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Cai, Yuan

From: Rosser, Mike
Sent: Wednesday, 23 September 2009 10:09 AM
To: Barrett, Chris (Treasurer's Office); Lee, Janice; Colmer, Patrick
Cc: Callaway, Andrew
Subject: Lynas EM ~~[SEC=IN-CONFIDENCE:COMMERCIAL]~~
Attachments: SD EM Lynas & CNMC - final to Treasurer 23 September 2009.DOC

Importance: High

Security Classification:
~~COMMERCIAL-IN-CONFIDENCE~~

Chris, latest draft attached - see page 2 for discussion of 49.9 and less than half of the directors.

We will call you shortly.

mike

23 September 2009
File: F2009/02742

Treasurer

cc: Assistant Treasurer

CHINA NONFERROUS METALS MINING GROUP CO., LTD — ACQUISITION OF 51.66 PER CENT OF LYNAS CORPORATION LIMITED

Timing: The statutory deadline is 2 October. However, the parties seek your early consideration to facilitate recommencement of the Lynas Project.

Recommendation: That you:

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  CNMC a willingness to consider a proposal for a smaller percentage.

Agreed/Not Agreed ...../...../2010

KEY POINTS

- The ASX listed Lynas (market capitalisation, $498 million, up from $90 million in February) is developing a rare earths mine at Mount Weld, near Laverton in WA, including a concentration plant at the mine and a processing facility in Malaysia. The GFC led to its debt providers withdrawing support and the February suspension of construction work.

- Lynas sought new financial backers and on 30 April the Chinese SOE CNMC agreed to acquire a 51.66 shareholding and four of eight board seats in exchange for $252 million as well as debt guarantees for China sourced project debt funding of US$184 million. CNMC has agreed to support Lynas' marketing strategy, which does not include selling into China. Lynas' share price has rebounded to 76 cents, double the 36 cents payable by CNMC.

The proposal raises the following three issues for consideration.

1. Security (and/or control) of international supply

- China is the dominant supplier of rare earths with 97 per cent of world production. s33

- Australia's two new rare earths projects when at full production would double China's expected export quota and be the only near term alternative sources of supply for non-Chinese users (in May another SOE received approval to acquire 25 per cent of Australia's other new producer, Arafura Resources - Minute 2009/1309).

- Concerns have been raised by international users and commentators that control of Lynas would s33 This would be inconsistent with the Government's policy of maintaining Australia's position as a reliable supplier to all our trading partners and hence potentially contrary to the national interest.

The possible options are:

a) Outright rejection; or

b) Approval based on undertakings from CNMC and Lynas (adherence to these could be made a condition under the *Foreign Acquisitions and Takeovers Act 1975* (the **FATA**); or

c) Approval of a lower percentage shareholding (for example, up to 25 per cent); or

d) Export controls.

Undertakings

- We explored undertakings CNMC and Lynas could provide that could deal with the issues raised by CNMC control of Lynas allowing China to further control of the rare earths market. Any undertakings would need to be publicly credible, practical, not unnecessarily intrusive into the company's affairs and, of course, effective. If they were ultimately ineffective, their acceptance as conditions would attract local and international criticism on the Government.
- The objective of the undertakings we explored was to ensure Lynas markets its product on an arm's length basis with non-Chinese buyers able to access it. Such undertakings would also ideally deal with the potential that arises, whether or not CNMC is a shareholder, for Chinese buyers to offer higher prices than other buyers, to corner the market.
- We also explored limiting CNMC's role in Lynas' corporate governance by removing its voting role in appointment of the non-CNMC nominated directors so the nominated individuals were not effectively subject to CNMC's pre-approval.
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- We have written to CNMC asking that it consider also undertaking limiting its shareholding to no more than 49.9 per cent, fewer than half of its board seats and that loans arranged for Lynas not have equity characteristics.

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- CNMC may not agree to these even though the deal would remain commercially very attractive and as mentioned they would have only negligible practical impact on its capacity to control Lynas. It may however, soften its position if it understood that an approval required these undertakings. Undertakings offered by CNMC/Lynas and those we initially suggested are at Attachment A.
- Notwithstanding the prospect of it agreeing to undertakings, having considered their practical benefits, we do not consider any undertakings formulation could reliably manage the risks. The Foreign Investment Review Board also considers that undertakings cannot address the national interest issues. Consequently, instead of pursuing undertakings, we recommend rejection of the current proposal if you consider it would be contrary to the national interest for it to proceed.

