Shock and Ore

From Page 1

secrets. People close to the case note the opportunities for bribery that can present themselves in a climate of iron ore shortage and large price differences between contract and spot market purchases. Many say the Chinese Government is unlikely to have gone as far as it has without what it considers to be sound evidence that is prepared to publicly present. A trial is likely to proceed by early next year.

But the Chinese Government's initial framing of the case as one of "national security" suggests Rio and Australia may also have been caught up in a larger struggle for influence over China's 540 private and state-owned companies, which together produce more steel than the rest of the world put together. Steel, with its central, visceral place in China's modernisation and national mythology, can provide a proxy battleground for the path of Chinese development.

"This is about: do you let the market determine prices domestically and internationally or do you insist on political intervention? " David Goodman, a professor of Chinese studies at the University of Sydney, says. "How do you allocate resources, politically or economically? Within the leadership you can imagine the arguments going on between those calling for a more open political and economic system and others saying, 'You must not rock the boat.' "

The stakes at play in China's steel industry were illustrated in an investigative story this week about how the new manager at the Tonggang steel factory in north-eastern China was recently beaten and thrown from a building to his death. The manager had been appointed by China's richest steel entrepreneur, Zhang Zhixiang, who had been attempting to take over the inefficient state-owned company in line with a provincial government reform drive. But the old guard managers and their local supporters fought back. Would the disgruntled managers of a local state-owned company resort to murder in order to keep their jobs?

Rio Tinto's immediate problems began with BHP Billiton's takeover bid in November 2007. The event immediately steeled Chinese leaders to push back against what they saw as an Australian iron ore monopoly. And Rio responded to BHP's aggression with new aggressive marketing strategies, including diverting iron ore from long-term contracts to the more lucrative spot market.

Chinese steel mills were furious. Rio itself was divided on the long-term wisdom of hurting its considerable standing in China. "We acted in accordance with the letter of the contracts, but not the spirit," Stern Hu conceded in conversation with *BusinessDay* at the time.

The incarceration of Hu suggests Rio and the Australia Government may have underestimated the humiliation and legitimate economic anxieties that could be generated in a country that is so dependent on steel.

If there was a single turning point, it probably occurred at a conference room at Baosteel's sprawling factory and corporate headquarters in north-eastern Shanghai, on June 23 last year. It was there that the lead negotiator, Will Malaney, and his negotiating assistant and translator, Stern Hu – with Bauert giving instructions from backstage – secured a jaw-dropping 79 per cent price rise for iron ore "fines" and 96.5 per cent rise for "lump".

At 6pm, after four months of deadlocked negotiations and a tense four-hour stand-off in that room, Malaney and Hu jumped up and clasped hands with Baosteel's Ding Shouhu and the three members of Ding's team. They cracked a bottle of fine champagne.

For Ding, the spontaneous joy was borne of relief that his torture was finally over, seven days before the majority of China's iron ore contracts would technically expire. But Baosteel's public and political standing had crumbled because the costs of Chinese steel production, the nation's inflation problem and its nationalistic sensitivities had all been raised.

The initial relief and exhilaration at Baosteel headquarters subsided as one of the four Baosteel representatives in the room phoned both the China Iron & Steel Association and the Ministry of Commerce to get final authorisation. News leaked out between the cracks of China's political bureaucracy before Rio had a chance to tell the stock exchange.

It was an ominous interregnum that hinted at the turf wars to follow. Steel officials saw the opportunity to secure new political patrons and try to balance Australia's iron ore "monopoly" by marshalling China's buying power – something that Japan had done successfully in the past, if not in such heavy-handed terms.

It is not just the Ministry of State Security that has intruded in this year's iron ore wars. A new super-ministry of industry and information technology has supplanted the Ministry of Commerce. And Baosteel, the innovative national champion that understands how both politics and markets work, has been pushed out by the retired steel mill officials and bureaucrats who run the China Iron & Steel Association (CISA).

