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HD **Iron ore is a giant game of chicken**

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Strategy The race is on to grab market share dropped by high-cost producers. Australian miners must move quickly to make sure Vale bails out first. Angus Taylor

The price of iron ore is on everyone's lips, and the obsession is warranted. For every drop of $1 per tonne, Australia loses about $600 million a year in revenue – and rising.

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Of that, $200 million goes to governments and the balance goes to shareholders. These are seriously big numbers and big stakes.

Ivan Glasenberg, chief executive of Glencore, is telling Rio Tinto's shareholders that their company doesn't get it and that a merger will fix the issue.

West Australian Premier Colin Barnett is telling us that such rampant expansion is unhealthy. Rio Tinto's Andrew Harding is reminding everyone that Rio's margins are very attractive, so extra volume is good.

The iron ore majors are engaged in a game of chicken, the likes of which has not been seen before.

The parameters are clear. We can still expect some solid growth in global demand for iron ore, but this isn't the real prize. In the coming months and years the price will settle at unprofitable levels for high-cost mines. Costly production, particularly privately owned Chinese mines, will exit the market.

As these mines inevitably close – and it will be painful – the surrendered volumes are an extremely valuable catch to low-cost producers and their host country. Questions remain over who gets to produce those tonnes.

The players are also clear. Rio Tinto and BHP Billiton have the advantage of well-prepared expansions in the Pilbara close to market. Vale, the Brazilian iron ore monster, has the lowest cost of production, but much further to ship to China.

Meanwhile, Rio can choose between expansions in Australia or Guinea in West Africa. The costs of other producers are too high to be relevant, with the possible exception of Fortescue Metals Group.Plenty at stake

The value of these expansions is enormous to Australia. If we can grab an extra 100 million tonnes it is worth close to $1 billion of recurring gross revenues, and at least $200 million in annual tax revenue. The expansions will require as much as $20 billion of investment – exactly what we need as other mining investment slows.

Game theory can shed light on such a game of chicken. First, the player with the lowest costs typically captures more of the market, as the French mathematician Antoine Cournot demonstrated in 1838.

All of the majors are pushing the envelope on costs, and telling us so. Vale is introducing supersized ships to address its distance from China.

Second, signalling your intention to "lock the steering wheel" will cause your competitors to "swerve" (in this context, halt or slow expansions). The economist Heinrich von Stackelberg worked this out in 1934. BHP has outlined plans to increase iron ore output by 65 million tonnes to 290 Mt by the end of 2017.

Rio Tinto, meanwhile, plans to ramp up output from its current 290 Mt to 330 Mt by 2015, not including its planned development in Guinea.

Third, the biggest producer, Vale – which has the most to lose – has blinked. No wonder Vale's director of planning has said "everyone is nervous about the iron ore price". None would be more nervous than Vale. Vale has the strongest incentive to slow global expansions, and despite extraordinary geological resources has been slow to expand, hindered by Brazil's complex licensing process.

Finally, secretly preparing to "swerve" (that is, to reduce production and expansions) at the last moment is typically smart for large players, so long as this really is a secret. But that requires flexibility far greater than Australia's current regulatory regime permits.Flexibility the way forward

So if Australia is to win this game, what do we need to do? We clearly need to stop jawboning Rio Tinto and BHP Billiton to halt their expansions. Doing so only gives our competitors a glimmer of hope.

We need to ensure that our producers are able to get their operational and expansion costs down. The government's focus on industrial relations in major development projects is important in this context. But more is needed.

Our miners need to be ready to move quickly and flexibly. This means reducing unnecessary regulatory constraints, as the government has done by streamlining environmental approvals. We must avoid any further risk of a cumbersome access regime coming into place, particularly given that our major producers are vertically integrated exporters.

And, of course, we have to avoid any risk of reintroducing the mining tax, with all the uncertainty that would create.

The Business Council of Australia has told us that we need an industry policy that builds on our competitive advantages. Policies supporting our biggest export industry to win do just that.

Angus Taylor is the federal member for Hume. He advised Australian and global organisations on strategy before entering politics.

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