Approval of a smaller percentage level

- We could advise CNMC that the Government would only be willing to consider a proposal that involved a smaller percentage shareholding (such as 25 per cent which another SOE has taken in Arafura). A lower shareholding would provide a level of assurance that undertakings could not by reducing CNMC's voting power and its capacity to control the company.

  – With 51.66 per cent (or even just under 50 per cent), CNMC would hold a FATA 'controlling interest' in Lynas and therefore any further acquisitions may not enliven your rejection or condition-making powers. Consequently holding CNMC at this or a lower level, or imposing conditions would need to be done now.

  – Should rejection or indicating to CNMC a willingness to consider a proposal for a lower percentage be pursued, for procedural fairness reasons we would seek CNMC's comments and a final decision should have regard to these.

- We note that if the current or a replacement proposal does not proceed there is a real likelihood that the Project will be delayed, possibly for some time while replacement funding is sought. This would result in a reduction in jobs in WA: 200 construction and 90 ongoing (the other jobs are in Malaysia for the refining plant: 1,000 construction and 300 ongoing).

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- Lynas' share price has however risen to double the price agreed with CNMC for the shares it is acquiring (now 76 cents with 36 cents payable by CNMC). While alternative capital providers were not available to Lynas earlier this year at the low point of stock markets in February/March, there has been a significant recovery since in markets and commodity prices. Consequently, given the Project's fundamental commerciality due to rising demand and very limited Chinese supply, alternative funding should be available, albeit after a delay.

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Export controls

- We do not recommend the Government directly imposing export controls or having Lynas voluntarily embedding such controls in its company Constitution. Such moves would have reputational and other risks for Australia and be inconsistent with our WTO obligations and trade liberalisation stance (see Additional Information).

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- The percentage sought is based on a debt/equity funding split agreed between the parties and a stated commercial desire for a controlling interest (i.e. more than 50 per cent) to facilitate CNMC guaranteeing debt funding and securing Chinese regulatory approvals. [s45]

- This proposal follows approvals ( ) where more than 50 per cent was approved based on case by case considerations reflecting the dire financial situation faced by the target and the expected flow-on impacts on the communities involved. In contrast, this proposal will lead to the creation rather than the preservation of jobs but the majority of these will be in Malaysia and less than 200 in Australia (80 per cent of funding is to build the Malaysia processing plant) and mine output would mainly be used by overseas manufacturers.

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Executive Member
Foreign Investment Review Board

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ADDITIONAL INFORMATION

Security of supply

1. Rare earths are important in a wide range of manufactured technological items such as fluorescent lights, superconductors, miniaturised magnets, rechargeable batteries such as in hybrid cars, and computer and TV screens. China dominates global supply treating rare earths as a strategic resource. It does not allow foreign ownership of the sector but does encourage manufacturers to establish in China allowing access to cheaper local supplies. Its recent draft six-year industry plan foreshadows further export restrictions and total bans for some rare earths.

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2. The EU and US have undertaken preliminary talks with Chinese officials to determine whether to launch a WTO challenge to Chinese policy restrictions on trade in rare earths. s33 DRET has provided some information that is relevant to these issues: see Attachment C.

Export controls

3. We have also considered the feasibility and effectiveness of Australia adopting export controls in relation to rare earths, including the possibility of requiring vetting of rare earths off-take contracts for compliance with the arm's length pricing principle.

- Australia has export restrictions on uranium ore concentrates and rough diamonds. These exist solely to help ensure Australia's compliance with various international treaties and Australian Government policies. They play no role in facilitating trade outcomes or domestic industry policy objectives.
  - Uranium: export restrictions reflect Australia's obligations under the Treaty on the Non-Proliferation of Nuclear Weapons (NPT) and Australian Government policy to only allow the export of uranium to countries which observe the NPT and which are committed to non-proliferation and nuclear safeguards.
  - Rough diamonds: export restrictions reflect Australia's obligations under the Kimberley Process Certification Scheme (restricting the international trade of conflict diamonds).