Steel executives and industry analysts enjoy nothing better than belittling association officials behind their backs. But influential Chinese analysts, such as the steel consultant and academic Xu Zhongbo, are now prepared to do it publicly. This is his appraisal of the association's secretary-general, Shan Shanghua, its deputy president, Luo Bingsheng, and its director of iron ore, Chen Xianwen:

"Shan was a director of steel planning initiatives in the past, when he was part of the Ministry of Metallurgy [now disbanded]. He has good experience for planning economics but not for international co-operation and business," Xu says.

"Luo is also a very stupid guy. If someone has a higher position than him, then he will always follow that position. And he can change his position very quickly. He did very poor work when chairman of Shougang [Capital Steel].

"And Chen Xianwen was director of iron ore purchasing at Wisco [Wuhan Iron & Steel Company]. But iron ore purchasing was an easy task five years ago; every iron ore miner wanted to make friends with him."

These three men, masters of a different era, have been endorsed this year to harness China's hugely fragmented steel industry and leverage their buying power. So far, the experiment has not worked.

Malaney, Hu and their boss, Ian Bauert, were no doubt bemused at the association's negotiating tactics. Rio would refer to what was happening in the underlying data about profits and production in the Chinese steel and iron ore mining industries. But negotiators across the table, including Chen Xianwen, would reply with political diatribes.

CISA negotiators across the table would reply with political diatribes.

CISA seemed to think that asserting steel production would slip would ensure that iron ore prices would also fall. These days Rio thinks China will produce about 570 million tonnes of steel this year, based on Chinese steel production and iron ore imports rising to new records almost every month.

But CISA has gone out of its way to ignore official public information – including the People's Bank of China's estimate that GDP grew 4 percentage points between the March and June quarters – to forecast 2009 production at just 500 million tonnes. CISA persists in arguing that this time, unlike every other year, it will be able to "control" the steel industry in accordance with Government directives by closing down small and allegedly inefficient mills and preventing new capacity from being installed.

In May the association missed its chance to follow Nippon Steel in agreeing to a 33 per cent cut in the benchmark contract price. The June 30 negotiating deadline came and went, and spot market prices soared higher.

Ironically, on July 6 the steel association held an internal meeting where it agreed to accept the Nippon Steel benchmark price subject to face-saving clauses that would allow them to renegotiate later if spot prices fell, according to senior Chinese journalists who spoke with the association's president, Shan Shanghua, that evening.

But news of the detention of Rio's Stern Hu broke the following day, July 7, before the association had an opportunity to inform the Anglo-Australian miner of its change of heart. Shan must have known about the Ministry of State Security's ongoing investigation – Rio's iron ore tendering results were being covertly supplied to CISA – but he evidently had no idea that Mr Hu and his colleagues had been detained.

If the detention of Rio's China iron ore team on national security grounds was a sign that China was drifting back towards central planning and tighter political control, then the downgrading of the Rio charges to stealing commercial secrets and receiving bribes may indicate the tide has since turned the other way.

China's leadership appeared to form the view that heavy-handed attempts to impose its will on the country's iron ore market was not working and not worth the costs to its international reputation.

Zhang Peihong, the lawyer for Rio Tinto's Wang Yong,said this week that China's top intelligence agency has handed the case to criminal authorities.

"The Ministry of State Security has handed the case to the Public Security Bureau," he said.

The politics of the Stern Hu case have largely been defused ahead of what may turn out to be relatively transparent legal proceedings. Rio Tinto's chief executive, Tom Albanese, said yesterday that "the grounds for [Hu and the others'] arrest do not seem to be as serious as first reported".

But Fortescue's Andrew Forrest gambled this week that the political winds continue to favour the steel association and its attempts to control the market.

"CISA was once viewed as a dog with a lot of bark. I think it is now viewed across China as a dog with a lot of bark and bite," Forrest told Australian journalists in China, after agreeing to a slightly larger price cut of 35 per cent on the condition of up to $US6 billion ($7 billion) in finance from an as yet undetermined Chinese institution.

Forrest said CISA has the political leverage to enforce the Fortescue price as the new benchmark price for all imported iron ore.

