

PUBLIC FILE 413.

Non-Confidential Attachment B-4.1.3

**Money for Metal: A Detailed Examination of Chinese
Government Subsidies to its Steel Industry**

MONEY FOR METAL:
A DETAILED EXAMINATION OF CHINESE GOVERNMENT
SUBSIDIES TO ITS STEEL INDUSTRY

Prepared for:

The American Iron & Steel Institute
The Steel Manufacturers Association
The Specialty Steel Industry of North America
The Committee on Pipe and Tube Imports



Prepared by:



Alan H. Price, Esq.
Timothy C. Brightbill, Esq.
Christopher B. Weld, Esq.

D. Scott Nance, International Trade Consultant

July 2007



Wiley Rein LLP
1776 K Street NW
Washington, DC 20006
www.wileyrein.com/money_for_metal

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	CHINESE GOVERNMENT OWNERSHIP AND CONTROL OF THE STEEL INDUSTRY	5
A.	Government Ownership	5
B.	Government Direction and Management of the Steel Industry	12
C.	Conclusion	24
III.	CHINESE GOVERNMENT SUBSIDIES TO THE STEEL INDUSTRY	25
A.	Cash Grants and Capital Infusions	26
B.	Equity Infusions and Conversions	31
C.	Land-Use Rights	39
D.	Government-Mandated Mergers and Transfers of Ownership on Terms Inconsistent with Commercial Considerations	44
E.	Preferential Loans and Directed Credit	47
F.	Tax Benefits Provided to the Steel Industry	52
G.	Value-Added Tax (VAT) Policies	60
H.	Benefits for Purchasing Domestically Produced Inputs and Equipment	67
I.	Raw Materials	70
J.	Energy (Electricity)	75
K.	Environmental Subsidies	77
L.	Currency Undervaluation	78
IV.	CONCLUSION	80
V.	APPENDICES	83

MONEY FOR METAL: A DETAILED EXAMINATION OF CHINESE GOVERNMENT SUBSIDIES TO ITS STEEL INDUSTRY

EXECUTIVE SUMMARY

- The Chinese steel industry is continuing to expand at an unprecedented and seemingly uncontrolled rate. China's steel capacity grew another 20 percent in 2006. Today, experts estimate that China's total steel capacity is already 500 million metric tons or more and will reach as much as 600 million metric tons by year-end 2007.
- This unparalleled expansion is the direct result of the Chinese government's direction and control of the Chinese steel industry, and its bestowal of an extraordinary range of subsidies to Chinese steel producers. The growth of China's steel industry has been both financed and directed by the Chinese government.
- Government ownership of the steel industry is far greater than previously reported. Eight of the ten largest Chinese steel groups are 100 percent owned or controlled by the Chinese government, while 19 of the top 20 groups are majority owned or controlled by the government. In terms of production, 91 percent of the production of the top 20 steel groups is state-owned or controlled. This degree of state ownership allows the government to exert direct control over the steel industry.
- This report identifies more than RMB 393 billion (US\$ 52 billion) in subsidies granted to Chinese steel producers. These documented subsidies include:
 - RMB 130.9 billion (US\$ 17.3 billion) in preferential loans and directed credit – The Chinese government uses subsidized loans granted to steel producers to carry out government policy. These policy loans account for the majority of all loans in China, and leading Chinese steel producers have received between 60 and nearly 100 percent of their loans from policy banks. This report details subsidized loans received by 15 major Chinese steel producers.
 - RMB 141 billion (US\$ 18.6 billion) in equity infusions and/or debt-to-equity swaps – China regularly injects substantial cash subsidies into steel producers, acquiring additional ownership shares in return. The Chinese government has also mandated widespread use of debt-to-equity swaps since the mid- to late-1990s. At least 37 different Chinese steel companies have benefited, including all of the major producers.
 - RMB 38.9 billion (US\$ 5.1 billion) in land-use discounts – The physical purchase of land is nearly impossible in China. Instead, the Chinese government provides lease agreements and then transfers land-use rights to

MONEY FOR METAL: A DETAILED EXAMINATION OF CHINESE GOVERNMENT SUBSIDIES TO ITS STEEL INDUSTRY

I. INTRODUCTION

The Chinese steel industry is continuing to expand at an unprecedented and seemingly uncontrolled rate. After an astounding five-year run-up of 170 percent between 2000 to 2005, China's steel capacity grew another 20 percent in 2006. Today, most experts estimate that China's total steel capacity is already 500 million metric tons or more¹ and will reach as much as 600 million metric tons by year-end 2007.²

This unparalleled expansion is the direct result of the Chinese government's direction and control of the Chinese steel industry, and its granting of an extraordinary range of subsidies to Chinese steel producers. For years, the Chinese government has owned, directed, and subsidized virtually all aspects of the Chinese steel industry. Even today, China's steel producers operate in an environment where basic market forces – supply, demand, comparative advantage – do not exist or apply, due to the persistent intervention of China's national, provincial, and local governments and the pervasive influence of WTO-illegal subsidies.

The growth of China's steel industry has been both financed and directed by the Chinese government. The Chinese government maintains substantial ownership and control over the steel industry. As documented below, the national, provincial and local governments own majority stakes in almost all of China's major steel producing groups

the companies for little or no cost. Steel producers enjoy these land-use rights for no charge, or for as little as US\$ 0.02 per square foot.

- o RMB 9.5 billion (US\$ 1.3 billion) in government-mandated mergers – The Chinese government is directing consolidation of the steel industry in China by permitting acquisitions for little to no cost. For example, in May 2007, Baosteel, China's second largest steel producer, received a 48.5 percent stake in Xinjiang, worth more than RMB 6 billion, at no cost.
- o RMB 2 billion (US\$ 268.6 million) in direct cash grants – Chinese steel producers continue to report outright cash grants, as well as grants for specific steel construction projects, on their balance sheets.

- The actual total subsidy amount is undoubtedly many times larger than this figure because of the limited number of companies reviewed and the partial nature of the data that even these companies reported.

- These subsidies have fueled China's steel industry expansion, resulting in sharp increases in China's steel exports. China moved from being a net importer of steel to a net exporter of steel in 2006. In the same year, China's largest single steel exporting country by volume, up from fifth largest in 2005. China's total finished steel exports surged to 33.8 million tons in the first half of 2007, up nearly 100 percent compared to the same period in 2006.

- The Chinese steel industry has benefited from massive direct and indirect subsidies, many of which violate China's World Trade Organization obligations. The result has been artificial growth of China's steel capacity and production, at the expense of its international competitors, including U.S. companies and their workers.

- The Chinese government should end its policy of control, direction and subsidization of its steel industry. If it does not, the United States and other trading partners should increase efforts to require China's compliance with its WTO commitments and international trade law.

¹ Li Hongmei, *China's 07 Steel Capacity Put At 500M Tonnies*, American Metal Market, June 4, 2007.
² Southeast Asian Steel Conference, *China's Finished Steel Exports To Fall In 2006*, CBI China, American Metal Market, June 15, 2007 (quoting Jimmy Ding, CBI China, an estimating China's total steel production capacity at 480 million tonnes in 2007 and 642 million tonnes in 2008).

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

and also hold key decision-making authority over the steel industry. This paper reviews the Chinese government's 9th, 10th and 11th Five-Year Plans, which have dictated the growth and direction of the Chinese steel industry. It also reviews provincial government five-year plans, which contain similarly detailed instructions for particular Chinese steelmakers. As these plans make clear, Chinese steelmakers do not operate according to market forces, and the key strategic and operational decisions are imposed by governmental fiat.

An earlier report, *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (July 2006),³ described the various ways in which the Chinese government provides direct and indirect benefits to the steel industry, including cash grants, land grants, transfers of ownership interests, conversion of debt to equity, debt forgiveness, preferential loans, tax incentives, and other methods. *Money for Metal* further examines these and other forms of subsidies and government intervention, adding new information that has been revealed in the last year. This report also expands upon earlier research through a detailed review of the financial statements of leading Chinese steel producers, including but not limited to Angang, Baosteel, Laitou, Maanshan, Shougang, and Wuhan. Although financial reporting by these companies remains opaque and elusive, these companies' own documents demonstrate that the Chinese government has provided – and continues to provide – massive amounts of financial assistance to China's steel industry. This assistance benefits the entire range of steel products, including sheet, plate, galvanized, long products, tubular products, and stainless steel products.

³ Wilbur Rein LLP, *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (July 2006), available at <http://www.wilburrein.com/docs/060706.pdf>

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

A partial compilation, which covers only a handful of the subsidies documented in this report, and including only a limited number of companies, reveals subsidies totaling more than RMB 393 billion (US\$ 52 billion). These documented subsidies include RMB 130.9 billion in preferential loans and directed credit, RMB 14.1 billion in equity infusions and/or debt-to-equity swaps, RMB 38.9 billion in land-use discounts, RMB 9.47 billion in government-mandated mergers, and almost RMB 2 billion in direct cash grants. The actual total subsidy amount is undoubtedly several times larger than this figure because of the limited number of companies reviewed and the partial nature of the data that even these companies reported.⁴

The result of these massive subsidies is that China's steel exports, particularly exports to the United States, are moving upward at an unprecedented rate. In 2005, China moved from becoming a net importer of steel to a net exporter of steel. In 2006, it became the largest single steel exporting country by volume, up from fifth largest in 2005. U.S. imports of finished steel products from China more than doubled in 2006, increasing from 2.3 million tons in 2005 to 5.35 million tons in 2006.⁵ This rate of increase has continued in the first half of 2007. U.S. imports from China reached 2.6 million tons in the first half of 2007, an increase of 23.8 percent over the same period in 2006.⁶ China's total finished steel exports surged to 33.8 million tons in the first half of

⁴ To gain a complete picture of subsidies bestowed upon the Chinese steel industry, it would be necessary to undertake a complete financial analysis of all steel producers in the industry (at least 15 years). This study is limited to only a few Chinese producers for which public financial statements were available. Even for those companies included in the study, financial statements were not available for all fifteen years. Moreover, the study does not encompass possible subsidies that are not readily apparent in the financial statements.

⁵ U.S. Dept. Commerce, Bureau of Census data.

⁶ *Id.*

this year, up nearly 100 percent compared to the same period in 2006.⁷ With total steel capacity that is now approximately five times larger than the entire North American steel industry, China's exports to the United States and the rest of the world will only increase.

China has not become the world's largest steel producer and exporter by accident, or by operation of free markets and comparative advantage. China has reached its position through a combination of subsidies, mandates, and planned governmental intervention.

II. CHINESE GOVERNMENT OWNERSHIP AND CONTROL OF THE STEEL INDUSTRY

The Chinese government maintains substantial ownership and control over the steel industry. In addition to owning majority stakes in almost all of China's major steel producers, the government retains a high degree of decision-making authority over the steel industry and continues to intervene extensively to direct the course of individual companies. The government's role with respect to steel is set forth in a number of policy directives and incentive programs through which it actively supports the growth and competitiveness of the industry. The Chinese government has implemented its policy of support for the steel industry by providing it with massive subsidies and other forms of assistance, including cash grants, capital infusions, preferential loans, and tax incentives. The result has been the creation of the world's largest steel industry.

A. Government Ownership

The Chinese Government's 10th Five-Year Plan for National Economic and Social Development establishes the framework for state ownership of the steel industry by providing that the "state must hold a controlling stake in strategic enterprises that concern the national economy."⁸ Because the iron and steel industry is considered a "strategic" or "pillar" industry, the Chinese steel industry remains predominately state-owned, with the government owning the vast majority of shares in almost all of China's major steel producers.

⁷ Li Hongmei, *China Moving End To All Steel Export Rebates*, American Metal Market, July 18, 2007.

⁸ See Gov't of the PRC, *The Tenth Five Year Plan for National Economic and Social Development of the People's Republic of China*, available at <http://www.gov.cn/jingji/2005/09/20050926001.htm>.

cently concluded, "[t]here is little or no opportunity for minority shareholders to exercise their voice and oppression of minority shareholders is a serious issue in practice."¹⁴

While the Organization for Economic Co-operation and Development ("OECD") estimates that state-owned enterprises account for 57 percent of total Chinese steel production,¹⁵ this estimate significantly understates actual government ownership. Table 1 below shows the considerable degree of government ownership of the top 20 Chinese steel producers. For the reasons discussed above, the following table focuses on Chinese government ownership of steel companies at the holding company or "group" level.

TABLE 1¹⁶
OWNERSHIP OF THE TOP TWENTY CHINESE STEEL GROUPS

Rank	Producer	2008 Prod. (Million MT)	Owner/Majority Shareholder	% Govt. Ownership
1	Anshan Benxi (Anben) Group	22.6	Central SASAC ¹⁷ and Liaoning Province SASAC	100.00
2	Shanghai Baosteel Group	22.5	Central SASAC	100.00
3	Tangshan Steel Group	19.1	Hebei Province SASAC	100.00
4	Shagang (Jiangsu Shagang) Group	14.8	Zhangjiagang City SASAC (25%), Shagang Labor Union (30%) ¹⁸	55.00

¹⁴ An Zhongping, *Shareholder Meetings and Voting Rights in China: Some Empirical Evidence*, Int'l Co. and Commercial L. Rev. at 11 (2007).

¹⁵ OECD Directorate for Science, Technology and Industry Steel Committee, *Current Situation of the Chinese Steel Industry*, DST/USUSC(2009), at 15 (Apr. 7, 2009).

¹⁶ Ownership and production information contained in Table 1 and Appendix 2 is current through the end of 2006.