4. While not ruling out export controls as an option, based on advice from DFAT and DRET, such a move would require detailed and careful consideration due to the significant reputational and other risks for Australia.

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- It may not be consistent with Australia's WTO obligations and would be open to public challenge, as well as being counter to Government policy on trade liberalisation. Other risks include damage to our diplomatic and trade links.

Proposed holding greater than 50 per cent

5. CNMC has stated that in consultations with Chinese and global financial institutions it has been advised that it must at a minimum make an equity investment equal or greater to the debt that it will guarantee.

6. On the proposed debt guarantees, CNMC has advised that its board would not approve the proposal if not a majority shareholding and that it needs to maintain a 50 per cent or more interest in

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order to consolidate this into its Group accounts. It has also stated that even though Chinese law does not expressly prohibit the provision of debt guarantees to an associate (i.e. less than 50 per cent owned subsidiary), in practice, it would not obtain approval from NDRC, SASAC and SAFE to provide the guarantees. In addition, it has indicated that such a holding would be more likely to enhance its ability to support Lynas' growth through future investment.

7. CNMC advised that there is no commercial rationale for it to make an equity investment unless the Project is fully funded. It also advised that a smaller percentage interest would represent a commercially different proposition that would require it to renegotiate the commercial terms, and may compromise any investment by it in Lynas.

- While a smaller percentage interest may reduce the commercial attractiveness to CNMC of proceeding and the provision by CNMC of debt guarantees may be blocked by Chinese regulators, there are no examples that we are aware of that either support or counter CNMC's assertion that Chinese regulators would block the proposal were it altered.
- Chinese banks have provided project debt funding in the absence of debt guarantees from the Chinese partner, with security against the Australian business and/or its project as the sole recourse in the event of default (e.g. [redacted] s45 [redacted]
- CNMC does not dispute that it would most likely acquire control with a lower percentage holding (i.e. Lynas would have no other substantial shareholders).

8. Lynas' Project is a greenfield development project [redacted] s45 [redacted] However, we note that case by case consideration is given to each investment proposal. Lynas states that the CNMC proposal is the only realistic short to medium term source of replacement project funding. This is a commercial judgement that is difficult for us to dispute, although we note that the stock markets have recovered significantly since their February and March lows when Lynas first sought replacement funding.

[redacted]

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ATTACHMENT A1

UNDERTAKINGS OFFERED BY CNMC AND LYNAS

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ATTACHMENT A2

UNDERTAKINGS PROPOSED TO CNMC AND LYNAS BY TREASURY

ATTACHMENT B

PARTIES TO THE PROPOSAL

China Nonferrous Metals Mining Group Co., Ltd (CNMC)

1. CNMC is a Chinese SOE under the State Owned Assets Supervision and Administration Commission of the PRC State Council (SASAC). It is a large nonferrous miner with operations in mainland China, Burma, North Korea, Mongolia and Zambia. The CNMC Group states that it does not sell rare earth materials. Its only Chinese rare earths interest is an indirect interest in a Chinese smelting and rare earths processor (CNF owns 71.75 per cent of Zhujiang Rare Earth Co., Ltd).

2. China Nonferrous Metal Industry's Foreign Engineering and Construction Co., Ltd (CNF), a Shenzhen listed widely-held entity in which CNMC holds 33.34 per cent, was recently granted approval to acquire 11 per cent of the ASX listed [redacted] s45 [redacted].

Lynas Corporation Limited

3. Lynas is a significant potential Australian participant in the global rare earths industry. Lynas currently has 45 employees. Its high grade rare earths deposit at Mount Weld [redacted] s45 [redacted] accounts for over half of Australia's reserves or 1 per cent of global reserves. Its estimated production will be equivalent to 60 per cent of China's 2008 rare earths export quota. Lynas is continuing exploration around its Mt. Weld open pit, with the surrounding areas known to contain a higher distribution of heavier and higher value rare earths. Lynas also owns a lower grade rare earth deposit in Malawi.