"There have been hundreds of other contacts and actions taken where there is a discipline being asked of steel companies to cease short-term profit-taking and encourage long-term price stability and move towards a uniform price," Forrest said.

"China's actions have gone way, way beyond Stern Hu."

But so far the big miners, led publicly by Rio, have ignored the Fortescue settlement and continued selling ore into China at the slightly higher price set with Nippon Steel.

This year's price negotiations are being seen as a costly debacle in Chinese industry circles, with the steel association wearing most of the blame. The drumbeat of discontent is getting louder.

A report this week by a Shanghai steel consultancy, Umetal.com, slammed the association's inability to comprehend economics. It pointed out that its 2 percentage point face-saving price deal with Fortescue would save China $US35 million, based on Fortescue's 10 per cent import market share, and contrasted this with the $US6 billion that the association had agreed to arrange to pump into Fortescue.

"The iron ore negotiations turned into a political struggle which China must win and cannot lose," the report said. "It is about the credibility of [CISA] in the whole industry. This is no longer about the simple issue of dozens of steel mills signs agreements with miners when prices are acceptable."

The Umetal report said that the Fortescue deal was an irrelevant face-saving deal for the association, as the big miners and Chinese steel mills were buying ore at the Nippon Steel price regardless.

"What is not important is that China gets the final say," it said.

Xu Zhongbo, the steel consultant, supports efforts to resist Australia's dominant market power. But he also believes the association has dealt itself out of play.

"This year CISA has lost power, it took too long to reach an agreement," he says. "Maybe next year Baosteel will have the power again."

Some reports say the decision has already been made to restore Baosteel's role as China's lead negotiator and boot aside CISA.

But CISA fought back this week and revealed the existence of "the State Council's No. 6 document", by which the cabinet-like body had empowered it to "prevent" speculative iron ore trading and "reasonably unify the price".

"It's not true that Baosteel will lead negotiations," a senior association source said yesterday. "Like this year, Baosteel will represent China to talk, under the lead of CISA, also with a group of China's 16 largest steel mills formed to make decisions."

But the iron ore wars are far from over and CISA is sticking to its guns.

Stan the Man knows his turf

GAMBLING

William Mellor and Chia-Peck Wong

ON A sultry June morning in Macau, the casino billionaire Stanley Ho strode into the Venetian, the gambling palace of his US rival Sheldon Adelson, and reflected on life, death and how not to succeed in the world's biggest gambling market.

For almost half a century, Ho, 87, has reigned as the king of gambling in the tiny island on the steamy South China coast.

Even when he lost his monopoly in 2004 he resisted the glitzy casino resorts of the Australian billionaire James Packer and the US moguls Adelson, Kirk Kerkorian and Steve Wynn.

Adelson's vision was particularly grandiose: He is spending $US12 billion to create a Vegas-style strip in Macau complete with a replica of his Nevada Venetian and its canals and singing gondoliers.

Ho was unimpressed. "The success of one market model cannot be migrated to another," he told an audience at an international gambling expo in Adelson's 3000-room Venetian, switching between English and his mother tongue, Cantonese.

"Ignoring Macau's special characteristics and duplicating a Las Vegas or an Atlantic City would not be a successful strategy."

Unnoticed by most Westerners in the audience, Ho, who has defied advancing age with daily swims and spins on the ballroom dance floor, uttered an aside in Cantonese that would prove prescient: "How many decades can a man live?" he asked rhetorically.

Two months later, Ho's role atop the Asian gambling haven that generated $US13.8 billion in revenue last year – more than Las Vegas and Atlantic City combined – took a precarious turn.

On August 4 Hong Kong's Adventist Hospital confirmed reports that Ho had been admitted for treatment. Nine days ago Ho's spokeswoman, Janet Wong, said reports that he had suffered a stroke were unfounded and he was progressing well. Neither of Ho's companies would comment.

In the absence of further details, investors scurried to study the sprawling Ho family tree – including Ho's 17 children by four different mothers – to determine who might take over.

An octogenarian who carried the Olympic torch in Macau last year, Ho has never announced a successor.