¹⁷ Labor unions in China are not independent, but rather controlled by the Chinese Communist Party (CCP) and the government. According to the Labor Union Law of China, labor unions according to the U.S. State Dept., "[t]he practice workers were not free to organize or join labor unions." The All-China Federation of Trade Unions (ACFTU), which was controlled by the CCP and chaired by a member of the Politburo, was the sole legal workers' organization. The trade union law gives the ACFTU control over all union organizations and activities, including enterprise-level unions, and re-

5	Wuhan Iron and Steel Group	13.8	Central SASAC	100.00
6	Jinan Steel Group	11.2	Shandong Province SASAC	100.00
7	Mangang Group (parent of Maanshan Steel)	10.9	Anhui Province SASAC	100.00
8	Liaoning Group (parent of Laitai)	10.8	Shandong Province SASAC	91.00
9	Shougang Group Corp	10.6	Central SASAC	100.00
10	Main Steel Group	9.9	Hunan Province SASAC	100.00
11	Haidan Steel Group	7.9	Hebei Province SASAC	100.00
12	Baolou Steel Group	7.5	Inner Mongolia SASAC	84.39
13	Anyang Steel Group	7.0	Henan Province SASAC	100.00
14	Panzhihua Iron & Steel Group	6.8	Central SASAC	100.00
15	Jiuquan Iron & Steel Group	6.6	Gansu Province SASAC	100.00
16	Fuyuan Steel Group	6.3	Shanxi Province SASAC	100.00
17	Tangshan Jiantong Industrial	6.0	Jiangling Iron & Steel Corp.	0.00
18	Luzhou Steel Group	5.4	Central SASAC (51%) ¹⁹ and Guangxi Zhuang SASAC (49%)	100.00
19	Baotai Iron & Steel Group	5.3	Liaoning Province SASAC	100.00
20	Tangshan Guofeng Steel	5.2	China Travel Service (Holdings) ²⁰	51.00

¹⁹ State-owned Assets Supervision and Administration Commission of the State Council (SASAC).

quires the ACFTU to "uphold the leadership of the Communist Party; independent unions are illegal in some cases the ACFTU and its constituent unions influenced and implemented government policies on behalf of workers. However, the CCP used the ACFTU to communicate with and control workers." U.S. State Dept., *Country Report on Human Rights Practices 2006: China* Section 6(a) (2007), available at <http://www.state.gov/documents/organization/200018771.pdf>.

²⁰ Luzhou Steel Group is 51 percent owned by Wuhan Iron & Steel (Group) Corp. ("Wuhan"), which, in turn, is 100 percent owned by the central government SASAC. See Appendix 2.

²¹ Tangshan Guofeng Steel ("Tangfang") is 51 percent owned by China Travel Services (Holdings) Hong Kong Co., which, in turn, is 100 percent owned by the central government SASAC.

As this table demonstrates, eight of the ten largest Chinese steel groups are 100 percent owned or controlled by the Chinese government, while 19 of the top 20 groups are majority owned or controlled by the government. In terms of production, 91 percent of the production of the top 20 steel groups is state-owned or controlled. This degree of state ownership allows the government to exert considerable control over the steel industry and enables the government to direct steel producers to act in ways that further governmental rather than market aims, such as maximizing tax revenue and employment. In addition, as discussed below, the high levels of state ownership make it significantly easier to implement and enforce government policy relating to the steel industry.

Table 1 also demonstrates the degree to which Chinese steel companies are owned by the various levels of the Chinese government: national or central, provincial, and local (county or municipal). Of the top 20 Chinese steel producers, seven are partly or wholly owned by the central government, 13 are partly or wholly owned by a provincial or regional government, and one is partly owned by a local government. Some companies, such as Anhe, are jointly owned by the central government and a provincial government, while other steel producers, such as Dongbei Special Steel Group, are jointly owned by multiple provincial governments.

The extensive and overlapping ownership gives each level of government a vested interest in the steel industry. However, this ownership structure often leads to competing interests among the multiple levels of government. For example, a recent industry report indicates that several provinces have disregarded an order from the cen-

tral government to increase electricity costs for certain industries including steel.²⁰ In addition, the central government's policy of capacity rationalization and elimination of obsolete capacity has largely been frustrated by provincial and local governments, which have strong, non-market incentives to increase production (i.e., tax revenue and employment). Indeed, many provincial and local government-owned producers have actually increased capacity in defiance of the central government. Steel production in Hebei Province, the largest steel-producing province in China, increased by 20 percent in 2006 despite the central government's attempt to curb production in that province. In short, the considerable degree of ownership by provincial and local governments, whose decisions are often based on factors such as employment, tax revenue, or corruption rather than market principles, will continue to frustrate even the limited efforts of the central government to pursue such goals as capacity rationalization, elimination of obsolete capacity, and energy efficiency.

While there continues to be debate about whether China is transitioning to a more market-oriented economy, the overwhelming degree of government ownership suggests that market principles will not penetrate China's steel industry to any significant degree in the near future. Because steel has been designated as a strategic industry, the central government has indicated that it plans to retain a strong state influence in the sector.²¹ Indeed, as recently as December 2006, the central government SASAC issued the "Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises," which identified sec-

²⁰ Vivien Tao, *Beijing Warns Provinces on Power Cost Order*, American Metal Market, Apr. 17, 2007.

²¹ *How China Has Made the Steel World Bounce*, Steel Business Briefing Insight, Issue 32, Mar. 1, 2007, at 3.

lors deemed to be critical to the national economy.²² The measure indicated that the government must maintain strong state control over "pillar" and "backbone" industries such as iron and steel.²³ Additionally, though China has used and continues to need billions of dollars in investment to fund new steel expansion, and because the government has identified iron and steel as a strategic sector of the economy, foreigners are not permitted to own a controlling stake in Chinese steel companies. This largely prevents foreign companies, including U.S. steel producers, from participating in the expansion of the Chinese steel industry and helps consolidate and maintain government control over the industry.

B. Government Direction and Management of the Steel Industry

The Chinese government exercises extensive control over the development of the Chinese steel industry not only through its ownership stake but also through a number of policy instruments which afford the government substantial leverage to direct the growth and evolution of the industry. The various levels of government have issued several industrial plans that designate steel as a preferred industry and provide for a wide array of government benefits, including grants, preferential loans, and tax incentives. Additionally, these plans provide for government management of almost every major aspect of China's steel industry and authorize the government to intervene directly and extensively in the steel industry.

All three levels of government maintain separate, and sometimes distinct, policies that impact the steel industry. While these policies are often in concert with one

²² U.S. Trade Representative, *WTO Trade Estimate at 136* (2007), available at <http://www.usitr.gov/docs/default-source/press-releases/2007/2007-WTE-RevisedFinalUpdated-0803-100500c1>

²³ *Id.*

another, as detailed below, the numerous policy directives from the various levels of government underscore the often compelling interests between the central, provincial, and local governments.

1. Central Government Policies

China's central government continues to maintain a high degree of decision-making authority over the management and development of the steel industry. Its policy framework for the steel industry is set forth in the Steel and Iron Industry Development Policy ("Steel Policy") issued by the National Development and Reform Commission ("NDRC") in July 2005. The Steel Policy provides for governmental management and control of almost every aspect of the industry's development, including resource and equipment utilization, regional output levels, quality improvements, technological innovation, investment management, and consolidation. Article 20 specifically provides for the reorganization of China's largest steel producers to create an industry with two 30 million-ton steel groups and several 10 million-ton steel groups by 2010.²⁴ The policy further prescribes the number and size of steel producers, their location, the type and mix of products that are permitted to be produced, and even minute details relating to the technology that will be used (e.g., size and composition of blast furnaces).

As described in detail in *The China Syndrome*,²⁵ the Steel Policy also mandates direct government subsidization of the steel industry. Article 16, for example, provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly devel-

²⁴ Steel and Iron Industry Development Policy, Order No. 25 of the National Reform and Development Commission, July 2005 ("Steel Policy") at Art. 20.

²⁵ See *The China Syndrome* at 17-18.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

oped domestic equipment.³⁶ The policy also encourages indirect government support by, among other things, restricting foreign investment, discriminating against foreign equipment and technology, and providing various export credits. In short, China's Steel Policy is a primary example of the government's attempt to dictate industry outcomes and involve itself in decisions that should be made by the market.

China's industrial development is also directed and managed by the central government through the following policy instruments:

Five-Year Plans. Issued by the Central Committee of the Communist Party of China, the five-year plans set forth which industries, enterprises, and products should be targeted for preferential government support and specifically enumerate the types of preferences to be provided such industries. According to the government, five-year plans aim to "arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets."³⁷ These plans serve as economic and industrial instructions for planning agencies, local and provincial governments, banks, and state-owned enterprises.

The 9th Five-Year Plan and 2010 Long-Term Program for National Economic and Social Development called for the government to promote the growth of industries considered to be critical for economic development, such as "pillar industries" (i.e., machinery, electronics, petrochemical, and construction), high-technology industries, and certain basic industries upon which other industries depended (e.g., the steel industry).

³⁶ Steel Policy at Art. 16.

³⁷ See WPI at the Five Year Plan, available at <http://www.chinainvestor.com/MA/TCW/13159.htm>.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

try).³⁸ Subsidies granted to the steel industry pursuant to the 9th Five-Year Plan still benefit the Chinese industry today.

The 10th Five-Year Plan for National Economic and Social Development, covering the period from 2001-2005, prescribed "energetically optimizing and improving [the] industrial sector" by enhancing traditional industries with new technologies and intensifying construction of transportation, energy and other infrastructure facilities.³⁹ According to the plan, these measures were "most important in the energy [and] metallurgy" industries.⁴⁰ Thus, in addition to providing for the addition of substantial new steel capacity, the plan also aimed to equip the industry with sophisticated technology and equipment to increase the industry's global competitiveness. It also provided for pervasive government intervention in the economy, stating that the "state must hold a controlling stake in strategic enterprises that concern the national economy" and must also "uphold the dominance of the public sector of the economy [and] let the state-owned sector play the leading role."⁴¹

Acknowledging the over-building of steel capacity during the 2000-2005 period, the central government's 11th Five-Year Plan (covering the years 2006-2010) focuses on capacity consolidation, along with the creation of new, high-efficiency steel facilities that can compete on a global scale. Specifically, the plan provides for (1) improving the quality of steel products through the acquisition of new technology and equipment and

³⁸ See Lu Ding, *Prospect of Industrial Policy Regime After the WTO*, CPB Nat'l Bureau for Economic Research, available at (2000), available at <http://www.cpb.gov.cn/industrialpolicy/industrialpolicy.htm>.

³⁹ See Court of the PRC, *The Tenth Five Year Plan for National Economic and Social Development - People's Republic of China*, available at <http://www.chinainvestor.com/MA/TCW/13159.htm>.

⁴⁰ *Id.*

⁴¹ *Id.*

2. Provincial and Local Government Policies

Provincial and local governments maintain similar control over the steel industry through a wide range of policy instruments. Shandong Province, for example, recently issued "guidelines" for the development of the steel industry in the province.³⁸ The guidelines include capacity and production targets for crude and finished steel through 2010, including targets for specific steel companies. The guidelines set forth the provincial government's intent to construct a new steel mill with crude capacity of 10 million metric tons and to form a giant steel mill with steel capacity of more than 20 million metric tons.³⁹ The guidelines even set targets for product mix and energy usage, and establish size requirements for sinter machines, coke ovens and BOFs.⁴⁰ These guidelines underscore the extent to which the provincial and local governments continue to direct the expansion of the steel industry.⁴¹

Provincial and local governments also exert control through regional five-year plans.⁴² Similar to the central government's five-year plans, the regional plans establish those industries and products which should be targeted for preferential government support. The five-year plan of almost every province in China establishes the iron and steel industry as a preferred industry and provides substantial government direction for the growth and evolution of the industry. Even Ningxia Province, with the least steel pro-

duction of any province in China, has designated its steel industry a "pillar industry" and states that it will support and encourage the completion of a steel wire production line for Shuishan Steel & Iron Company as well as improvements to the company's smelting and rolling equipment.⁴³

Specifically, in the five-year plans, the provincial and local governments set detailed production and capacity targets for the region as well for individual companies. For example:

- Anhui Province's 11th Five-Year Plan, covering the period 2006-2010, states that a "5 million ton sheet project will be built by Maanshan Iron & Steel Company" and that the same company "will reach 20 million tons in 2010."⁴⁴
- The government of Jiangxi Province intends to "promote competitive steel & iron processing and focus on the construction of [a] 3 million ton sheet project in Xingang."⁴⁵
- The 11th Five-Year Plan for Jilin Province indicates that the provincial government will "accelerate the construction of important projects including Tonghui Steel & Iron Company's 10 million ton steel project."⁴⁶
- The Hubei provincial government states that it will support "steel capacity expansion[on] ... to 22 million tons" by 2010.⁴⁷

Notably, as these examples demonstrate, many provincial and local governments are encouraging the expansion of the local steel industry at the same time that the central government purports to be eliminating obsolete capacity and limiting overall capacity. These policies underscore the often competing interests between the central government's policy of consolidation and elimination of inefficient capacity and the provincial

- ³⁸ Ningxia Province 9th Five-Year Plan.
- ³⁹ Anhui Province 11th Five-Year Plan at 5.
- ⁴⁰ Jiangxi Province 11th Five-Year Plan at 8.
- ⁴¹ Jilin Province 11th Five-Year Plan at 4.
- ⁴² Hubei Province 11th Five-Year Plan at 11.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

and local governments' desire to expand steel capacity for revenue, employment and other factors. It is not surprising, then, that many mills at the local and provincial level have invested in new capacity with the support of local governments but without official approval from the central government.⁴²

In addition, provincial governments use the five-year plans to manage product mix and direct certain companies and regions to focus on specific steel products, including sheet, plate, galvanized, bars, tubular, and stainless products. For example:

- The Jiangxi provincial government has directed steel producers in the region to "extend plates and tubular products, develop plates for ships, for boiler furnaces, for pressure vessels, etc; develop high strength low alloy steel tube, replace solid drawn tube with welded tube, and develop welded steel tube for automobiles; and further develop plate spring and cold belt, eliminate hot rolled sheet, ordinary tubular steel, etc."⁴³
- The Liaoning provincial government has specified that the "continuous casting ratio will be 72 percent, plates and tubes proportion will be 60 percent, [and] products with high added value will amount to 45 percent."⁴⁴
- The 11th Five Year Plan for the Inner Mongolia Autonomous Region indicates that its goal is to "accelerate steel industry restructuring and implement capacity expansion and rebuilding project of Baotou Steel" and to "improve [the] product mix including increasing the proportion of medium plate, automobile plate, specially steel, ... and stainless alloy."⁴⁵

Certain provincial governments even dictate which company will produce which product. The Shandong provincial government, for example, has directed that "Jinan Steel company will develop sheet plate ... Liewu Steel company will focus on the development

⁴² See How China Has Made the Steel World Bounce, Steel Business Intelligence Insight, Issue 32, Mar. 1, 2007, at 3.

⁴³ Jiangxi Province 10th Five-Year Plan at 11.

⁴⁴ Liaoning Province 9th Five-Year Plan at 12.