4. Lynas also has a polymetallic deposit at Mount Weld (rare metals for which no JORC resource has been defined). It intends to conduct a feasibility study on the latter after it completes the development of its rare earths Project. It has stated that if proven economic, the resource could account for 20 per cent of global supply of Niobium (75 per cent currently supplied by Brazil and 7 per cent Canada), an element that used in small quantities improves the strength of steel. [redacted] s45 [redacted]

5. Lynas' substantial shareholders are the US JP Morgan Chase and Co (6.9 per cent) and Capital Group (6.7 per cent). In the absence of alternative financing, Lynas has indicated it expects its cash to be exhausted by end October, with a risk that the company will not remain as a going concern due to liabilities associated with the currently suspended construction associated contracts.

RARE EARTHS

China the dominant player and restricting supply to the international market

6. China dominates the supply side of the rare earths market, accounting for around 97 per cent of global supply. The main consumers of rare earths are China, the US, Japan, Korea and Thailand, with China reportedly consuming about 60 per cent of its rare earth production.

7. [redacted] s33 [redacted] in 2007, Lynas decided to switch its proposed processing plant from China to Malaysia. [redacted] s33 [redacted]

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Potential Australian production

8. Australia's two potential projects (Lynas and Arafura Resources) at target full production would be equivalent to 123 per cent of China's 2008 rare earths export quota and thus would be an important source of supply for end-users outside of China. See 'Consultations' in Attachment C.

MOUNT WELD PROJECT

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ATTACHMENT C

CONSULTATIONS

AGD, the ACCC, ASIC, ASIO, the ATO, Austrade, DFAT, PMC (ONS), Defence and the WA Government were consulted raising no objections. DRET and DFAT's comments included:

DRET:

'According to Geoscience Australia (GA), Australia's Economic Demonstrated Reserves (EDR) of rare earths is 1.65 million tonnes, equating to 1.98 per cent of estimated world EDR of rare earths. Of this, Mt. Weld accounts for 50 per cent of Australia's EDR, with 0.829 Mt at a grade of 12.65 per cent.

The two main players in Australian rare earths mining are Lynas (Mt. Weld deposit) and Arafura Resources (Nolan's Bore deposit), accounting for a combined 80.9 per cent of Australia's EDR of rare earths. Other players in the industry include Navigator Resources, Red River Resources, Alkane Resources, Uranium Exploration Australia, and Capital Mining.

China dominates the global rare earths market, with approximately 96.8 per cent of global rare earths production, and consumes about 60 per cent of production.

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Defining rare earth deposits as a strategic asset

Demand for rare earths for use in high end technological applications is expected to increase considerably in the near future. Access to non-Chinese sources of rare earth products is highly prized and likely to become more important for high tech manufacturing industries located in North East Asia, Europe and the US. Ensuring that Australia is able to be a supplier of rare earth products into the future would be consistent with Australia's overall resource export policy objective of remaining a stable and secure supplier of mineral resources.

If demand increases as it is forecast to increase and s33 access to domestic sources of rare earths for export could become strategically important. If FIRB determines this to be the case, there could be scope to investigate undertakings that would enhance Australia's capacity to retain some level of control over the development, processing and use (including sale) of rare earth resources. The following may assist in FIRB's consideration re: whether rare earth deposits in Australia could be categorised as strategic assets.

Export revenue: Rare earth concentrate has been produced in Australia (Mt. Weld) in the past but in small quantities and sold at prices which are unlikely to reflect future long term prices for rare earth products (assuming sustained higher future demand and limited non-Chinese supplies). We are currently unable to provide a quantifiable value of Australia's rare earth resources and potential contribution to Australia's export earnings into the future. Nor do we currently have data on Australia's projected share of the global rare earths market in the near future. Work with GA could be undertaken to progress this if necessary. Projections would need to be undertaken on future prices along with the likelihood of future project development (s33) and expected tonnages.

Domestic applications: Domestic demand for rare earth products is currently limited. DIISR informally advises that Australia is currently pursuing a number of manufacturing activities involving hybrid and electric vehicles e.g. Hybrid Camry and a number of small operations that retrofit motor vehicles with electric drive-trains. However, DIISR noted that the components requiring rare earths will generally be imported as a finished product for use in the assembly process/conversion here. Given the IP sensitivities surrounding these applications, it is likely that IP owners would not readily consent to the manufacturing of hybrid vehicle components in external markets including Australia. Hence, the importance of a readily available source of rare earth products for domestic automotive manufacturing applications is marginal. At this stage we have not undertaken consultation with other policy areas re: the importance of rare earth product supplies to manufacturing activities for TVs, fluorescent lights, petroleum refining and defence applications.'

