

Norilsk Nickel in the Global Economy

Keynote welcome address by Denis Morozov, General Director, MMC Norilsk Nickel, at the EuroNickel Conference, Moscow, 8-9 April 2008

Introduction

Good morning, ladies and gentlemen. I should like to add my welcome to that of the organisers, Informa Group. Both to EuroNickel and to Moscow. Norilsk Nickel is delighted to be the principal sponsor of what the brochure informs us is the 'first ever international nickel event in Moscow'.

The holding of such an important global industry conference in Moscow marks just one of the many ways in which the global economy - and our industry - are changing.

Russia today

Many of you will be aware that ten years ago, in 1998, the Russian economy hit rock bottom, suffering a major financial crisis. The crisis prompted a series of reforms and measures for market liberalisation that stabilised the economy and provided the foundations for rapid economic growth.

Since that time, the Russian economy has grown at an average rate of almost 7% a year. Last year, it recorded growth of 8.1% and, this year, forecasts are for growth of around 7%. Russia's economy is now the seventh largest in the world, when GDP is measured using purchasing power parities.

Since 1997, Russia has been a member of the G8 and it is currently working towards membership of the WTO. Its foreign currency reserves, at \$480 billion, are the third largest in the world after China and Japan. Not bad for a country that was effectively bust only a decade ago.

With disposable incomes in Russia growing twice as fast as the economy as a whole, Russia's consumer markets are on fire. Unlike some of their counterparts in Asia, Russians know how to

spend – as you may have noticed. It is estimated that there are now some 85 million Russians with material spending power. This makes Russia potentially the largest consumer market in Europe.

For small-ticket items, such as washing machines, mobile phones, fruit juices and beer, where companies have been able to solve the distribution challenges, Russia is already Europe's largest market. For bigger-ticket items like PCs and cars, Russia is typically the fourth largest European market but, if present trends continue, will become the first or second largest market in the next couple of years.

Investment in the Russian economy has also been powering ahead, achieving a growth rate of 21% in 2007.

The strength of domestic demand, as represented both by consumption and investment, coupled with the existence of a government budget surplus and its large foreign currency reserves, should permit Russia to maintain its growth, even as the global economy slows, as it seems likely to do in 2008. This prospect is encouraging more and more foreign companies to come to Russia.

Although you wouldn't necessarily guess it from negative press coverage of Russia and its diplomatic relations, foreign direct investment rose to a record high of \$28 billion in 2007. This made Russia the second largest recipient of inward FDI amongst the emerging market economies after China, and a larger recipient of FDI than the UK, Germany, Italy or France. It is not just this conference, but it seems that the world wants to come to Russia. At the same time, Russian companies want to go abroad and invest elsewhere in the world, so outward investment from Russia is also rising steeply.

Mineral commodities have, of course, played a key part in the revival of Russia's economic fortunes. Oil and gas have been the biggest contributors to be sure, but the mining and metal sectors have also played their part. For pretty much any metal you care to name - nickel, copper, aluminium, gold or iron ore – Russia's production has been on the increase since 1998. And revenues, of course, have also been given a lift by the extraordinary strength of mineral and metal prices since the early 2000s.

To maintain momentum in the development of its mineral resources, Russia clearly needs massive investment. It may be the world's largest country, and it may host enormous mineral wealth, but the fact is that Russia's mining sector has been chronically underinvested for very many years. Moreover, the infrastructure needed to develop its resources and to get the mineral product to market is also woefully underinvested.

However, investment is coming. The government has said it is preparing to commit \$200 billion to the development of Russia's roads, rail, pipelines, ports, power plants and transmission lines over the next few years and is looking to the private sector to contribute \$800 billion more. Foreign investors are expected to play a part in this.

It takes a while, of course, for investment in the minerals sector to bear fruit. The process is, nevertheless, under way and the evidence suggests that Russia is once again beginning to attract the sort of exploration and investment interest that you would expect given the country's size and mineral endowment.