⁴⁵ Inner Mongolia Autonomous Region 11th Five-Year Plan at 10.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

and improvement of sectionals ... [and] Qingdao Steel company will put emphasis on wire with light sections."⁴²

The provincial five-year plans further specify which technologies should be used in steel production. A recent five year plan issued by the Inner Mongolian government stated that the "metallurgy industry should give priority to Baotou Steel, eliminate lagging open-hearth steelmaking technology and improve ... equipment levels in order to achieve energy saving and consumption reduction."⁴³ Liaoning Province's Five-Year Plan states that "Angang should ... eliminate the open hearth furnace ... and build modern tipping converters and assorted casters to achieve continuous casting."⁴⁴

Provincial governments also control the development of raw material output and transportation infrastructure to benefit the steel industry. Beijing's provincial government has stated that it will "strictly limit and control the ore mine industry" for the benefit of the steel industry,⁴⁵ while another provincial government has pledged to "build more transportation facilities on the coast of northern China to meet demands for iron-ore imports of the steel companies located in north-east China and northern China."⁴⁶

In short, through the five-year plans, provincial governments retain a significant degree of control over all aspects of steel production and development, including output, product mix, technology, raw materials, transportation, and energy. Provincial governments continue to assume a large role in economic development and continue to assert the authority to intervene in economic development at all levels. Such state intervention

⁴² Shandong Province 10th Five-Year Plan at 11.

⁴³ Inner Mongolia Autonomous Region 10th Five-Year Plan at 5.

⁴⁴ Liaoning Province 9th Five-Year Plan at 12.

⁴⁵ Beijing Province 11th Five-Year Plan at 45.

⁴⁶ Beijing Province 10th Five-Year Plan of Communication.

is documented and explicitly encouraged in the five year plans. A recent five year plan for Xinjiang Province states that the "regional government should strengthen and improve macro-control by comprehensively using the plan and the financial means to play the role of price and revenue lever, and formulating positive macro-control policies to create a favorable macroeconomic environment for the implementation of the plan."³⁷

3. Other Forms of Government Control

Another method by which the government maintains control over the steel industry is by installing party members or other government officials as senior officers and directors of steel companies. For example, the following directors and supervisors of Maanshan Iron & Steel also serve as government officials or as officers in state-owned banks:

- Zhao Jianming, a director of Maanshan Iron & Steel, also holds the office of Secretary of the Party Committee of Magang.³⁸
- Li Kazhang, supervisor of the company, is also Deputy Secretary of the Party Committee of Magang and Chairman of the Labor Union of Magang.³⁹
- Wang Xiaoxin is an independent supervisor of the company and has been appointed General Manager of the International Business Department of the China Construction Bank and Deputy President of the China Construction Bank, Anhui provincial branch.⁴⁰
- Jiang Yulin, an independent supervisor of Maanshan Iron & Steel, is also President of the Industrial and Commercial Bank of China, Wuhu branch, and Deputy President of the Industrial and Commercial Bank of China, Anhui Provincial branch.⁴¹

³⁷ *Xinjiang Province 10th Five-Year Plan* at 26.
³⁸ Maanshan Iron & Steel ("Maanshan") 2004 Annual Report at 34.
³⁹ *Id.* at 35.
⁴⁰ *Id.*
⁴¹ *Id.* at 36.

- Tang Xiaoping, an independent supervisor of Maanshan Iron & Steel, has served as Director of Finance of the Bank of China, Anhui Province, and is now Deputy President of the Bank of China.⁴²
- Dou Qingyun, a supervisor of the company, is also the Deputy Secretary of the Party Committee and Labor Union Chairman.⁴³

In fact, in 2003, seven out of 18 directors and supervisors of Maanshan Iron & Steel also served as officials in the Party Committee or as officers in a state-owned bank.⁴⁴ Maanshan is not unique in this regard. Angang Steel, for example, has numerous directors who also serve in various levels of the government, including: Liu Jie, Chairman of the company and an alternate member of the 16th Central Committee of the Communist Party of the PRC and a representative in the 10th National People's Congress; and Yang Hua, Vice Chairman of Angang and a member of the Standing Committee of the Party Committee of Angang Holding.⁴⁵

Through direct participation in the decision-making and overall management of steel companies, the government is able to ensure adherence to its policies and maintain substantial control over the direction of the industry. Moreover, having officials of state-owned banks serving simultaneously as directors of major steel companies undoubtedly facilitates the injection of state capital into the companies and facilitates the process of securing government loans. It should be little surprise that in 2004 Maanshan Iron & Steel was the recipient of long term loans worth RMB 1.5 billion, plus EUR 2.1 billion and US\$ 165 million from the Industrial and Commercial Bank, the China Construction Bank, and the Bank of China, each of which had representatives in the

⁴² *Id.*
⁴³ Maanshan 2003 Annual Report at 35.
⁴⁴ *Id.* at 34-36.
⁴⁵ Angang New Steel Company Ltd. 2005 Annual Report at 24.

senior leadership of Maanshan at the time the loan was secured.⁶⁶ In 2005, Maanshan secured long term loans worth RMB 4 billion, plus EUR 16.6 million and US\$ 791 million from the same banks.⁶⁷ This is but one example of how the Chinese government exercises its control in multiple, interrelated ways to benefit the steel industry.

C. Conclusion

In summary, through its ownership stake, policy instruments, and direct participation in company management, the Chinese government maintains control over the growth and evolution of the steel industry. As discussed in further detail below, the Chinese government exercises its control and implements its policy of support for the steel industry by providing it with massive subsidies and other forms of assistance, including cash grants, capital infusions, land grants, transfers of ownership interests on terms inconsistent with commercial considerations, conversion of debt to equity in steel companies, preferential loans and directed credit, debt forgiveness and inaction regarding non-performing loans, and a variety of tax incentives.

⁶⁶ Maanshan 2004 Annual Report at 153.

⁶⁷ Maanshan 2005 Annual Report at 183-184.

III. CHINESE GOVERNMENT SUBSIDIES TO THE STEEL INDUSTRY

This section of the report details China's various subsidies to its steel industry. A partial compilation, which covers only a handful of the subsidies documented in this report and including only a limited number of companies, reveals subsidies totaling more than RMB 393 billion (US\$ 52 billion). As summarized in the table below, these documented subsidies include RMB 130.9 billion in preferential loans and directed credit; RMB 141 billion in equity infusions and/or debt-to-equity swaps; RMB 38.9 billion in land-use discounts; RMB 9.47 billion in government-mandated mergers and almost RMB 2 billion in direct cash grants.

Table 2: Total Documented Chinese Steel Subsidies⁶⁸

Type of Subsidy	Amount (RMB)	Amount (USD)
Loans	130,991,528,889	17,317,301,088
Equity Conversion	141,008,728,000	18,641,591,708
Land Use	38,900,000,000	5,142,645,620
Grants	1,956,359,069	258,639,257
Gov't Mandated Mergers	9,470,000,000	1,251,949,975
Currency Under-valuation	70,862,053,501	9,368,083,010
Tax Benefits	unknown	unknown
VAT	unknown	unknown
Domestic Preference Programs	unknown	unknown
Raw Materials	unknown	unknown

⁶⁸ Each of these estimates is based on information covering only a small portion of the Chinese steel industry. Conversions are calculated using the exchange rate as of 1/24/2007 (7.5642 RMB/US\$ 1).

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

Electricity	unknown	unknown
Environmental	unknown	unknown
Total	393,188,709,469	51,980,210,658

The actual total subsidy amount is undoubtedly much greater, and probably several times greater, than the amounts shown in this table and tabulated in this report. For example, the amounts shown for cash grants are based on the financial reports of only nine Chinese steel producers, and the amounts shown for government mandated mergers are based on only two recent merger transactions. In addition, for several large subsidy categories (such as excessive VAT rebates, raw materials, domestic preference programs, electricity and environment), this report does not attempt to quantify the benefits received for the industry as a whole. As a result, the amounts documented in this report only scratch the surface of the actual subsidization amounts.

A. Cash Grants and Capital Infusions

The Chinese government's most overt subsidies are its direct cash grants and capital infusions to Chinese steel producers. Though cash grants are becoming less frequent, given their obvious nature as countervailable subsidies, nine Chinese steel producers – including Baosteel, Maanshan, Jinan, and JISCO – reported approximately RMB 2 billion in direct cash grants, “specific construction projects,” and similarly earmarked funds on their financial statements. Other companies have also reported receiving direct cash grants from the Chinese government – grants that continue to benefit these companies today.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

1. Description of Types of Grants Offered by China

Grant subsidies have been, and remain, a favorite tool for China's promotion of its steel industry. The U.S. Department of Commerce reported to the President in 2000 that the Chinese government admitted that it would spend more than US\$ 6 billion within several years to upgrade and transform its steel industry.⁶⁸ At the time of the announcement, the Chinese Ministry of Commerce stated that the central government would direct local and provincial governments to give the steel industry priority with respect to land use, raw materials, transport, equipment, and water and power supplies.⁶⁹

The Chinese government continues to provide a variety of direct subsidy grants. These subsidies include grants for small and medium sized companies, state-owned enterprises operating at a loss, technology and research, export promotion, upgrades and renovation, “outward expansion” of industry, and environmental incentives, to name a few. China's own WTO subsidies notification admits to several programs for small and medium-sized enterprises that provide direct grants. Such programs include funds for supporting technological innovation, development funds, and funds for exploration of international markets.⁷⁰ In 2004 alone, China budgeted RMB 1.6 billion for these grants.⁷¹ A substantial portion of these subsidies likely go to favored and state-owned industries, such as China's numerous small and medium sized steel producers.

⁶⁸ U.S. Dept. Commerce, Report to the President, Global Steel Trade: Structural Problems and Future Solutions at 148 (2000).
Id.

⁶⁹ WTO, News and Full Notification Pursuant to Article XVI.1 of the GATT 1994 and Article 25 of the SCM Agreement, No. GSC/MW/12/CHN, at 35-37 (Apr. 13, 2006) (hereinafter “China Subsidies Notification”).
Id.

China has also admitted in reports to the WTO that it continues to offer grants and tax subsidies to state-owned enterprises that are operating at a loss.⁷² The government identified the following industries as benefiting from these subsidies: metallurgy, ferrous-metal, machinery, coal, oil, chemical, textile, tobacco, and others.⁷³ Despite repeated promises to eliminate these subsidies, China has yet to follow through on its commitments.

In addition to offering grants for enterprises operating at a loss, the government provides grants and loans for technology and research.⁷⁴ According to a 2004 WTO report, one such program is administered by the Ministry of Finance pursuant to State Council Circular No. 93 of 1987.⁷⁵ In 1998, the last year for which data is available for this program, the total amount of payouts under the program was RMB 64.1 billion.⁷⁶

In addition to China's own admissions, other governments have identified actionable direct subsidy grants in the course of trade remedy cases brought against China. In a recent countervailing duty case against China, for example, Canadian authorities identified actionable subsidies in the form of direct cash grants provided by the government to steel and other manufacturing industries for export performance. The Canadian government found benefits to the Chinese steel industry in the form of direct grants to

enterprises satisfying export criteria as well as grants to enterprises to assist in expanding export sales.⁷⁷

Additionally, in a recent countervailing duty investigation of China, the U.S. government found that the State Key Technology Renovation Project Fund ("Key Technology Fund") offers cash grants for technical upgrades and renovation.⁷⁸ The Key Technology Fund was created pursuant to state circular Guojingmao Touzi (1999) No. 886 and operates under the regulatory guidelines contained therein, including the Measures for the Administration of National Debt Special Fund for National Key Technology Renovation Project, and state circulars Guojingmao Touzi (1999) No. 122, Guojingmao Touzi (1999) No. 1038, and Guojingmao Touzi (2000) No. 822. According to the U.S. Department of Commerce, the specific purpose of this subsidy program is to promote: (i) technology renovation in key industries, enterprises, and products; (ii) facilitation of technology upgrades; (iii) improvement of product structure; (iv) improvement of quality; (v) supply increase; (vi) expansion of domestic demand; and (vii) continuous and healthy development of the state economy.⁷⁹

Local and provincial governments also provide substantial cash grants to steel producers. These programs are often little more than creatively titled export subsidies.

For example, certain funds for "outward expansion" are provided to industries in

⁷² Canadian (NI) Trade Tribunal, *Dumping of Certain Carbon Steel and Stainless Steel Fasteners Originating in the People's Republic of China and Chinese Taipei and Subsidizing of Certain Carbon Steel and Stainless Steel Fasteners Originating in the People's Republic of China and Chinese Taipei*, Nos. 4243-38, 4218-17, ADI1308, CVD103, at 40-41 (Statement of Reasons and Final Determination). While this case involved steel fasteners, many of the types of programs found by the Government of Canada and cited in that paper are granted to manufacturers of other types of goods and are also indicative of the types of subsidies granted to both upstream and downstream manufacturers.

⁷³ Coated Flat Sheet (Paper) From the People's Republic of China, 72 Fed. Reg. 17,484, 17,491 (Dept. Commerce Apr. 9, 2007) (unpublished paper) ("Coated Flat Sheet").

⁷⁴ *Id.*

Guangdong Province for (i) market exploration, (ii) export credit insurance, (iii) loan interest on offshore processing trade projects, (iv) export research and development, (v) responding to antidumping duty cases, (vi) export rebate account loan payments, and (vii) export-oriented enterprises.⁴¹ Steel producers located in the province, including Shaoguan Steel and Guangzhou Steel, likely benefit from this program. Export interest subsidies are also available for enterprises located in Shenzhen or Zhejiang Province.⁴² Under this program, RMB 800 million in benefits were to be distributed to eligible companies in 2006.⁴³ Lastly, local payments are made as incentives and rewards to encourage enterprises to conduct clean production inspections.⁴⁴ The program, "Provisional Measures on Clean Production Inspection," went into force in October 2004 and was authorized by Decree No. 16 of the NDRC and the National Administration of Environmental Protection.⁴⁵

2. Documented Grants Provided to Chinese Steel Producers

Numerous Chinese steel producers report direct cash grant subsidies in their financial statements. For instance, Baosteel reported that it received more than RMB 25 million in government "subsidies" in 2005, in addition to substantial subsidy income in the preceding two years.⁴⁶ These cash grants do not appear to be slowing – through

⁴¹ WTO Transitional Review, *Questions from the European Union to China concerning Subsidies and Price Controls*, No. GSCMQ2CHN24, at 2 (Oct. 20, 2006) (EU Subsidies Questionnaire), *Guangdong Supports Private Enterprises to Expand Overseas*, TDC Trade, Mar. 1, 2004.