One obvious contender is his son Lawrence, whose Nasdaq-listed Melco Crown Entertainment, is 34 per cent owned by his Melco International Development and 34 per cent by Packer's Crown. The company owns two Macau casinos, including the City of Dreams.

Macau is key to Ho senior's strategy and so far it has dealt him a winning hand.

Adelson, 76, who arrived in the former Portuguese colony in 2004, has seen his plan to recreate the Las Vegas experience in the Chinese territory fall away. He has delayed construction on nine hotels and casinos, leaving swaths of the Cotai Strip covered by steel and concrete skeletons.

Kerkorian, 92, with his MGM Mirage, has amassed $US12.4 billion of debt worldwide, and his company reported a $US212 million net loss for the second quarter. Adelson and Wynn, 67, have announced plans to increase capital by selling shares in their Macau businesses on the Hong Kong stock exchange.

But Ho has so far managed to outfox the newcomers.

No glitz, no nonsense . . . Stanley Ho gives the Macau punters what they want. Photo: Reuters/Bobby Yip

In Macau, the 23.5 million visitors who came last year stayed an average of 1.3 nights, compared with three nights in Las Vegas, which augments gambling with Broadway-style shows and restaurants.

Macau's gamblers have been known to catch some sleep in massage parlours rather than pay for a hotel.

"When the Americans showed up, they thought they would literally reshape Macau like Las Vegas," says Alex Motola, at New Mexico-based Thornburg Investment Management. "The Macau audience is less focused on the ancillary things around gambling. Stanley, with his wealth of experience, understood that better."

'No matter how thorny the problem is, I will find a way through.' STANLEY HO

Now the Hos are struggling with a concern that vexes all family-run businesses, especially those in Asia, says David Webb, a shareholder activist and a former independent director of the Hong Kong exchange and publisher of Webb-Site.com.

"In Europe, many family companies have been around much longer," he says.

"There's an internal meritocracy that enables them to choose whoever is the best qualified cousin to be chief executive."

Ho's current companion, Angela Leong, 48, mother of his five youngest children, is one likely candidate to head the family empire SJM.

Three of Ho's daughters by his second wife hold top positions at another entity, Shun Tak.

Ho has also built a long-serving non-family management team headed by the SJM chief executive Ambrose So.

But first, Ho's women, children and siblings will have to get along."There has been serious family feuding," says Steve Vickers, Hong Kong-based chief of FTI International Risk, who has performed investigations for Macau investors.

"Stanley Ho was the magma that held the tectonic plates together," he says. "I don't think any one of his wives or children will be strong enough to operate in the way he did."

Ho's family also has to navigate the challenges confronting all of Macau's gambling tycoons. Next year two casinos will open in Singapore – one of them Adelson's $US5.25 billion Marina Bay Sands – to attract high rollers that account for two-thirds of Macau's annual revenue.

At the same time the global recession is squeezing gambling worldwide. In the first six months of this year Las Vegas Strip casino revenue fell 15 per cent, adding to what had been a record 11 per cent decline last year.

Macau's gambling revenue dropped 10 per cent in the first seven months of this year, in part because of visa restrictions. Atlantic City's revenue was down 15 per cent.

In his office high above one of Hong Kong's trendiest nightlife districts, Lawrence Ho ponders the impact of the gloomy economy on his City of Dreams. The mega-casino, across from Adelson's Venetian on the Cotai Strip, opened on June 1. That was two months before the economist Paul Krugman predicted that a global recovery would take two years or more.

On the plus side, the younger Ho says, it is good to be up and running when your rivals are hurting. The downside? "If City of Dreams doesn't open well, it's the endgame for us."

So far the signs are that Ho and Packer may keep their shirts. After a June when high rollers made too much money, the house won more of the bets placed last month and early this month.

Stanley Ho has not had such worries because he did not go for the glitz. Ho says thrift and local know-how leave him in good shape.

"Macau is limited in size and land is expensive, so gaming and leisure development must be more efficient," he wrote. "We follow a very conservative financial strategy. No matter how thorny the problem is, I will find a way through."

Bloomberg