According to the annual survey of exploration expenditure conducted by Metals Economics Group, Russia last year attracted over \$600 million of exploration spending, making it the fourth largest target for exploration spending in the world after Canada, Australia and the USA. In 2001, just six years previously, it was in fifteenth place. Norilsk Nickel accounted for over \$100 million of this spend in Russia, both in projects it is undertaking on its own, and in projects it is doing in joint ventures with Rio Tinto and BHP Billiton. Amongst the projects it is currently looking at are two interesting large nickel-bearing deposits at Kingashskaya in Krasnoyarsk and at Iysko-Tagulskaya in Irkutsk.

In late March, the Ministry of Natural Resources said it was proposing to spend 544 billion rubles – equivalent to around 23 billion US dollars - on mineral exploration by 2020, with about half of this going to hydrocarbons. This is more than twice what it was proposing to spend under the previous, 2004, plan.

The transformation of global metal markets

While Russia has been busy rebuilding its economy since 1998, so over the same period the shape of the world's commodity markets have been being transformed by developments in Asia, and notably China. Largely as a result of the rapid growth in this region, the emerging and developing market economies collectively now account for almost half of global GDP according to the most recent data from the IMF. Moreover, because of the investment and export intensive nature of this growth, these countries have accounted for effectively *all* the growth in global metals use over this period. This is a change of simply massive proportions - an historical watershed. And it is only beginning.

Reference has already been made to the extraordinary impact of China at this conference and before it is over there will no doubt be many more. In truth it is difficult to exaggerate the scale of this impact and the speed of its arrival.

Just consider the following. China has this year completed the construction of the world's largest airport at Beijing - the terminal building is three kilometres long and covers an area the size of one hundred and seventy football pitches - and is currently nearing completion of the longest sea-crossing bridge in the world, a 36 kilometres span across Hangzhou Bay, linking Ningbo and Shanghai.

There are plans in place to expand China's railway network, which is becoming a major constraint on the country's growth, from 78,000 kilometres to 120,000 kilometres by 2015. This is the biggest expansion of railway capacity undertaken by any country since the nineteenth century. In 2008 alone, \$42 billion have been allocated to the project. Further, the government has this year announced that, to meet the soaring demand for air travel, it plans to add another 97 airports by 2020 to the 142 that already exist in China.

Such investment projects, along with the rapid expansion in residential construction and in the markets for consumer durables, are having a profound impact on the market for metals. At the start of this decade, China was a minor consumer of nickel, accounting for a mere 4% of world nickel use.

Today, helped by rapid growth in the production of stainless steel, China accounts for 24% of world nickel use. Output of stainless steel has grown at over 40% a year since 2000 and in 2007

stood at around 7.5 million tonnes. In 2008, it should be close to 9 million tonnes, with domestic demand for stainless steel being of roughly similar scale.

Impressive as this growth is, however, there are two cautions for nickel producers that should be noted. The first is that, while the primary driver of China's growth in stainless steel production has come from the internal market, some of it has undoubtedly come at the expense of producers elsewhere in the world. And this pressure on producers elsewhere is increasing, not least in Europe.

The second is that rather more of the production in Asia than we would like is coming from no-nickel, ferritic, grades of stainless steel and rather too little from high-nickel, 300 series, products. This is a worrying development and something that the nickel industry clearly needs to be aware of and respond to. In particular, we need to be concerned that the underperformance of no-nickel and low-nickel grades of stainless steel in demanding applications where 300 series products represent the optimal solution may have negative impacts on the perception of *all forms* of stainless steel, including high nickel variants.

The transformation of Norilsk Nickel

It is against the background of this transformation in global markets for metals and the transformation of Russia's economy over the past few years that Norilsk Nickel has been busy re-inventing itself as a modern, transparent, global mining and metals company.

The company, Norilsk Nickel, is based around what is truly one of the great ore bodies of the world. God must, however, have a sense of humour, since he chose to put this ore body in one of the most remote and climatically challenging corners of our country.

As historians amongst you will know, Norilsk Nickel had a long, productive, though sometimes traumatic, history as a Soviet state enterprise. As General Director of the company, I am mindful of the remarkable people who established its mines and metallurgical plants in the far north of Russia under extraordinarily difficult conditions and who, over the years, have contributed to their successful operation and development.

Because the company has, through its history, been knitted into the very fabric of life on the Taimyr peninsula, it has a special bond with the people who live and work there and our social programmes reflect the seriousness with which we take that bond and the responsibilities that go with it.