⁴² WTO Transitional Review, *EU Subsidies Questionnaire*, No. GSCMQ2CHN24, at 2, *Export Interest subsidy for Shenzhen Enterprises Raised*, TDC Trade, May 1, 2004.

⁴³ *Id.*

⁴⁴ The purpose of this program is to provide incentives and rewards (monetary or non-monetary) to encourage enterprises to conduct clean production inspections, with the goal of protecting the environment.

⁴⁵ *Central Press Sheet*, 72 Fed. Reg. at 17,497.

⁴⁶ Baosteel 2005 Annual Report at 46.

the first half of 2006, Baosteel received RMB 21 million in government subsidies.⁴⁷ Maanahan Iron & Steel reported in its 2003 financial statements that it received more than RMB 276 million in 2003 and RMB 525 million in 2002 in "government subsidies granted for specific construction projects," in addition to "subsidy income for steel export."⁴⁸ Additionally, Jinan reports that it received direct grants from the "provincial financial office as the technology research and development fund of 2nd national high-tech industry development project."⁴⁹ JISCO identified almost RMB 300 million in direct subsidies in 1999.⁵⁰ Using the U.S. government's subsidy calculation methodology results in a countervailing duty rate of nearly 10 percent for JISCO for grants alone. The rate would undoubtedly increase substantially if additional subsidies (e.g., subsidized loans, tax rebates, raw materials procurement) were included.

Other steel producers have also reported receiving substantial cash grants from the government, including Baotou, Handan, Wuhan, Laiwu, and Shougang.⁵¹ Notably, Baotou and Handan both reported receiving subsidy income as recently as 2006.

B. Equity Infusions and Conversions

Equity infusions in the Chinese steel industry take at least two forms. First, there is the familiar straight injection of additional cash into a company, usually in exchange for newly minted shares. As the dominant shareholder in most major steel companies, the Chinese government receives no additional rights when it issues additional shares.

⁴⁷ Baosteel 2006 First Half Report at 18.
⁴⁸ Maanahan 2003 Annual Report at 144 and 151.
⁴⁹ Jinan 2005 Annual Report at 53-54.
⁵⁰ JISCO 2000 Annual Report at 52.

⁵¹ See Baotou Steel Union ("Baotou") 2006 Annual Report at 3; Handan Steel 2006 First Half Report at 34; Laiwu Steel ("Laiwu") 2006 Third Quarter Report at 5; Shougang 2005 Third Quarter Report at 5; Shougang 2003 Annual Report at 33; Shougang 2002 First Quarter Report at 3.

Unless it demands a reasonable commercial return on its investment (in the form of dividends or higher return on sale), the government, in effect, is granting the steel company a straight cash grant. The second form of equity infusion is the debt-to-equity conversion. This popular capitalization technique relieves cash-starved companies of their obligations to repay their massive debts in exchange for assuming the debt burden, the government receives additional shares in companies they already own. Added together, a review of publicly available financial statements reveals equity grants of at least RMB 141 billion, or nearly US\$ 19 billion, over the last ten years.

1. Description of Equity Infusions Offered by China

As explained in detail above, the government owns a majority stake in almost all of China's top steel producers. This has been accomplished in large part through the government's ongoing equity infusion scheme, which enables the government to acquire additional ownership shares in steel companies at the same time that it provides substantial cash subsidies to steel producers. Indeed, China regularly uses equity infusions as a grant-giving operation in order to effectuate its economic policy goals.

Equity infusions and other forms of government-backed investment guarantees are well known and expected in China. The US-China Business Council has documented China's use of such tools, including "new infusions of capital," to prop up failing firms.¹² Its report concludes the following:

The unfortunate reality is that many of these firms have no market potential, and as such, will never take off if exposed to market forces. Time and again, policymakers and managers alike may persuade themselves that each new infusion of capital is a last supper, but what everybody knows—

¹² US-China Business Council, *The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Sweep in Context at 3* (July-Aug. 2000).

or at least what many managers have come to believe—is that each last supper has been, and will always be, a free lunch.¹³

Private investors readily support the use of such non-commercial tools, given the government-guaranteed return on investment. Investors can make a "safe bet" on a Chinese steel producer, knowing that the government will not allow it to fail. As the government's consolidation plan unfolds, the need for a government guarantee increases because, with a few very large firms, a "too big to fail" policy becomes a necessity. Thus, government intervention is a self-perpetuating cycle that becomes more important with time.

2. Documented Equity Infusions Provided to Chinese Steel Producers

An examination of public financial statements for China's top steel producers demonstrates the pervasiveness of the equity infusion subsidy scheme. For example, in 2005, Baosteel issued five billion ordinary shares.¹⁴ At RMB 5.12 per share, the company raised over RMB 25 billion.¹⁵ Three billion of these shares were purchased directly by Baosteel's 100 percent state-owned holding company, Baosteel Group, resulting in an infusion of more than RMB 15 billion in government cash.¹⁶ Baosteel's financial statements explain that, "upon the completion of new share issuance and asset acquisitions, the company raised its production capacity of crude steel to 20 million tons and established three steel production systems, namely, carbon steel, stainless steel,

¹³ *Id.* (emphasis added).

¹⁴ Baosteel 2005 Annual Report at 32.

¹⁵ *Id.*

¹⁶ *Id.*

and specialty steel systems.⁴⁷ Further, the new share issuance "helped to standardize the Company's governance structure" and thus "won support from the investors and capital market."⁴⁸

It is not surprising that private investors and the capital markets were pleased with Baosteel's share issuance given the government guarantee associated with the sale. The government, through the 100 percent state-owned Baosteel Group, proclaimed publicly that it would (1) retain the shares for a certain window period, (2) not sell its shares for less than RMB 5.63 after the window period, and (3) never own less than 67 percent of the total number of shares.⁴⁹ Further, the government stated that it would prevent Baosteel's share price from ever falling below RMB 4.53 in order to "protect the interests of investors."⁵⁰ The government would do this by manipulating prices, if necessary, through further injections and/or purchases of public shares on the Shanghai Stock Exchange.⁵¹ Thus, Baosteel successfully increased its production capacity and made acquisitions, all according to government design, with government cash as well as private cash guaranteed by the government.

Maanshan Iron & Steel, another top steel producer, provides a further example of the pervasiveness of the equity infusion subsidy scheme. From 1993 to 1997, the company received government infusions of more than RMB 18 billion – subsidies that still benefit Maanshan today. These equity infusions have also enabled Maanshan to grow substantially over the past 15 years, in line with government policy. Indeed, every

⁴⁷ *Id.* at 16.

⁴⁸ *Id.*

⁴⁹ *Id.* at 110 n.30.

⁵⁰ *Id.*

⁵¹ *Id.*

year the company reiterates that its increases in capacity, consolidation, and acquisitions are all made according to government-established plans. For example, in its 2005 financial statements, Maanshan explains that "[t]he implementation of the Company's master plan for technology reforms and structural adjustments in relation to the Eleventh Five-Year Plan ... was carried out ahead of schedule," including, for example, a thin plate production line with a 5 million ton capacity.⁵² Maanshan's current capabilities would not have been possible if not for the government's substantial infusions of cash years ago.

3. Description of Debt-to-Equity Conversion

Debt-to-equity swaps are another tool utilized by the Chinese government to prop up state-owned enterprises. In the year 2000 alone, China Daily reported that 37 different Chinese steel companies benefited from debt-to-equity swaps worth a total of RMB 62.5 billion (US\$ 7.53 billion).⁵³ In 1999, the total benefit from debt-to-equity swaps was RMB 27.5 billion.⁵⁴

The debt-to-equity swap is a disguised grant-giving operation. Throughout the 1980s and 1990s, Chinese banks helped implement the economic goals of the government by distributing capital to favored firms and industries.⁵⁵ As a result, many of these firms amassed tremendous liabilities and over-invested in capacity expansions, all the while facing declining real returns on investment.⁵⁶ The government continues to

⁵² Maanshan 2005 Annual Report at 10.

⁵³ China: Debt-to-equity swaps help steel makers, China Daily, Mar. 26, 2000, available at <http://www.industrybase.com/indusbase.asp?formmode=view&id=5490>.

⁵⁴ *Id.*

⁵⁵ US-China Business Council, The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Swaps in Context at 1 (July-Aug. 2000).

⁵⁶ *Id.*

utilize the debt-to-equity swap as a tool to save favored industries that are loaded down with insurmountable debts.¹⁰⁷ Indeed, as of September 2003, the MOFCOM website stated that it would exempt certain state-owned enterprises ("SOEs") from "repayment of non-performing loans, and provide a debt-to-equity swap policy. The policies will support firms' development, make good use of domestic and foreign trade development funds, provide subsidized interest for technical innovation loans, and accelerate infrastructure development."¹⁰⁸

The debt-to-equity swap also serves as a mechanism to effectuate the government's long-standing policy goals. A report by the US-China Business Council explains that the debt-to-equity swaps are "a sort of response, 16 years later, to the 1984 policy of shifting SOE [state-owned enterprise] financing from direct subsidies to bank loans (to gal dai)."¹⁰⁹ The idea was to use "market forces," by offering interest-bearing loans rather than direct subsidies, in order to increase performance. However, as the report notes

[W]hen performance failed to improve—when return on investment actually declined and firms proved unable to repay loans—the conclusion, somehow, was not that market forces were working (as they, indeed, actually were). Few policymakers or enterprise officials would accept the possibility that the gal dai was doing exactly what it should have done: identify poor performers so that resources could be shifted away from them. After all, market forces were not supposed to destroy losers. Rather than tolerating market outcomes, therefore, decisionmakers [sic] backed away from their own policies. When enterprises could not repay the

¹⁰⁷ *Id.*

¹⁰⁸ See WTO Transitional Review, *Questions from the United States to China Concerning Subsidies and Price Controls ("U.S. Subsidies Questions")*, No. GS/MT/2/CHN/14, at 4 (Sept. 29, 2005).

¹⁰⁹ US-China Business Council, *The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Swaps in Context* at 2 (July-Aug. 2000).

bank loans that had replaced direct subsidies, new loans were simply pumped in year after year.¹¹⁰

The report explains that Chinese firms and policymakers mistakenly believed that market forces would benefit all enterprises regardless of their efficiency.¹¹¹ In other words, policymakers did not confront the reality that market forces will, by nature, weed out inefficient enterprises. The report continues:

What is important to recognize is that some of these beliefs are alive and well in China today, a reality confirmed by the current attitude of many enterprise managers toward debt-equity swaps. Theoretically, the last thing a manager in a market economy should want is a debt-equity swap. After all, equity financing is generally more expensive than debt financing over the long run (otherwise, why would an investor purchase equity if he or she could achieve higher returns by simply putting money in the bank?), and the swap itself is an indicator of default.¹¹²

In China, however, the debt-to-equity swap is just another source of free capital.¹¹³

4. Documented Debt-to-Equity Swaps

The Chinese government began widespread use of the debt-to-equity subsidy program in 1999.¹¹⁴ Since then, many of China's largest steel companies have benefited substantially from such swaps.

- A division of Baoshan Iron & Steel, Meishan Corp., received a US\$ 200 million debt-to-equity conversion in 1999. The China Construction Bank ("CCB"), a government-owned and controlled policy bank, was loaded down with some US\$ 30 billion in problem loans.¹¹⁵ To deal with the debt, China's Finance Ministry provided US\$ 1.2 billion to create a state-owned bank asset management company

¹¹⁰ *Id.*

¹¹¹ *Id.* at 2-3.

¹¹² *Id.* at 3.

¹¹³ *Id.*

¹¹⁴ China's *Red-Desk Cops* Get Going, *Business Week*, Oct. 4, 1999.

¹¹⁵ *Id.*

("BAMC") named China Cinda Asset Management Corporation ("Cinda")¹¹⁸ Cinda, which is completely government owned, controlled, and financed,¹¹⁹ promptly converted more than US\$ 200 million in debt to equity for Meishan Corp.¹²⁰

- Shortly after Meishan's debt-to-equity swap agreement in 1998, Huarong AMC and the China Development Bank completed agreements with three more subsidiaries of Baosteel. First, more than RMB 2 billion in debt owed by Baosteel Plant of Shanghai was converted into equity in the company. Second, a deal was signed. Shanghai No. 1 Iron & Steel Co. for RMB 800 million. Third, an agreement with Baosteel Shanghai No. 5 Steel Co. swapped RMB 500 million of the company's debt for RMB 500 million of equity in the company. Fourth, Huarong AMC was to hold most of the equity while the remaining portion would be shared among the AMCs of other creditor banks.¹²¹ The agreements also called on the AMCs and their parent banks to work with the companies to improve their operations. After the debt-to-equity swaps, ratios of liabilities to assets for the Shanghai Baosteel subsidiaries decreased by 25 percent on average, saving annual loan interest payments of approximately RMB 300 million. Company officials admitted that the deals were necessary because the companies all have levels of liability considered 'abnormal,' hindering normal operations.¹²²
- Xingang Steel was established in 2000 through a debt-to-equity swap in which several of China's BAMCs purchased non-performing loans and then injected capital into the steel company.¹²³
- Valin Lianyuan Steel Corp., a small producer in Hunan province, successfully converted RMB 740 million in debt to equity in 2000.¹²⁴
- In 2001, Anyang, a 100 percent state-owned entity,¹²⁵ received a massive equity infusion of RMB 1.7 billion to pay off long-term loans for assets it could not otherwise pay.¹²⁶

118

119

120

121

122

123

124

125

126

¹¹⁸ See China's debt-to-equity swaps proceed despite concern, Japan Economic Newswire Plus, Nov. 13, 1999.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ Debt-to-Equity Swap Brings Economic Results to Steel Firm, People's Daily Online, June 7, 2001, http://www.peopledaily.com.cn/2001/06/07/eng010607_71885.htm

¹²⁴ A Remarkable Leap in the Industrial Revitalization of Hunan, Xinhua News Agency, Oct. 27, 2005.

¹²⁵ See Appendix 2.

ewise pay.¹²⁵ Anyang's long-term debts were almost entirely eliminated.¹²⁶ At the same time, its shareholder equity increased nearly 80 percent.¹²⁷ In other words, when the debts matured and the company was unable to pay, the government stepped in and injected cash. Anyang then paid off the debt, and the financial statements remained healthy. Simply put, one arm of the government paid off the other while the company acquired the assets at no cost.

