TRENDS AND ISSUES IN THE RESOURCES SECTOR
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Introduction

Good afternoon my name is Chris Lynch and I am CFO of BHP Billiton. I would like to start by thanking our hosts for the invitation to speak to you today.

While this is my first visit to Kyoto I feel quite at home, surrounded as I am by so many of our customers and colleagues.

Of course, having customers in the audience makes my task doubly difficult. While my brief talk presents a picture of a sector in fundamentally good shape, I would stress that the fundamentals are very much a consequence of an extended period of consolidation. So for those in the room involved in negotiations this is a heads up on where we can go.

My presentation addresses three principal areas:

- Current structure of the resources industry
- Global outlook for commodity demand
- The impact on the Japan/Australia relationship of continued demand growth from China.

Current Structure of the Resources Industry

In 1990 the market value of the resources industry (excluding oil companies) was about US$ 150 billion. The industry was characterised by a large number of players and significant fragmentation. BHP, with a market cap of US $9 billion, was the largest. The top five companies represented less than 25% of the market capitalisation of the industry.

What is also interesting to note is that no one company was a truly global company or had real diversification in terms of their commodity mix.

The market capitalisation of the industry today is around US$300 billion – a low growth rate in anyone's terms.

BHP Billiton is five times larger than it was in 1990 with a market cap of US$44 billion, and the top five companies now account for 45% of the total value of the industry, nearly double the size of ten years ago.

This reflects the consolidation that has occurred during this period in the industry with the creation of major diversified mining companies such as Rio Tinto, Anglo American and BHP Billiton. The balance of the industry has essentially remained small and focussed on a single commodity or single region.

There are now two very different types of mining companies. The major companies are well capitalized and financially strong, characterised by a tight financial and capital discipline and driven as much by value as volume. The consolidation has also led to better supply side discipline within these companies.

By contrast, companies which are reliant on returns from single commodities traditionally maximise output when prices fall. This exacerbates the supply overhang and increases the volatility of the market creating uncertainty for both the customer and producer.

As a consequence the major companies are now focussed on the demand side of the equation and customer needs rather than the old model of dig and deliver where we were focused on production and hoped that the product found a market. Partnering with customers to provide a quality product at a competitive price in a reliable manner through commodity supply cycles is a positive development that will provide sustainable benefits to both parties.

Consolidation will, we hope, continue to reduce volatility, but ultimately we will always we driven by global demand for our products. So how do we see the world today?

Global Demand Outlook

Historically the **United States** has been the market that has set the pace for the rest of the world. While the US remains a very important market for our products, it is clear that demand is being led by Asia. The US has had three years of fairly low growth. It appears that confidence is increasing led by expansionary fiscal policies, in the form of lower interest and tax rates, and increased government spending. This increased confidence, however, has not yet produced increased investment and employment, which in our view, are the signs for true economic recovery. As a result, commodities demand from the US remains muted.

In **Europe**, we see a situation that lags the United States. While the European central bank has lowered interest rates, this has failed to create the desired environment for increased business spending. A general lack of growth, with some major European countries technically in recession, means that we don't foresee any pick up in demand in the near term. Of course, with a diversified portfolio such as our own there are always exceptions. The exception in Europe has been thermal coal where a very hot summer has caused the shut down of nuclear reactors and lower than normal hydro power, leading to strong demand for our South African and Colombian thermal coal into Europe.

I feel duty bound to report some good news, especially as it comes from my home country Australia. According to the IMF in its September 2003 World Economic Outlook, Australia will continue to be one of the fastest growing advanced economies in the world next year and grow by 3 per cent in 2003, before rebounding to 3.5 per cent in 2004. The IMF also expects the unemployment rate to remain low and inflation moderate and commented favourably on Australia's sound fiscal position, noting that public debt continues to be paid down.

Asia, and in particular **China**, has been the global growth engine for the past year, and is likely to remain so for some time to come. Chinese consumption now accounts for about 20% of total global consumption for many commodities.

China is showing the growth characteristics of the so-called tiger economies in other parts of Asia, and this has major implications. For example, the tiger economies doubled their per capita steel consumption in around 5 years – from around 100 to 200 kg. If China shows anything like this growth – and the use of per capita numbers for China can be misleading – it is clear that Chinese steel demand will be a lot larger than the current 200 million tonnes per year.

However, China looks more like the US than a tiger. That is – most of what China produces is for domestic consumption. Not surprising, perhaps, if you recognise that China has an urbanisation rate of some 4.5% a year. There is an immense requirement for basic infrastructure – roads, rail, pipelines, telecommunications and buildings.

Some of this domestic consumption has been a surprise. With the rapid growth in aluminium smelter construction in China, we were expecting to see around 1 million of tonnes of aluminium exported from China this year. In fact, exports are currently running at an annualised rate of less than half that figure and metal is not being stockpiled. This can mean only that the metal is being used internally.

Chinese demand is having a profound impact on other economies. Japan, South Korea, Taiwan and Australia all stand to benefit. For example, here in Japan, steel production has remained above 100 million tonnes a year despite stable domestic demand for finished product and in Australia we are seeing a number of expansion plans for iron ore and alumina output. The knock-on effect is likely to continue for some time.

Impact on our industry of continued Chinese demand growth

The phenomenal rate of Chinese growth is the key issue for the resources sector. The industry has not had to face such an issue in the past 30-35 years. From around 1950 to the late 1960s, the re-industrialisation of Europe and Japan and the consumer boom in the US led to real increases in demand and prices for mineral commodities.

If Chinese growth is re-creating this scenario, how should the resources sector react?

There is no complete answer but let me offer a few suggestions.

First, rapid commodity price increases are counter-productive. They reduce the profitability of producers' customers and ultimately reduce demand – sometimes very quickly. Strong price rises also encourage the development of second and third tier mining projects that would not be economic at normal prices, and probably should never be built. The problem with these projects is that once they are built they are usually run for cash and eventually hold down the market.

Second, the industry needs to ensure certainty of supply. Our customers should be confident that sufficient raw materials will be available at reasonable prices to meet their own expansion plans. The resources industry has woken up to the fact that boom and bust is bad. Steady and visible capacity growth underpins customer confidence.

Third, major producers are more likely to respond to Chinese demand at this stage through brownfield development rather than by building new projects. It is a great deal more capital-efficient to expand existing facilities by de-bottlenecking the various parts of the supply chain than it is to build a greenfield asset that requires new transport infrastructure. This allows producers to adjust more easily and flexibly to market fluctuations.

The message is that the resources sector – and in particular the Australian industry that has such a strong relationship with Japan – values long term markets and long term partnerships. Producers are only too aware of the dangers to all of us of the pursuit of short term gain at the expense of investment based on the solid foundations of established markets, mutual confidence between supplier and customer and efficient capital deployment.

This is the basis on which all of us need to approach this phenomenal Chinese demand. Australia and Japan have a common interest in servicing Chinese growth.

Conclusion

The last decade has seen a fundamental shift in both the capital base and structure of the resource sector. This has in part been driven by the need to respond to competitive pressures and volatile markets, but it has also been driven by a recognition by the major companies that they can no longer simply produce and sell. The consolidation of the industry reflects the understanding that they are in a partnership with their customers. A partnership in which their products not only meet customer needs, but investment in capacity matches demand cycles. This efficient use of capital and capacity will ensure that products remain competitive through time.