The year 2001 marked the low point for the nickel market, with prices falling to under \$5000 a tonne. Difficult to believe now! It also marked a low point for Norilsk Nickel. However, crises sometimes prompt creative responses, and 2001 also saw the arrival of Mikhail Prokhorov as Norilsk Nickel's General Director and the beginning of the company's turnaround.

Since that time, an enormous amount has been achieved. The company has completely overhauled its organisational and financial structures and stabilised its production. Output from its Russian operations has been held steady now over five successive years.

At the same time, the company has secured control over the power supplies to its operations and is well advanced in its plans to establish full control over its polar shipping links, having invested heavily in ports and in the construction of a new generation of ice-breaker carriers to transport product out of Norilsk all year around. Meanwhile, it has also established a worldwide sales network for the marketing and distribution of its products.

On the corporate front, Norilsk Nickel has introduced standards of governance and transparency which make it one of Russia's most progressive companies, a fact acknowledged by the credit rating agencies which have accorded Norilsk Nickel the highest rating of any non-state Russian company. Norilsk has worked hard to ensure, successively, the liberalisation of data on trade in its products and on its production and reserves. Since 2006 it has routinely published its production on a quarterly basis and the public disclosure of its activities now stands comparison with the best in the sector worldwide.

Marking another stage in its growing maturity, Norilsk Nickel has stepped out of Russia onto the world stage to become a more fully global company. Although involvement in projects around Russia will remain one of its key long term competitive advantages, the company has always made clear that it wants a global presence so as to achieve greater geographic diversity, exposure to a wider range of operating conditions, as well as access to a larger pool of skills and resources.

This project took a big step forward in 2007 with Norilsk Nickel's acquisition of the nickel assets of the OM Group and the nickel producer Lion Ore. This latter, incidentally, was the largest ever overseas acquisition by a Russian company.

Later in the conference, my colleague, Tav Morgan, will have more to say about this in his presentation on the production and strategy of Norilsk Nickel.

Industry developments

In making the acquisition of Lion Ore, Norilsk Nickel was contributing to the structural change which has been going on in the nickel industry since 2005, a process that has seen the disappearance of such historical names as Inco, Falconbridge and Western Mining and which also for a while threatened to see Xstrata being swallowed up by Vale. There has also been a general mopping up smaller nickel companies, including Jubilee by Xstrata, and Allegiance Mining by Zinifex.

In fact, one of the few things to have remained constant through this upheaval in the industry has been Norilsk Nickel's status as the world's largest nickel producer. The changes have also left it effectively the only 'large cap' specialist nickel company in the business. How long this will last we will have to see. As you may be aware, there has been much speculation in recent months around the possible coming together into a single merged entity of Norilsk Nickel, UC RusAl and Metalloinvest. However, that is another story for another time.

In looking for an explanation for the structural changes that have been taking place in the nickel industry, some might argue that there is no need to look further than the enormous cash flows being generated by some of the companies in the industry and the desire of such companies to get bigger. However, dig a little deeper and another explanation suggests itself. This is that mining companies are faced with a diminishing pool of good quality resources and, like anything that is getting scarcer, the justification for buying now is that the price is expected to be higher later on.

The fact is they aren't making minerals any more. And while acquisition prices may have been high, it could be that it is cheaper and less risky to buy what is out there now than go looking for

something better in the hope of being able to develop it later. This is not to suggest, of course, that nickel is running out but it is to suggest that the industry's remaining resources will likely be more costly to develop and to run than those that have formed the industry's core production in the past.

This process which the industry has been going through is often referred to as a 'consolidation'. In fact, the industry has scarcely become more concentrated as a result of recent corporate changes and remains a lot more fragmented today than it was during the 1960s and 1970s. Certainly it has not consolidated to a degree where producers have any meaningful pricing power. The major thing that has occurred is a change of ownership, with some of the bigger nickel producers being absorbed into larger, more diversified, companies.