- In 1997, Maanshan benefited from a similar subsidy scheme which continues to benefit the company today.¹²⁸ At the time, Maanshan engaged in numerous "projects under construction," including "buildings, plant houses, machine and equipments [sic] and other fixed assets which under [sic] construction or installation."¹²⁹ As with Anyang, when Maanshan's loans came due, an equity injection of over RMB 600 million was made and its debts were paid.¹³⁰

These massive infusions benefit the Chinese steel industry today. Recent press reports indicate that the government continues to provide the steel industry assistance in this manner. However, the true extent of this assistance is unknown. The OECD reports that the transactions in China involve "substantial reductions in debt loans in return for restructuring arrangements whose details have not been fully revealed."¹³¹ Indeed, back in 1999, *Business Week* predicted the overall plan "could mark the start of a serious effort by the banks to clear away an estimated \$250 billion in bad debt."¹³²

C. Land-Use Rights

China's steel industry also receives heavily subsidized lease agreements for the land utilized by its massive operations. Based on documented benefits reported in the

¹²⁵ Anyang 2001 Annual Report at 13-16, 24-25.

¹²⁶ *Id.* at 13.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ The U.S. Dept. of Commerce would likely use a 15 year average useful life ("AUL") for steel assets. Thus, a debt-to-equity swap in 1997 is still disadvantageous today.

¹³⁰ Maanshan 1997 Annual Report at 3.

¹³¹ *Id.* at 1.

¹³² OECD, *Reforming China's Enterprises* at 78 (2000).

¹³³ China's Bad-Debt Cops Get Going, *Business Week*, Oct. 4, 1999.

public financial statements of several major producers, we estimate a total benefit to the Chinese steel industry of at least RMB 38.9 billion (US\$ 5.1 billion).

1. Description of Land Subsidies Offered by China

Private land ownership, either by individuals or corporations, is prohibited in China.¹³³ Instead, the Chinese government offers lease agreements or other forms of land-use rights rather than transferring actual ownership.¹³⁴ Essentially, the Chinese government assumes the role of landlord by controlling the lease of land to domestic industries. Once the government-granted land-use rights are transferred, the rights are then classified as normal, depreciable assets of the company. The land-use rights are typically listed either as intangible assets or deferred expenses, given a depreciable lifespan (usually 50 years), and then used as any other normal asset. For example, land-use rights are routinely used as collateral in securing future financing.¹³⁵ As seen in the table below, several of the largest Chinese mills report the use of this accounting method. The land-use rights are booked at their original "cost", amortized on an annual basis, then carried at the reduced value

¹³³ Memorandum from David M. Spooner, Asst. Sec'y for Import Admin., to Joseph A. Speltini, Deputy Asst. Sec'y for Antidumping Duty Investigations, dated August 1, 2006, and attached to the Report of the U.S. Trade Representative to the People's Republic of China ("China 3") - China's Status as a Non-Market Economy, (Dept. Commerce Aug. 30, 2006).

¹³⁴ See Barry Naughton, *The Assembling Center: Beijing Moves Against Local Government Control of Land*, China Leadership Monitor, No. 20 (Winter 2007).

¹³⁵ See, e.g., Angang Steel Company Ltd. 2006 Annual Report at 119.

2. Documented Land Subsidies Provided to Chinese Producers

Accounting for Land-Use Rights by Selected Chinese Steel Mills^{136 137 138}

	1993	2004	2005	2006
Cost (original value)	354,200	354,200	354,200	5,638,300
Depreciation charge for year	7,392	7,107	7,179	57,000
Accumulated Depreciation	35,534	42,626	50,033	115,000
Carrying Amount (book value)	311,274	304,167	296,988	5,466,300
Cost (original value)	1,721	1,690	1,305,909	1,334,134
Depreciation charge for year	31	188	48,798	29,012
Accumulated Depreciation		1,690	1,357,110	1,305,122
Carrying Amount (book value)				
Cost (original value)	1,052,989	1,069,247	1,202,380	1,781,504
Depreciation charge for year	20,757	21,647	22,207	32,367
Accumulated Depreciation	168,423	189,179	210,727	273,414
Carrying Amount (book value)	884,566	879,068	991,653	1,508,087

Using the annual amortization charges as a proxy for annual rental payments, it becomes clear that Chinese steel mills enjoy the use of land at prices substantially below any market-determined value. For example, Baosteel - China's second largest steel group with significant operations in Shanghai - booked only RMB 28,012,000 in land-use rights amortization for 2006. In other words, Baosteel apparently valued the cost of using land in Shanghai, plus thousands of acres more throughout China, at approximately US\$ 3.6 million in 2006. Similarly, Angang Steel Group booked a land-use rights amortization of approximately US\$ 7.1 million in 2006 for land used in operations in nearly every region of China, including major urban areas

¹³⁶ Angang 2003 Annual Report at 83; Angang 2004 Annual Report at 104; Angang 2005 Annual Report at 115; Angang 2006 Annual Report at 119.

¹³⁷ Baochuan Iron & Steel Co. ("Baoshan") 2003 Annual Report at 86; Baoshan 2004 Annual Report at 75; Baoshan 2005 Annual Report at 89; Baoshan 2006 Annual Report at 129.

¹³⁸ Maanshan 2003 Annual Report at 139; Maanshan 2005 Annual Report at 170; Maanshan 2006 Annual Report at 41.

million. Moreover, if the same methodology is applied to the Chinese steel industry as a whole, the subsidy totals more than US\$ 5.1 billion (RMB 38.9 billion).

D. Government-Mandated Mergers and Transfers of Ownership on Terms Inconsistent with Commercial Considerations

One of the newer tools used by the Chinese government consists of government-mandated mergers and transfers of ownership. These mergers are being driven by China's 11th Five-Year Plan. Where China previously emphasized growth of unprofitable capacity through grants and equity infusions, it is now emphasizing the creation of several consolidated world-class entities through required mergers and ownership transfers. While the terms of many of these mergers have never been made public, an examination of just two of these mergers demonstrates that they involved RMB 9.47 billion in government subsidies.

1. Description of Government-Mandated Mergers and Transfers

As discussed above, consolidation within the Chinese steel industry is a stated focus of the government's Steel Policy. Because so many Chinese steel companies are controlled by government entities, the government can essentially order companies to merge. One common means of doing this is to offer ownership stakes in state-owned steel companies to other, larger steel producers at prices below the market value, or even for free.

2. Documented Mergers and Transfers

The China Syndrome described how, in January 2005, Wuhan Iron and Steel Group acquired a majority stake in Ercheng Iron and Steel at no cost, in return for

Wuhan's agreement to merge Ercheng into it.¹⁴⁷ Wuhan received a 51 percent stake in Ercheng, which at the time produced 3 million metric tons of steel a year. At the time, Citigroup valued the assets involved at RMB 2.7 billion.¹⁴⁸

Consolidation activity has accelerated since that time. Another prominent government-directed merger occurred in May 2007 when Baosteel received a 48.46 percent stake in Xinjiang Bayi Iron & Steel Group ("Bayi") – at no cost.¹⁴⁹ At the time, Xinjiang's assets were worth approximately RMB 6.77 billion.¹⁵⁰

This transfer was only possible because the Chinese government owns and controls both entities. The Xinjiang government, through the Xinjiang SASAC, owned Bayi, the largest steel producer in Xinjiang.

Bayi produced 3.6 million tons of crude steel in 2006. It intends to increase its crude steel capacity to 5 million tons per year by the end of 2007.¹⁵¹ Bayi completed a major upgrade of its cold-rolled mill in December 2005¹⁵² and is currently constructing a project that will produce 1.2 million tons of hot rolled steel per year.¹⁵³ There are reports

¹⁴⁷ The China Syndrome at 22.

¹⁴⁸ China Steel Industry: Capacity Continues to Grow, So Does Surplus, Citigroup Global Markets, Feb. 21, 2006, at 26, 59.

¹⁴⁹ Regulator Clears Baosteel's Takeover Of Bayi Steel Group, American Metal Market, June 18, 2007.

¹⁵⁰ When Baosteel formally took control of Bayi, it received 48.5 percent of Bayi. It agreed to inject RMB 3 billion into the company, after which its stake would rise to 70 percent. This is an increase of 21.5 percent. If 21.5 percent of Bayi is worth RMB 3 billion, then 48.5 percent would be worth RMB 6.77 billion.

¹⁵¹ Li Hongmei, Baosteel Takes Formal Control Of Xinjiang Bayi, American Metal Market, May 17, 2007.

¹⁵² Li Hongmei, Sherman Unit Commences China Mill Upgrade, American Metal Market, Dec. 9, 2005.

¹⁵³ Li Hongmei, Baosteel Takes Formal Control Of Xinjiang Bayi, American Metal Market, May 17, 2007.

Significantly, this injection of capital will go into Baiy; it is not payment to the Xinjiang government. Ultimately, the Xinjiang government will continue to hold either an 11 or a 20 percent stake in Baiy, according to reports from different sources.¹⁵ This uncertainty over the extent of the Xinjiang government's share of the company is a further indication of the extent to which the takeover did not comply with normal commercial considerations.

It is quite likely that transactions of this type will continue to occur. For example, in 2004, the largest specialty steel producer in Northeast China, **Dongbei Special Steel Group Co., Ltd.**, was created through the merger of three "key" SOEs: Liaoning Special Steel Group (i.e., Dalian Iron & Steel Group Co., Ltd.); Fushun Special Steel Group

104. *Id.*

105. Regularly. *Cleary Brothers's Takeover Of Bay Steel Group*, American Metal Market, June 18, 2007, <http://www.amm.com/Articles/061807/06180701.htm>.

106. U. Hongmei, *Baosteel takes formal control of Xinyang Bay*, American Metal Market, May 17, 2007, <http://www.amm.com/Articles/051707/05170701.htm>.

107. *PricewaterhouseCoopers, Forging Ahead: Mergers And Acquisitions Activity In The Global Metals Industry, 2006 at 3* (2007).

Co., Ltd. and Berman Special Steel Co., Ltd. (major operational assets only).¹⁵⁸ More recently, Baosteel has been conducting talks with the government of Inner Mongolia to acquire Baotou Iron & Steel, which is owned by the Inner Mongolian government. A Baotou official stated on July 23, 2007, that "[i]f the merger can be considered a done deal, Baosteel will take us over, either by paying or getting an asset transfer free of charge. It will happen very soon, as our local government is very keen for the merger."¹⁵⁹ The Chinese central government also supports the acquisition.¹⁶⁰ Baotou produced 7.5 million tons of steel in 2006.¹⁶¹ The lowest international acquisition price for a steel producer not in bankruptcy in 2006 was US\$ 533/ton, which ArcelorMittal paid for Sarcaria in December 2006.¹⁶² If Baotou were in fact transferred to Baosteel free of charge, this would represent a subsidy to Baosteel of at least US\$ 2.6 billion.

E. Preferential Loans and Directed Credit

The government also directs credit to Chinese steel producers in order to effectuate its policy goals. Central, provincial and local governments provide both direct and indirect preferential loans through the state-owned banks. In just the last five years, 15 of China's top steel producers received more than RMB 130 billion in subsidized loans, and the total amount of preferential loans and directed credit is far higher. Experts estimate that the majority of all loans in China are policy (preferential) loans.

[illegible]

1. Description of Preferential Loans and Directed Credit

China's banking system is dominated by the four state-owned banks – the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China – which account for over 60 percent of all loans.¹⁴⁰ Traditionally, these banks have made loans based on political directives from the central or provincial governments, rather than creditworthiness or other market-based factors. These "policy loans" have generally gone to state-owned enterprises and to industries favored by the government, including steel, on preferential, non-commercial terms.¹⁴¹

The Chinese government has not hidden its preferential loan policy. As the Department of Commerce noted in its 2000 Report to the President, the Chinese government has publicly stated the amount of discounted loans provided to Chinese steel companies:

The [Chinese] government recently announced that \$6 billion will be spent over the next few years to upgrade and transform the steel industry, with the hope of ensuring its international competitiveness when China enters the WTO. Baoshan, Wuhan, Anshan, and Shougang head the list of steel producers slated to benefit from this assistance. Nearly \$3.4 billion will be in the form of low-interest loans. It is not clear whether this amount represents the volume of low interest loans or, alternatively, the reduction in interest payments that the government will cover.¹⁴²

¹⁴⁰ Luo Ping, China Banking Regulatory Comm'n, *Challenges for China's Banking Sector and Policy Responses* (New Delhi (Nov. 14-16, 2003)), available at <http://www.cbrc.gov.cn/eng/pressroom/2003/2003111601.htm>.

¹⁴¹ See *Report of China's Banks, Burdened by Bad Loans, Is Priority for Government*, June 1, 2005, <http://bigl.com.cn/eng/pressroom/2005/2005060101.htm>. A recent IMF report concludes that "banks remain exposed to several sectors that are vulnerable to an economic slowdown and/or consolidation, including construction and are therefore vulnerable to an economic slowdown and/or consolidation in these sectors." Richard Phipps, IMF, *Progress in China's Banking Sector Reform: Has Bank Behavior Changed?*, No. WP/05/71, at 11 (Mar. 1, 2006).

¹⁴² U.S. Dept. Commerce, Int'l Trade Admin., *Report to the President: Global Steel Trade – Structural Problems and Future Solutions* at 141 (July 2000) (emphasis added).

These preferential policy loans continue to be granted to China's steel producers today. Indeed, China's Steel Policy provides for direct government subsidization of the steel industry, including support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly developed domestic equipment."¹⁴⁶ The policy also mandates the provision of export credits, restrictions on foreign investment, and discrimination against foreign equipment and technology.¹⁴⁷ For steel projects that utilize domestic equipment, the policy further calls for "policy support in such aspects as taxation, interest subsidy, and scientific research funds."¹⁴⁸ Such projects, therefore, not only receive government loans but also subsidies to pay for the loans, as well as other benefits.

A November 2005 WTO report confirms China's state support to various industries through the banking system "in the form of policy loans, the automatic roll-over of unpaid principal and interest, forgiven and non-performing loans and the selective use of below-market interest rates."¹⁴⁹ In its recent countervailing duty action against China, Coated Free Steel Paper, the Department of Commerce found such loan programs to be countervailable subsidies.¹⁵⁰

China's policy of preferential loans to favored industries is further evidenced by the devastation these policies have created in its banking system – specifically the high level of non-performing loans and the numerous bailouts of the state-owned banks.

