any other form of control or influence over any of the Strategic Alliances or relevant strategic assets.

## No change of control of Rio Tinto marketing

Chinalco will have neither the incentive nor the ability to exert downward pressure on commodity prices or otherwise control Rio Tinto marketing.

Chinalco is not a customer of Rio Tinto (other than making relatively small purchases of alumina). It is not a purchaser of iron ore at all. Chinalco's principal business involves the production and sale of bauxite, alumina and aluminium. Chinalco's objective will be to maximise the return on its US$19.5 billion investment. Although Chinalco is ultimately

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[29] US$250 million in the case of iron ore, US$150 million in the case of bauxite and US$250m in the case of the other aluminium Strategic Alliance assets.

owned by the Chinese Government, Chinalco operates independently of both the Chinese Government and other Chinese state owned enterprises.

In any event, Chinalco will have no ability to depress or influence commodity prices for the following reasons:

- Chinalco will receive a cash return on its Tracking Notes; it will not receive product in kind
- Rio Tinto will continue to be solely responsible for marketing all output from the strategic alliances, except that jointly owned sales companies would be appointed as Rio Tinto's sales agent to market (a) in China, 30 per cent of Hamersley iron ore production from the 100 per cent Rio Tinto owned mines subject to the iron ore Strategic Allicance; and (b) outside of Australia, with a focus on exports to China, 60 per cent of surplus Weipa bauxite[30]. It is important to note that the iron ore assets included in the Strategic Alliance represent around only 55% of all iron ore exports by Rio Tinto from the Pilbara. Today, well over 50 per cent of all iron ore produced from the wholly-owned Hamersley Iron assets is exported to China
- Although each joint sales company will be owned 50:50, the sales companies will ultimately be controlled by Rio Tinto as a result of a Rio Tinto appointed chairman having a casting vote at all meetings
- Furthermore, a 100 per cent Rio Tinto owned company will provide all marketing services to each joint sales company for the life of the arrangement, and will effectively be responsible for day-to-day marketing
- The jointly owned sales companies will have no role in relation to the setting of prices. They will not, for example, participate in iron ore benchmark price negotiations. Rio Tinto will retain sole control of the pricing of its products

The principal purpose of the joint marketing company arrangement is to enable Rio Tinto to leverage Chinalco's deep understanding of the Chinese market, to broaden its customer base and to grow its share of sales in China. The arrangement will enable this to be achieved without jeopardising Rio Tinto's control of marketing activities.

The joint sales arrangements are modelled closely on standard joint marketing arrangements for unincorporated joint ventures in the resources sector. Rio Tinto is a party to many such arrangements and has a proven track record of delivering value for its shareholders from existing joint ventures, including with customers. The limited joint sales arrangements for iron ore and bauxite proposed in this case are very similar to the sales arrangements in relation to Rio Tinto's Robe River joint venture, in which Japanese steel mills (Nippon Steel and Sumitomo), are amongst Rio Tinto’s partners.

In exercising its control of the joint marketing companies and carrying out day-to-day marketing activities, Rio Tinto will continue to have the same incentives and abilities that

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[30] i.e. 60 per cent of Weipa bauxite production that is surplus to the needs of Rio Tinto’s refinery system (both in Australia and overseas), including supply to joint venture participants; and existing supply obligations (including extensions and renewals).

it has today to achieve a full market price for its commodities and to maximise sales of its products to customers in all countries. Rio Tinto's Australian resources will continue to be marketed to all of Australia's trading partners.