The implications of this will reveal themselves in due course. One possibility is that such companies may be better able to confront and to manage the huge financial, organisational and geopolitical challenges which some of the new generation of large nickel mines appear to pose. It has also been suggested that the incorporation of nickel production into larger diversified companies might make for more controlled investment behaviour in future since diversifieds are under less pressure to protect market share, something that has been a problem for the nickel industry in the past.

In truth, however, controlled investment behaviour is not one of the current problems of the industry. Quite the reverse. The bigger problem has been getting new capacity committed and then up and running. Our failure as an industry to be more effective in achieving this has resulted in the rapid emergence in the market of high cost and poor quality sources of nickel to plug the gap. I am thinking here of the development of nickel pig iron in China.

While we doubt the long run viability of this source of nickel, we should perhaps be grateful for its arrival since it has enabled nickel to hang onto markets which might otherwise have been lost to substitution, but treat it as a wake-up call for the industry to be better adapted to respond to changes in demand in the future. If we do not, then we create an incentive for large nickel-consuming countries concerned about the security of supply of their raw materials, and their often state-backed companies, to backward integrate into our industry in projects of questionable

commercial merit and thereby threaten the economics of those of us seeking to make a living out of mining and metal production.

Future markets

So what of the future market for nickel? Here, I think we can look forward with confidence.

At the time the deposits in and around Norilsk were originally found and developed, nickel had a rather limited range of uses. A large part of the nickel produced in fact went into weaponry; into armour plate and into various types of military and naval ordnance.

Subsequent to Second World War, nickel of course developed a very wide range of new applications. However, even through to the 1990s, its use was, by comparison with other metals such as steel, aluminium and copper, very heavily concentrated in the developed world economies. The reason for this is that its uses tend to be focused on technically demanding applications like chemical plants, refineries, food processing and aerospace, and on high-end consumer products such as catering equipment, kitchenware, bathware and automobiles.

Nickel, and the stainless steel into which much of it goes, can be thought of as a rather middle class, middle income, sort of metal. Accordingly, as countries experience rapid growth in their middle class, middle income, populations, so the demand for nickel and nickel-containing products has a tendency to accelerate very fast indeed and much faster than GDP generally. Whilst the OECD countries were going through this phase in their development, the demand for nickel consistently grew at an average rate of 6% a year. This is the phase that China, and many other emerging market economies, are now going through and this should help underpin the demand for nickel for many years to come, bearing in mind that the populations involved are so very much larger than was the case with the OECD.

Nickel, and the products into which it goes, has extraordinary versatility. It is difficult to see some of its applications - in aerospace, in food processing, in health services, in domestic appliances, in batteries, in plant for the petrochemicals industry, in offshore oil platforms, in LNG container vessels, or in robust and attractive domestic fixtures and fittings - becoming anything except more important with time. A greater preoccupation with health care, with

performance and with safety, as society ages and becomes more heavily regulated, will only add to nickel's appeal and market potential.

We cannot, however, be complacent about this. We should not ignore the fact that recent high prices have put some of nickel's uses under threat. We will need to work hard to stem these problems. No one is going to solve them for us. We need to get the output of nickel up so as to ensure that nickel is available in sufficient quantities and on competitive terms for those who wish to use it. And we need to win back markets where nickel has been displaced by inferior, but cheaper, alternatives as a result of high prices.

And finally, we will need to battle hard to ensure that restrictions on the use of our product being devised by well-meaning bureaucrats in Europe and elsewhere, under legislation such as the Dangerous Substances Directive and programs such as REACH, do not needlessly deny our customers the substantial economic and social benefits that nickel and the products into which it is incorporated have to offer.

To do this, we cannot adopt a wholly defensive stance and set our face against change of any sort. We have to engage positively in the process. We need to support scientifically sound and proportionate regulation of nickel-containing substances - as of all other competing substances - and we need to encourage the appropriate use of nickel. At the same time, we need to bolster the credibility of our engagement in the process by demonstrating to the regulators and to our customers our own commitment, as an industry of responsible producers, to the principles of long term sustainable development.

We have a great product but we operate in a highly competitive, and increasingly regulated, market place and as an industry need to understand the challenges that are out there and devise ways to effectively manage them. In such a process, conferences like this one have a valuable part to play in bringing together the relevant and interested people and in debating the issues.

Thank you for your attention. And enjoy the conference.