¹⁴⁶ Steel Policy at Art. 17 (emphasis added).

¹⁴⁷ Article 27 of the Steel Policy, for example, provides that "the State encourages and will provide export credit and other support for enterprises engaged in the production of steel and related production equipment"

¹⁴⁸ Steel Policy at Art. 17 (emphasis added).

¹⁴⁹ WTO Transitional Review, *Chenping's Report to the Council for Trade in Goods on Transitional Review in China*, No. GSCM/18, at 12 (Nov. 8, 2005).

¹⁵⁰ Coated Free Steel, 73 Fed. Reg. at 17,484.

3. Steel Group received subsidized loans totaling RMB 2.4 billion to fund a 1.3 million ton cold-rolled steel sheet project.¹⁷⁶ Other companies, such as **Baoiron Steel**, have reported receiving export financing at below market rates.¹⁷⁸ In 2006, **Anshan Steel** received export credit totaling US\$ 1.03 billion for its exports of high-end products.¹⁷⁹

Many more Chinese steel producers have been given subsidized loans to carry out Chinese government policy. For instance, Maanshan proclaimed in its financial statements that it "continued with the implementation of the 10th Five-Year Plan" completing major projects including a cold-rolling plant, galvanizing line, a new blast furnace, a coke dry quenching project, a high-speed rod production line, and a coil coating line after receiving over RMB 6 billion in loans at interest rates as low as 0.25 percent from the Bank of China.¹⁸ Maanshan explained that its increase in "long term loans by 107 percent was mainly attributable to the increase in the long term loans for construction" in accordance with the plan.¹⁹

Baosteel states in its 2005 financial statements that excessive growth and overcapacity are a major problem, echoing the government's 11th Five-Year Plan.¹⁹² To solve this problem, Baosteel explains, "China has strengthened macroeconomic control

According to one estimate, policy loans account for nearly 60 percent of all loans.¹⁷³ Two of China's top steel producers, *Baosteel* and *Maanahan*, have received between 60 to almost 100 percent of their loans from policy banks.¹⁷⁴ Baosteel funded one-half of the RMB 10 billion cost of a new stainless steel production facility with subsidized loans.¹⁷⁵ Another producer, *Anshan Steel Group*, received RMB 10 billion in

¹⁷¹ See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government, June 1, 2005, <http://knowledge.wharton.upenn.edu/index.cfm?i=printArticle&ID=1202>

¹⁷² See WTO Transitional Review, U.S. Subsidies Questions, No. G/SCM/Q2/CHN/14, at 3 (Sept. 29, 2005).

175 Luo Ping. *Challenges for China's Banking Sector and Policy Responses*, China Banking Regulatory Commission, 2005.

http://www.limf.org/external/nap/du/geminats/2003/newswater/pmg.pdf.

¹⁷⁴ Boosted 2005 Annual Report at 106 n.28; Maanshan 2004 Annual Report at 148 n.14, 152-153 nn. 24-25.

China Corporate Culture Web, <http://www.ccc.com>

© 2007 Wiley Rein LLP

© 2007 Wiley Periodicals, Inc.

Xinhuanet, Sept. 28, 2005. <http://finance.sina.com.cn/jj/ck/k/20050928/0828328489.shtml>.

177 Stockstar.com, Sept. 2005.

http://source.stocksjar.com/info2005/article.asp?id=SS_20050921_30268085&goumu=

⁷⁸ See, e.g., 2002 Baulou Annual Report at 57 (noting a US\$ 20 million export credit from the China Construction Bank Inner Mongolia Branch).

Anshan Steel Secures 3-Year Funding From China Eximbank, American Metal Market, Mar. 19,

2007.

Maanshan 2004 Annual Report at 10-11, 154 n 25.

Maanshan 2005 Annual Report at 185

Baosteel 2005 Annual Report at 25.

over [the] steel industry" which aims to "increase industry concentration led by major enterprise groups."¹³³ Accordingly, Baosteel quadrupled its long-term loans and quintupled its short-term loans in 2005, in part for new projects and acquisitions.¹³⁴

Angang received almost RMB 500 billion in long-term loans which were "guaranteed by Angang Holding." Angang's 100 percent government-owned holding company.¹³⁵ Finally, Angang more than tripled its long-term loans in 2005 for construction of a converter-rolling mill.¹³⁶

In the last five years, 15 of China's top steel producers received more than RMB 130 billion in subsidized loans. The average interest rate these companies paid is eight percentage points lower than the commercial rate calculated by the U.S. government in the *Coated Free Sheet Paper* subsidy investigation. The below-market rates enjoyed by Chinese steel producers are due to the pervasive interference in the credit market by the government. The loan subsidies attributable to 2005 total more than RMB 8 billion alone.

F. Tax Benefits Provided to the Steel Industry

The central, provincial and local Chinese governments provide a variety of tax exemptions, reductions and credits that directly benefit the steel industry. These programs, detailed below, provide a financial contribution to the steel industry in the form of foregone revenue by the Chinese government. Notably, many of these tax incentive programs were part of the Chinese government's WTO subsidies notification and are the subject of the U.S. subsidy complaint currently pending at the WTO.

¹³³ *Id.*

¹³⁴ *Id.* at 101 n.15, 106 n.28.

¹³⁵ Angang 2001 Annual Report at 71.

¹³⁶ Angang 2005 Annual Report at 42-46.

1. China's Tax Policies and Programs

China's tax policies mandate tax incentives for specified industries, including steel. Article 16 of China's Steel Policy explicitly provides for government support in the form of "tax refunds ... and other policy support for major iron and steel projects."¹³⁷ Moreover, China's "Catalogue of Industries, Products, and Technologies To Be Encouraged for Development on a National Level" identifies the steel industry and roughly 30 different steel products as an industry/products to be encouraged. Industries and products identified in the Catalogue receive a wide variety of benefits, including an exemption from Customs duties and VAT on imported equipment used in the production process.¹³⁸ In addition, a 50 percent corporate income tax reduction is offered to those companies that derive more than 70 percent of their revenues from manufacturing products listed in the Catalogue.¹³⁹

In support of these policies, the Chinese government has implemented a wide array of programs that provide substantial benefit to Chinese steel companies. Indeed, China's April 2006 WTO subsidies notification identifies more than 45 different tax incentive programs, many of which benefit the steel industry. These programs include measures which provide tax refunds, reductions, and exemptions to (1) enterprises in China that are Foreign Invested Entities ("FIEs") or export-oriented, and (2) enterprises in China that purchase domestic over imported goods.

¹³⁷ Steel Policy at Art. 16.

¹³⁸ See Nat'l Dev. Zones, available at <http://www.cadp.org.cn/eng/zhongguo1.htm>.

¹³⁹ See e.g., Foreign Affairs Information Review, Current Catalogue of Key Industries, Products and Technologies the Gov. of Which is Encouraged and Supported (Issued by the State Council on Dec. 31, 1997), available at <http://www.bfep.gov.cn/english/zhongguo144.htm>.

a. Tax Benefits for Export-Oriented Producers and FIEs

- **The Two Free, Three Half Program.** FIEs that are profitable and scheduled to operate not less than 10 years are exempt from income tax in their first two profitable years and pay only half of their applicable tax rate for the following three years.¹⁴⁰ FIEs in the metallurgical industry are automatically eligible for these tax exemptions and reductions.
- **Income tax reduction for export-oriented FIEs.** According to China's subsidies notification, an FIE may continue to pay half of its applicable income tax rate following the expiration of the "Two Free, Three Half Program" if exports constitute 70 percent of the company's sales.¹⁴¹
- **Income tax reduction for FIEs based on location.** The government provides a complex system of tax benefits to FIEs operating in Special Economic Areas (SEAs) such as coastal economic zones, export processing zones, and economic and technical development zones. For example:
 - Under Article 7 of the FIE Tax Law and Article 71 of Decree 85, "productive" FIEs located in the designated economic zones pay income tax at a reduced rate of either 15 or 24 percent.¹⁴² The standard income tax rate for corporations in China is 30 percent, plus a 3 percent provincial income tax.
 - The Jiangsu Yangtze International Metallurgical Industrial Park Zhangjiagang City, an industrial park composed primarily of steel companies, advertises the following tax incentives for foreign-funded manufacturing companies located in the industrial park, the "Two Free, Three Half program": local income tax exemptions; a VAT exemption for exported products; exemption of VAT and customs duties on equipment used in the manufacturing process; and a full refund of income taxes paid on profit which is reinvested in export-oriented enterprises.¹⁴³
 - The China Association of Development Zones cites additional tax incentives, including: (i) the **Loss compensation schemes** whereby any losses experienced by companies in development zones can be offset through reductions in income taxes for a period of 5 years after the loss is

¹⁴⁰ See Coated Free Sheet, 72 Fed. Reg. at 17,484.

¹⁴¹ China Subsidies Notification at 64, 11, p. 3; see also Articles 75(7) and 75(8) of the Rules for Implementation of the Income Tax Law (the provisions that provide for foreign investment and Foreign Enterprises, Articles 8 and 9 of the Provisions on the Encouragement of Foreign Investment, and Articles 6 and 8 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; see also United States Consular Report Request with China on Export and Domestic Preference Subsidies, Feb. 2007.

¹⁴² See Coated Free Sheet, 72 Fed. Reg. at 17,484.

¹⁴³ See Investment Guide, Jiangsu Yangtze Int'l Metallurgical Industrial Park.

incurred;¹⁴⁴ (ii) **Regional tax incentives** whereby companies in specified regions, including the "Middle Western Areas," are eligible for a 15 percent reduction in income tax after the original exemption-reduction period is over;¹⁴⁵ and (iii) **Export-oriented tax incentives** whereby taxes are reduced by as much as 50 percent for export-oriented enterprises which export 70 percent or more of their total annual output.¹⁴⁶

- A 15 percent income tax reduction is granted to FIEs that are engaged in projects encouraged by the State.¹⁴⁷
- FIEs that establish or expand an export-oriented enterprise or a technologically-advanced enterprise in China are granted an income tax exemption.¹⁴⁸
- According to China's subsidies notification, FIEs that qualify as technology-intensive or knowledge-intensive and have major products listed in the *Catalogue of High and New Technology Products of China* are eligible for a reduced income tax rate of 15 percent.¹⁴⁹
- A 40 percent income tax refund is given to FIEs that reinvest profit directly into that enterprise or that use their profit to establish other enterprises with foreign investment.¹⁵⁰
- Other tax benefits are provided to FIEs that are recognized as high or new technology enterprises or are engaged in research and development.¹⁵¹

Moreover, Article 9 of the FIE Tax Law delegates to China's provincial and local governments the authority to provide exemptions and reductions of local income taxes

¹⁴⁴ See Nat'l Dev. Zones, available at <http://www.scitdc.org.cn/eng/zhong11.htm>.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ China Subsidies Notification at 64, 11, p. 3; see also Articles 75(7) and 75(8) of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Articles 8 and 9 of the Provisions on the Encouragement of Foreign Investment, and Articles 6 and 8 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries*.

¹⁴⁸ Article 81 of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Articles 6 and 10 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Article 10 of the Provisions of the State Council on the Encouragement of Foreign Investment.

¹⁴⁹ China Subsidies Notification at VI, p. 7.

¹⁵⁰ Article 81 of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Articles 6 and 10 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, Article 10 of the Provisions of the State Council on the Encouragement of Foreign Investment.

¹⁵¹ China Subsidies Notification at VIII, p. 8 and XXVII, p. 31.

for "productive" FIEs. Jiangsu Province, for example, exempts FIEs from local income taxes during the period in which they benefit from the "Two Free, Three Half" program, pursuant to the *Regulations for the Local Income Tax Exemption and Reduction of Jiangsu Province for Enterprises with Foreign Investment*. Xuzhou Province also exempts productive FIEs from local income taxes pursuant to its *Policies for Encouraging Investments of Xuzhou Economic Development Zone*.²⁶⁷

b. Domestic Preference Tax Benefits

The Chinese government also provides tax refunds, reductions, and exemptions to certain enterprises on the condition that those enterprises purchased domestic rather than imported goods. In February 2007, the United States requested WTO consultations with China on a number of these domestic preference measures, including the following:

- A VAT refund for enterprises with foreign investment for their purchases of domestic equipment. The purpose of the provision is to "encourage enterprises with foreign investment to use domestic equipment."²⁶⁸
- An income tax refund of up to 40 percent for FIEs that purchase Chinese-made equipment rather than imports.²⁶⁹
- Preferential tax policies for Chinese enterprises purchasing Chinese-made equipment for the purpose of technological upgrades.²⁷⁰

²⁶⁷ *Policies for Encouraging Investments of Xuzhou Economic Dev. Zone*, July 14, 2004.

²⁶⁸ See Circular of the State Administration of Taxation Concerning Transmitting the Interim Measure for the Administration of Tax Refund for Domestic Investment for Their Domestic Equipment Purchases, GuoshuiFa [1999] No. 171 (Aug. 1999), available at <http://www.irs.gov/ceq/EOFD/EOFDhtml.htm>; see also Coated Free Sheet, 72 Fed. Reg. at 17,498.

²⁶⁹ See Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Issue of Tax Credit for Business Income Tax for Home-made Equipment Purchased by Enterprises with Foreign Investment and Foreign Enterprises, CaiShui [1999] No. 49 (Jan. 1999), available at <http://www.irs.gov/ceq/EOFD/EOFDhtml.htm>; Circular of the State Administration of Taxation on Priming Foreign Investment and Foreign Enterprises to Invest in Domestic Enterprises, GuoshuiFa [2000] No. 171 (May 18 2000), available at <http://www.irs.gov/ceq/EOFD/EOFDhtml.htm>; see also Coated Free Sheet, 72 Fed. Reg. at 17,498.

After two rounds of consultations, the United States requested formation of a dispute settlement panel on July 12, 2007.