<u>DFAT</u>:

'There are no WTO disputes currently on the horizon related to Chinese measures affecting the exports of rare earths. The US and EC have begun dispute settlement proceedings against China on Chinese measures affecting the exports of a range of raw materials, but the scope of the dispute does not include rare earths. [s33] (Incidentally, the fact that there are no WTO challenges at the moment to China's restrictions on rare earths does not, of course, necessarily mean that those restrictions are all WTO consistent.)'

FOREIGN INVESTMENT POLICY

The proposal is subject to the FATA as a foreign person is proposing to acquire a substantial shareholding in an Australian corporation valued at more than $100 million. If the applicant would be in a position to determine the control of the target company and it was decided to be contrary to the national interest, action to either prohibit the proposal or attach ameliorating conditions would be available under the FATA.

Under the foreign investment policy, direct investments by foreign governments and their agencies require approval irrespective of size. Such investments are considered with reference to principles that reflect issues that may be raised for some foreign government investments (see <u>Attachment D</u>).

Under the foreign investment policy, approval is normally only given for a specific transaction which is expected to be completed in a timely manner. If an approved transaction does not proceed at that time and/or the parties enter into new agreements at a later date, or if a transaction is not completed within 12 months, further approval must be sought for the transaction. Under the Treasurer's authorisation, the proposal cannot be dealt with by the Department.

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ATTACHMENT D

EXAMINATION AGAINST THE GOVERNMENT'S GUIDING PRINCIPLES FOR FOREIGN GOVERNMENT RELATED INVESTMENTS

1. An investor's operations are independent from the relevant foreign government

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2. An investor is subject to and adheres to the law and observes common standards of business behaviour

CNMC is subject to regular independent audits of its finances and activities in accordance with China's auditing and accounting standards. CNMC states that it complies with applicable laws, operates as a commercial concern, and observes common standards of business behaviour.

We have no specific information to suggest that CNMC does not adhere to laws or observes common standards of business behaviour. While questions have been raised over CNMC's Burma operations, there is insufficient information to sustain allegations going to its corporate conduct.

3. An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned

Concerns have been raised about this proposal together with the recent acquisition by another SOE of a 25 per cent interest in Australia's other potential producer Arafura Resources.

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CNMC has publicly committed itself to support Lynas' business model, which is to complete its Mount Weld project and become a reliable alternative source of supply to China. While undertakings have been explored, we have concluded that they would not be able to exclude the possibility that Lynas' production could be controlled to the detriment of non-Chinese end-users.

We do not consider export controls are a viable alternative in dealing with the issues raised.

4. An investment may impact on Australian Government revenue or other policies

The construction and commissioning of the Mount Weld Project would be expected to increase Australian revenue, through company profits, increased employment and Project royalties.

The proposal will not affect Lynas' Australian tax residency status. It is likely to reduce Lynas' debt levels and debt servicing costs with it holding less debt and having lower interest costs that the former bond funding. The level of withholding tax that would be applicable to the distribution of future dividends by Lynas to CNMC will be dependent on the investment holding structure to be adopted by CNMC (which is yet to be decided).

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5. An investment may impact on Australia's national security

This proposal does not appear to impact on Australia's national defence or security. However, it raises issues about free trade and supply of important manufacturing input materials and the economic security of such materials. The resources in question are rare, expensive and in short global supply outside China reflecting its export controls and also low production levels.

6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community

CNMC has publicly stated its support for Lynas' current business model. Its investment will allow Lynas to recommence development of its Project and remain a going concern, bringing benefits to the WA community and existing Lynas shareholders, as well as potentially providing an alternative source of supply over the medium to longer term for non-Chinese end-users of rare earths. Much of the proposed Project investment is offshore with the majority of jobs to be located in Malaysia.

In the absence of this proposal, the Project would have remained undeveloped until alternative financial backers could be secured. The stock market has recovered significantly since Lynas lost its previous bondholder funding with Lynas having sought replacement funding in February and March when global stock markets were ate their lowest point. Given the Project's fundamental commerciality due to rising demand and restricted Chinese supply, alternative funding should become available, albeit after a delay.