HD **Digging beneath China's interest in Australian iron ore projects**

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The Australian iron ore industry is no place for the faint hearted. On April 11, Padbury Mining spectacularly announced billions in funding (reportedly backed by Chinese investors) to develop the Oakajee Port north of Geraldton in Western Australia's mid-west. This infrastructure would open up development of massive magnetite iron ore deposits in the State's mid-west, bypassing the bottleneck at existing port and rail facilities at Geraldton. Even more spectacularly, by April 30 Padbury announced it was all off.

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Clive Palmer's Sino Iron Chinese partners (CITIC) were no doubt miffed by his suggestions in February that he was defending Australian firms from being "raped and disrespected by foreign-owned companies". His joint venture relationship with Chinese State owned CITIC has been strained by cost overruns associated with the processing of low-grade magnetite into shippable ores at the mine site in the Pilbara.

These events have been unfolding in the context of some big moves in the price of iron ore. The price for 62% Fe iron ore delivered to the Port of Tianjin peaked at more than US$180 per tonne in late 2010 – during a Chinese Government economic stimulus program that required large amounts of steel. Since then the iron ore price has declined to around US$103 per tonne. While speculating on the future of commodity prices is little more than guesswork, the trend is clearly downward.

China's agenda

Last week Chinese state-owned Baosteel announced a surprise takeover offer for Aquila Resources (in conjunction with Aurizon as a junior partner). It is the latest of many investments in Australian iron ore by Chinese investors, most with close ties to the Chinese government. These investments are welcome, as the Australian economy's structural shortage of capital requires such foreign investment. However, it's worth pondering why there is such interest in Australia's iron ore industry by China, and what this might mean for the future.

China's steel mills – mostly state owned - purchase around 70% of the world's traded iron ore. China is expected to import 850 million tonnes of iron ore in 2014. To put this into context, Australia is expected to produce 610 million tonnes in 2013-14. The vast majority of Australia's production is from the Pilbara region of Western Australia, and most is "direct shipping ore" (DSO) – able to be dug up and shipped without processing.

In essence, the Pilbara has plenty of high quality ores that are cheap to mine and require little processing. Many of the large new projects - for example Padbury's - however are based on low grade magnetite ores that require significant and costly processing.

China is keen to see production grow, both from new DSO deposits and from processed (or beneficiated) magnetite. The reason for this is simple. For every US$10 per tonne drop in the iron ore price, the Chinese economy saves US$8.5 billion. The US$70 ore price decline since 2010 is thus saving China more than US$40 billion per year on current import quantities.

Is it too far-fetched to link these issues? Are Chinese state investors investing in new production primarily to lower prices, rather than to develop profitable mining operations?

Prices matter

The demand for iron ore is highly inelastic – at current prices iron ore accounts for around one quarter of the final value of steel, but the demand for steel is determined primarily by demand from the construction, infrastructure and manufacturing sectors. As a material with few substitutes, the consumers of steel tend to demand steel based on their need, rather than its price.

One aspect of free market economics that even nominal Communists understand is that increasing supply in markets with inelastic demand can in fact reduce overall revenues – in fact can **lead** to a situation where buyers get more of the product for less of their money. As such, upstream investment in unprofitable production can make economic sense in a convoluted manner.

A signal that this might be occurring would be new production being developed that would never be considered by rational investors, where the expected returns just don't justify the risks. One such investment was Clive Palmer's Sino **Iron** joint venture development. Original estimates suggested that this operation would require US$2.5 **billion** to bring to operation, although costs ended up being closer to US$10 **billion**.

As Palmer's ores require on-site processing prior to dispatch to **China**, ongoing operational costs are far higher than other Pilbara DSO **operations**. These costs, as well as transport and logistics, are perhaps as high as or higher than prevailing market prices. Even ignoring the requirement to repay the **billions** in "sunk'"capital investment, this project looks problematic. It would be very unlikely to be developed today.

The Sino **Iron** project, however, is old news, and problems there have been a long time coming. Is there evidence of more recent investments, with high operational and investment risks, that just don't make economic sense?

Watch what happens at Oakajee

To answer this, we can look to what happens next in Western Australia's mid-west. While the region east of Geraldton has plenty of direct shipping ores, it has vastly more lower quality magnetite. One big mid-west producer, Gindalbie **Mining**, has been making whopping losses **mining** and processing its vast deposit of low quality magnetite at Karara. Western Australia has even granted the **company** royalty relief - a sure sign of dire financial problems.

At current low world prices, **mining** and processing magnetite doesn't make a lot of sense. This will become even more true as massive new deposits come on stream, including Simandou in Guinea (West Africa), which could one day rival the Pilbara.

So if the Oakajee Port does get the go ahead in the near future, backed with **Chinese** funding as Premier Colin Barnett has predicted, that will be an ominous sign.

Should Australia care if **Chinese** state-owned enterprises undertake such investments? The Western Australian government will get their royalties and jobs will be created. Surely all development is good development?

Australia should almost certainly care. Governments need to build infrastructure that may become idle in future as supplies of ores from new regions come on stream. Australians will be dislocated as they relocate for jobs that are mothballed as high cost **operations** are closed. In short - there will be costs, and these costs will be borne widely.

Nil.

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