2. Documented Tax Benefits to Steel Producers

Chinese steel companies benefit considerably from these tax incentive programs. Numerous companies, for example, benefit from the "Two Free, Three Half" program granted to FIEs. As Angang's 2006 Annual Report explains, its jointly controlled entity, ANSC-TKS, is "exempt from income tax during its first two profitable years. . . . A 50% income tax exemption is granted to ANSC-TKS from the third profitable year to fifth profitable year. No income tax was provided by ANSC-TKS as the year 2006 is the first profitable year of ANSC-TKS."²⁷¹ Nor did ANSC-TKS pay income taxes in 2005, as the company failed to make a profit that year.²⁷² Other steel producers that benefit from this program include TISCO and Hunan Valin.²⁷³

Chinese steel companies with foreign investment have also been eligible for a reduction in income tax from 33 percent to 15 percent, including the following steel groups or subsidiaries of these groups: Angang, Maanshan, Benxi, Lawu, Handan Steel, Tangshan, Wuhan, TISCO, and Hunan Valin.²⁷⁴ For example, certain subsidiaries of Maanshan were subject to a preferential income tax rate of only 15 percent in

²⁷¹ See Circular on Distribution of Interim Measures Concerning Reduction and Exemption of Enterprise Income Tax for Investment in Domestically Made Equipment for Technological Renovation, CaiShui [1999] No. 290 (Dec. 8, 1999), available at <http://www.irs.gov/ceq/EOFD/EOFDhtml.htm>.

²⁷² Angang Annual Report 2006 at 103.

²⁷³ *Id.*

²⁷⁴ See, e.g., Hunan Valin 2005 First Half Report at 28-29.

See Angang Annual Report 2005 at 96-100; Maanshan 2006 Annual Report at 62, 65; Benxi Iron 2001 Annual Report at 18; Lawu 2000 Annual Report at 36; Handan Steel 2001 Annual Report at 10; Tangshan 2001 Annual Report at 8; Wuhan 2007 Annual Report at 13; TISCO 2004 Annual Report at 28; Hunan Valin 2001 Annual Report at 14.

2006 (and preceding years) because of foreign investments in the company.²¹⁰ According to Hunan Vallin's financial statements, pursuant to "File No. 160, 1999 issued by the People's Government of Hunan Province, our company enjoys the preferential income tax policy which states that our company first pays the income tax of 33 percent and then the fiscal department of the province returns 18 percent."²¹¹ Other companies pay even less in income taxes as a result of provincial programs. Baotou Steel, for example, is eligible for an income tax rate of only 10 percent from 2003 through 2007 as a result of a policy issued by the Department of Finance of the Inner Mongolia Autonomous Region.²¹²

Chinese steel producers also benefit from tax incentives granted to enterprises that purchase domestically-produced equipment. Angang Steel, for example, states in its financial reports that "[i]n accordance with Guishuifa (2000) No. 13 issued by the State Administration of Taxation on 17 January 2000, the Company enjoyed tax exemption relating to investment in technical development of domestic-produced machinery amounting to RMB 163 million."²¹³ Maanshan Iron & Steel states in its 2006 Annual Report that:

The amount of 2005 represents a tax concession, approved by the Maanshan City local tax bureau, in respect of the purchases of certain manufacturing plant, machinery and equipment in Mainland China. The tax concession is calculated at 40% of the purchases of such manufactured plant, machinery and equipment in Mainland China in the year of purchase.²¹⁴ The amount is deductible in not more than five years....²¹⁵

²¹⁰ Maanshan 2006 Annual Report at 82, 85.

²¹¹ Hunan Yash 2001 Annual Report at 14.

²¹² Baotou 2006 Annual Report at 13.

²¹³ Angang Steel Company Limited 2006 Annual Report at 103.

²¹⁴ Maanshan 2006 Annual Report at 103.

From 2004-2006, Maanshan received tax reductions worth RMB 370 million pursuant to this program.²¹⁶ Other steel producers have benefited from this program as well. In 2004, Tangshan received an income tax credit worth RMB117 million for purchases of domestic-produced equipment, while Benxi Steel received a tax credit worth RMB 130 million for its investments in domestic equipment.²¹⁸

Other steel companies have received tax benefits due to their status as high and new technology enterprises. For example, Hualing Guangyuan Co., a subsidiary of Hunan Yalin, is a high and new technology enterprise and is therefore exempt from income taxes for two years starting from the first year of profit. Pursuant to this policy, issued by the Science and Technology Bureau of Hunan Province, after the two-year exemption the company is then eligible for a preferred income tax rate of 15 percent.²¹⁷ Other companies such as TISCO and Angang have received tax benefits as a result of engaging in research and development promoted by the State. Angang, for example, was granted tax exemptions worth RMB 337 million in 2006 as a result of engaging in research and development activities encouraged by the State.²¹⁸

The vast number of tax exemptions, reductions and credits granted to Chinese steel producers by the various levels of the Chinese government have resulted in significant monetary benefits for individual steel producers. As the following table demonstrates, Angang Steel has received more than RMB 1.37 billion in tax benefits over the last 5 years.

²¹⁶	Maanshan 2006 Annual Report at 103; Maanshan 2005 Annual Report at 85; Maanshan 2004 Annual Report at 71.
²¹⁷	Tangshan 2004 Annual Report at 2; Benxi Steel 2004 Annual Report at 67; see also TISCO 2004 Annual Report at 28.
²¹⁸	Hunan Yalin 2005 First Half Report at 28-29; Angang Steel Company Limited 2006 Annual Report at 103.

Certain Tax Benefits Received By Angang Steel Company¹⁶

(in millions of RMB)	2002	2003	2004	2005	2006	2003-2006 Total
Investment in technical develop- ment of domestic-produced ma- chinery	-	219.95	37.13	24.15	163.00	443.76
Enterprise research and devel- opment costs	54.22	87.24	-	66.39	377.19	595.04
Output from environmental pro- tection facilities	-	-	-	-	166.32	166.32
VAT Rebate/Exemption	28.27	5.85	7.29	117.20	-	158.51
Export tax refund	-	-	5.95	-	-	5.95
Total	82.50	282.06	50.26	237.75	706.51	1,389.07

G. Value-Added Tax (VAT) Policies

The Chinese government also provides subsidies to steel producers through its value-added tax ("VAT") rebate programs. There are at least three types of VAT rebate and exemption programs. These VAT programs are actively managed by the govern- ment to encourage production of selected steel products. Moreover, it is also unclear whether Chinese producers even pay the VAT on which they receive rebates.

1. China's VAT Policies and Programs

The government operates a VAT and tariff exemption program on imported equipment. The State Council's *Circular on Adjusting Tax Policies on Imported Equip- ment* (Guofa No. 37) exempts both FIEs and certain domestic enterprises in encour- aged industries from paying VAT and tariffs on imported equipment not for resale.²⁰ The objective of this program is to encourage foreign investment, introduce foreign ad-

¹⁶ Angang 2002 Annual Report at 108; Angang 2003 Annual Report at 83 & 131; Angang, 2004 An- nual Report at 161 & 146; Angang 2005 Annual Report at 99 & 162; Angang Steel Company Limited 2006 Annual Report at 161.
²⁰ Circular of the State Council Concerning the Adjustment in the Taxation Policy of Import Equip- ment, Guofa [1997] No. 37, available at <http://www.lawglobe.com/CHINA/ENGLISH/11101>.
Coated Free Sheet, 72 Fed. Reg. at 17,496.

vanced equipment, and upgrade industrial technology. The program was enacted in 1997²¹ and was included in the government's subsidy notification to the WTO.²² The U.S. government has already found this program to be an illegal subsidy and the De- partment of Commerce has imposed preliminary countervailing duties on imports which benefited from this program.²³

Certain VAT refunds are also available to companies that operate in specific lo- cations in China. For example, enterprises located in the Economic Development Zone of Hainan enjoy VAT tax preferences.²⁴ According to the "Preferential Policies Regard- ing Investment by Manufacturers," high-tech or labor intensive enterprises with an in- vestment of more than RMB 3 billion and more than 1,000 local employees are re- funded 25 percent of the VAT paid on domestic sales; the percentage of the tax re- ceived by the local government.²⁵ The subsidy starts the first year the company has production and sales and continues for five years.²⁶ The U.S. government has already found that program to be an illegal subsidy, and the Department of Commerce has im- posed preliminary countervailing duties on imports that benefited from this program.²⁷

The VAT subsidy program with the greatest impact is known as the value added tax rebate program, which provides direct payments to steel producers and exporters.²⁸ The program is conditioned upon export performance. Although characterized as a le-

²¹ *Id.*
²² Xinhua Guanghua website, <http://www.xinhua.gov.cn/jijinhua/03000160guanghua.htm>.
²³ Coated Free Sheet, 72 Fed. Reg. at 17,496.
²⁴ *Id.*
²⁵ *Id.*
²⁶ *Id.*
²⁷ *Id.*
²⁸ The Provisional VAT Rule replaced rules that had been in place since Sept. 18, 1984.

is not met, however, the result is a prohibited export subsidy. China's VAT rebate system for exported products has no process to ensure that excessive rebates do not occur. In fact, given its targeted application to a limited number of products and myriad rebate rates, it is in fact a policy tool through which the government promotes the exportation of certain products.

The Chinese government has regularly changed these rebate rates to effectuate its economic policies. For example, in October 2003, the government announced a reduction in the VAT rebate rate for steel products from 15 percent to 13 percent.²³⁷ On March 28, 2005, the government terminated the export tax refund applicable to some steel products under HTS numbers 7203, 7205, 7206, 7207, 7218, and 7224, which cover non-alloy steel and stainless steel in ingots or other primary forms, semi-finished products of non-alloy steel, and stainless.²³⁸ Effective May 1, 2005, the government reduced VAT rebates on all steel products under HTS Chapter 72 to 11 percent.²³⁹

News articles published contemporaneously with the 2005 revisions to the VAT rebate schedule explain the genesis of the VAT rebates and the subsequent elimination of VAT rebates for some products:

According to a document issued by the ministry in cooperation with the State Administration of Taxation, China began

²³⁷ Circular of the Ministry of Finance and the State Administration of Taxation on Adjusting the Export Rebate Rates (CaShui [1999] No. 222, at § 4 (Oct. 13, 2003), available at <http://www.csg.gov.cn/gov/csg/ENGLISH/ENGLISH11.htm>.

²³⁸ Circular of the Ministry of Finance and the State Administration of Taxation on the Cess of Export Tax Refund to Such Primary Steel Products as Billet, CaShui [2005] No. 57 (Mar. 28, 2005), available at <http://www.csg.gov.cn/gov/csg/ENGLISH/ENGLISH11.htm>. Although CaShui 57 refers to an "export tax refund," the only refund applicable to primary steel products is the export tax refund. Export Tax Rebate And Exemption in China, *Getting Your Money Back From The Chinese Government*, Global Sources, Aug. 24, 2005. Thus, it is clear that such an export tax refund is a VAT refund.

²³⁹ Ministry of Finance and State Taxation Administration's Notice on Lowering VAT Rebates for Steel Exports, CaShui [2005] No. 73 (Apr. 27, 2005), available at <http://www.csg.gov.cn/gov/csg/ENGLISH/ENGLISH11.htm>; China Tax Alert, Deloitte Touche Tohmatsu.

to offer the tax exemption since 1998 when the prices of Chinese steel products were higher than the world market prices, and downstream firms in China imported steel products from overseas in huge quantities, causing great difficulty for domestic steel producers.

That tax privilege has been very helpful in supporting domestic steel firms in turning out steel products in accordance with the country and improving their industrial market supply to the document. But things have changed in terms of steel trade situation at home and abroad as steel prices in China are lower than that of the world market, and steel production causes too much pollutants, consumes too much energy and other resources, the ministry said.

With permission from China's State Council, or the central government, the two government departments, therefore, decided to call off the tax privilege to ease the country's energy shortage and growing environmental pressure from industrial pollution, according to the document.²⁴⁰

On September 14, 2006, the Ministry of Finance, NDRC, MOFCOM, the General Administration of Customs and the State Administration of Taxation jointly announced another major revision to the Chinese VAT export refund policy.²⁴¹ According to this revision, the VAT rebate on exports of some products was eliminated; the VAT rebate on exports of other products was reduced; and the VAT rebate on yet other products was increased, in some instances to the full 17 percent, for "some high-tech products encouraged by the State's industrial policies"²⁴² The VAT rebate applicable to all ex-

²⁴⁰ China Scraps VAT Exemption For Export-Oriented Steel Products, People's Daily Online, July 1, 2005, http://english.people.com.cn/200507/01/20050701_193615.htm.

²⁴¹ Circular of the Ministry of Finance and Four Other Ministries/Administrations Concerning the Adjustment of Export Tax Rebates, CaShui [2006] No. 139 (Sept. 14, 2006), available at <http://www.csg.gov.cn/gov/csg/ENGLISH/ENGLISH11.htm>.

²⁴² *Id.*

product. Thus, the amount rebated is tied to the value of the final product, whereas the level of VAT incurred is based on the value of the taxable income. For example, if the VAT rebate is fixed at 13 percent of the value of the finished product, but the VAT collected is only 13 percent of the value of the taxable inputs, then the rebate on exports exceeds the VAT actually incurred by the following formula:

rebate is fixed at 13 percent of the value of the finished product, but the VAT collected is only 13 percent of the value of the taxable inputs; then the rebate on exports exceeds the VAT actually incurred by the following formula:

$$13\% \times \text{non-VAT taxable inputs (e.g., labor, capital, overhead)} \\ + \text{profit earned on the sale of the finished product}$$

In other words, the VAT rebate exceeds the VAT cost imbedded in the exported product. As such, it is a classic over-rebate of an indirect tax.

In sum, the Chinese Government's VAT rebate program, with rates and availability that vary by product and industry, is a policy tool through which the government seeks certain programs for export benefits. Moreover, the program appears to provide an excessive rebate beyond the VAT cost, and the government does not have in place any workable program to ensure that rebate payments are not excessive.

H. Benefits for Purchasing Domestically Produced Inputs and Equipment

As *The China Syndrome* explained, the Chinese government provides income tax credits and VAT rebates on purchases of domestic inputs, machinery and equipment.²⁴⁸ Under the SCM Agreement, subsidies for the use of domestic over foreign products are fully prohibited.²⁴⁹ The United States included all of these programs in its WTO subsidy case against China.²⁵⁰

149 The China Syndrome at 34.

⁴⁸ See Annex 1A: Multilateral Agreements and Goods of the General Agreement on Tariffs and Trade 1994, Art. 3.1 ("Agreement on Subsidies and Countervailing Measures").

United States Consultation Request with China on Export and Domestic Preference Subsidies.
Feb. 2007 at 1.

1. China's Domestic Preference Programs

In its subsidies notification to the WTO, the Chinese government summarized its program for granting tax credits for the purchase of equipment and machinery produced in China:

For the technology upgrading projects which are consistent with the state industrial policies of the domestic enterprises, forty per cent of the expenses on purchasing domestically produced equipments shall be deducted from the increment of income tax of that year compared to the previous year.²³¹

The same subsidy is available to FIEs that purchase domestically produced machinery and equipment as well.²³² The subsidy is available only to machinery or equipment produced in China; it does not apply to equipment that has been imported and re-sold, or even subject to further manufacturing in China.²³³ To receive these benefits, the company requesting the tax credit must file an application with the local tax authority within two months of purchasing the equipment.²³⁴

The U.S. Commerce Department has found that the tax credit for the purchase of domestically produced equipment by FIEs provides a countervailable subsidy. In the Coated Free Sheet Paper investigation, the Department determined that the program provided a financial contribution in the form of revenue foregone by the Chinese government. The amount of the benefit equals the tax savings of the recipient company.²³⁵ Because the program rewards the purchase of domestic over imported products, it is

²³¹ China Subsidies Notification at 67-68.

²³² *Id.* at 66.

²³³ *Id.*

²³⁴ Coated Free Sheet, 72 Fed. Reg. at 17,495.

²³⁵ *Id.*

considered *per se* specific under U.S. law.²³⁶ The Department also preliminarily determined to treat these programs as providing recurring benefits, so that the entire benefit is allocated over sales in the year in which the benefit is received.²³⁷ In its preliminary determination, the Department found that the *ad valorem* benefit from this program alone was 2.98 percent.²³⁸ The Department did not address the identical program for domestic Chinese enterprises (*i.e.*, those with no foreign investment), but the logic of the Department's determination would require exactly the same result, since the programs are generally identical.

In addition, as noted above, the Chinese government refunds the VAT paid on certain domestically produced equipment that is purchased by FIEs.²³⁹ The Commerce Department also preliminarily determined this program to be countervailable for the same reasons as the tax credit program.²⁴⁰ As with the tax credit program, the Department treated the benefit as a recurring subsidy. The *ad valorem* subsidy amounts for the Chinese producers under this program ranged from 0.35 to 1.45 percent.²⁴¹

2. Documented Use of Domestic Preference Programs

Several Chinese steel producers confirm in their financial statements that they have received benefits from domestic preference programs. Benxi Steel, for example, noted in its 2004 annual report that it received a reduction in income taxes for purchases of domestic equipment between 1999 and 2001. The total value of the tax

²³⁶ *Id.* Under the SCM Agreement, prohibited subsidies, including subsidies that promote the use of domestic over imported products, are automatically considered "specific." SCM Agreement at Art. 2.3.

²³⁷ Coated Free Sheet, 72 Fed. Reg. at 17,485.

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.* at 17,496.

credit was RMB 130.4 million. Because this amount exceeded Benxi's total income tax due, a credit of RMB 100 million was applied to 2004, with the remainder to be applied to 2005.²⁸²

Similarly, Maanshan reported in its 2004 annual report that it had received RMB 110.3 million in tax credits for the purchase of plant machinery and equipment produced in China. The year before, it had received RMB 238.4 million in tax credits for this purpose.²⁸³ Applying the methodology used by the Commerce Department, this program alone would have provided Maanshan with a countervailable benefit of 0.4 percent *ad valorem* in 2004, and 1.5 percent in 2005.

While amounts reported by other companies were smaller, they were also significant; TISCO, for example, received a tax credit for purchases of domestically produced equipment of RMB 22.0 million in 2004.²⁸⁴

1. Raw Materials

In addition to direct contributions to the domestic steel industry, the Chinese government at the national and local levels has undertaken programs to ensure that the steel industry has ready access to material inputs in quantities and at pricing levels that give Chinese steel producers additional unfair market advantages. In an environment where the Chinese government has encouraged the exportation of finished goods in order to ensure inward flows of foreign currency, the government has restricted the exportation of certain goods in order to ensure abundant domestic supply of goods and correspondingly low market pricing for those goods. Moreover, the government has

²⁸² Benxi 2004 Annual Report at 87.

²⁸³ Maanshan 2004 Annual Report at 71.

²⁸⁴ TISCO 2004 Annual Report at 28.

made clear its intention to continue to restrict exports of raw materials where this will benefit the steel industry. Article 30 of the Steel Policy specifically states that "[t]he export of such preliminarily processed products as coke, iron alloy, pig iron, waste steel and steel base (ingot) with high energy-consumption and serious pollution shall be restricted."²⁸⁵

1. Metallurgical coke

For many years, the Chinese central government used a licensing system to restrict the exportation of metallurgical coke – a necessary input for the production of steel in integrated facilities (i.e., blast furnaces). In 2004, the European Union complained that the licensing scheme created significant imbalance in the global market, and demanded that the Chinese government eliminate its program.²⁸⁶ While the central government agreed to a minimum quantity of coke to be supplied to the EU, the government sought ways to ensure that the licensing scheme stayed in place and was vigorously enforced. For example, the Chinese Ministry of Commerce began enforcing regulations forbidding the trading or selling of metallurgical coke export licenses among Chinese coke producers.²⁸⁷ Indeed, at the same time that the Chinese government promised to provide a guaranteed quantity of coke to the EU, the government was reducing total exports to a targeted goal of "just 9 million to 10 million tonnes" in 2004 "in order to preserve coke for its booming domestic steel industry."²⁸⁸

²⁸⁵ Steel Policy at Art. 30.

²⁸⁶ Philip Shawcross, *Steel Or Coke, The Compass Is Pointing To Asia's Giant, EU Set To Challenge Chinese Licensing*, *American Metal Market*, May 12, 2004. See also Nancy E. Kelly, *US, EU Protest Chinese Coke Export Controls*, *American Metal Market*, June 1, 2004.

²⁸⁷ Kil Ling Wong, *Chinese Ministry Issues Warning On Resale Of Coke Export Licenses*, *American Metal Market*, July 28, 2004.

²⁸⁸ *Id.*

Under continued pressure from the EU and from other trading partners, the Chinese government agreed to end its coke export licensing scheme in 2006.²⁶⁶ However, while it eliminated a WTO-illegal practice, the central government continued to protect its domestic industry by employing various tax measures to ensure that metallurgical coke stayed in China – including the elimination of tax rebates for exported coke. Indeed, to ensure a plentiful domestic supply of coke, the Chinese government has begun contemplating additional measures – including additional export taxes – to prevent the increased exportation of coke.²⁶⁷ As a result, Chinese producers continue to enjoy a discount of approximately 15 percent on coke pricing. Whereas the world market price for coke is approximately US\$ 171 per ton, Chinese domestic prices stand at approximately US\$ 150 a ton. This pricing level, coupled with large quantity reserves, artificially reduces the cost of manufacture for Chinese steelmakers.

2. Ferroalloys and other nonferrous metals

Ferroalloys and other metals are used in a variety of ways in steelmaking. Ferroalloys such as ferrosilicon and ferromanganese are used to increase alloy content in steel in order to meet certain metallurgical standards and specifications for particular uses. Other metals such as zinc and chromium are used primarily to coat intermediate level steel goods to become coated steel products (e.g., galvanized steel sheet). In the world market, each of these ferroalloys and non-ferrous metals are sold at high prices – and these prices have increased substantially in recent years.

²⁶⁶ China Will Control Coke Exports Even After Canceling Coke Export Quota, Xinhua News Agency, May 16, 2005.
²⁶⁷ Extra Tax Muffed On Coke Exports, Xinhua News Agency, Mar. 24, 2007.

In response, the Chinese government has actively sought to restrict the exportation of ferroalloys and non-ferrous metals in order to protect the domestic steelmaking industry. Indeed, as recently as the spring of 2007, the central government has sought to raise the tax rate on exported ferroalloys – now as high as fifteen percent – in order to ensure that the “ferroalloy industry [] meets domestic demand in the first place” and to “rein in export[s].”²⁷¹ With respect to products such as zinc and other metals that are used in coated steel production, the Government of China has announced that “[a] provisional export tax rate of 10 percent will apply to 30 tax items of steel products such as ... unwrought zinc.”²⁷² The stated position of the government with respect to the increased export taxes is that they “reduce[] exports of high energy-consuming and highly polluting products, while encouraging the import of raw energy materials and low-level resource products in an attempt to address China’s trade imbalance.”²⁷³ However, the main beneficiary of the tax is the domestic steelmaking industry. According to one recent article, the tax is necessary as “controlling exports of zinc and nickel is imperative given domestic demand.”²⁷⁴

3. Iron ore

Along with coke, iron ore is one of the fundamental inputs in integrated steelmaking. The Chinese government has subsidized domestic iron ore production, as well as

²⁷¹ China Expects Ferroalloy Export in 2007 To Reduce, Steel Guru, available at <http://www.steelguru.com/newsfiles/2007/06/06/China%20China%20Exports%20ferroalloy%20export%20to%20reduce.html>.

²⁷² Notification of the Adjustment of the Provisional Tariff Rates for Certain Merchandise, Customs Tariff Commission of the State Council (May 21, 2007).

²⁷³ China’s Planned Aluminum-Product Export Tax Rebate Reduction Worries Industry, Resource Investor, May 21, 2007.

²⁷⁴ David Harman, China To Impose Or Increase Export Tax On Metal Products On June 1, Resource Investor, May 22, 2007, available at <http://www.resourceinvestor.com/060526/526rinf32114>.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

foreign ventures created to obtain iron ore from abroad. Individual companies have received as much as RMB 1.3 billion in subsidies and/or substantial price discounts.

Historically, China has been a resource poor country as it pertains to high-grade iron ore, and has traditionally imported significant quantities of iron ore from countries such as Australia, Brazil, and Indonesia. In 2007, it is estimated that China will import nearly 355 million tons of iron ore.²⁷⁵ At the same time, China has attempted to improve both the quantity and quality of its domestically sourced ore. According to Chinese press reports, domestic mines produced at least 521 million tons in the first 11 months of 2006 – an increase of 38.2 percent compared to the same period last year.²⁷⁶ The growth in domestic production of iron ore and the continuous need for foreign-sourced iron ore has led to the institution of numerous subsidy programs to benefit the primary users of iron ore – steel mills.

As part of its transition out of Beijing and into Shanxi province, Shougang has worked with the provincial government on a package beneficial to both the company and the province. With the arrival of Shougang, the government of Shanxi Province has pledged to provide the necessary coking coal and iron ore for Shougang's steelmaking operations – presumably free of cost or at highly preferential prices.²⁷⁷ With respect to foreign sourced iron ore, the government has granted subsidies to local steelmakers to help defray the costs associated with ventures created to obtain iron ore. For example, the government recently awarded RMB 1.30 billion in subsidies to Jiangsu Shagang

²⁷⁵ China To Import 355 Mtn Tons Of Iron Ore Next Year, Xinhua News Service, Dec. 30, 2006, available at <http://www.xinhuanet.com/english/shinew/021177.html>.

²⁷⁶ *Id.*

²⁷⁷ Shougang to Set up JV in Shanxi Province, Steel Business Briefing, Mar. 2, 2006.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

Steel Group to support the steel group's iron ore mining project in Australia.²⁷⁸ Finally, Angang Steel has received significant raw material subsidies through its relationship with its government-owned parent. Specifically, Angang Holding, a government-owned entity, has provided guaranteed price discounts to Angang Steel with respect to the steelmaker's purchases of iron ore.²⁷⁹ According to the company's financial reports, Angang Holding has guaranteed a 10 percent price discount on the average import price paid by Angang for iron ore.

J. Energy (Electricity)

Like many of the direct subsidies bestowed on Chinese industries, it is widely known that particular industries, including steel, are eligible for discounted electricity rates in the effort to promote production.²⁸⁰ While data on the actual rates given to individual companies is unavailable, steel companies' own financial reports as well as other information make clear that the steel industry continues to benefit from electricity at no cost or at rates well below market value.

A comprehensive study on the price of electricity in China published in 2004 concludes that not only are "capital costs of state-owned power plants generally not reflected in electricity prices,"²⁸¹ but that "electricity prices in China are highly subsidized and below the average total costs."²⁸² In other words, prices charged by the Chinese power companies are not sufficient to cover their marginal costs. Indeed, the steel in-

²⁷⁸ China Jiefang Over 6 M RMB Of Subsidies To Overseas Investors, Financial Times, Feb. 15, 2006.

²⁷⁹ Angang Steel Company Limited 2006 Annual Report, at 74.

²⁸⁰ In 2004, Commerce Secretary Donald Evans cited Chinese utility subsidies as an unfair trade advantage. See Peter Navarro, Report of The China Price Project, at 12 (Marquette School of Business, University of California-Irvine (Jan. 2007)).

²⁸¹ Pun-Lee Lam, Pricing Of Electricity in China, Energy, No. 26, at 287 (2004).

²⁸² *Id.* at 288.

dusty, like many other Chinese industries, was built with the help of subsidized electricity costs. Moreover, because much of the electricity is generated by SOEs, the government continues to use energy prices as a tool of coercion by rewarding companies in line with stated policies with lower rates, and withdrawing preferred rates from those who are not. Recent articles claim that the price of non-compliance with certain government directives may be the loss of electricity altogether.²⁴

Steel producers' own financial statements indicate that some companies have been granted the right to use electricity by the government. Chinese electricity subsidies, like land subsidies, are often classified as depreciable assets, which strongly suggests that electricity is transferred to companies by the government as a credit. The government likely awarded companies a certain quantity/value of electricity – most likely at the date of incorporation – which is now simply reduced by the amount of annual use.

Baosteel electricity subsidies (All amounts in RMB)²⁵

At January 1st 2003	Amortization for the year	At December 31 2003	At January 1st 2004	Amortization for the year	At December 31 2004
1,344,244.10	36,114.28	1,308,129.84	1,308,129.84	210,685.56	1,097,444.28

As shown above, Baosteel reported an electricity subsidy ("subsidy" for power supply) worth RMB 1,344,244.10 at the beginning of 2003. This amount is depreciated by RMB 36,114.28 and carried at the reduced value of RMB 1,308,129.84. According to Baosteel's 2004 annual report, the end-of-the-year value of RMB 1,308,129.84 was carried over to the beginning of 2004. Again, this value is then depreciated by what is presumably the amount of electricity used, and again is carried over to the beginning of 2005. This highlights the likelihood that electricity credits were given to the Group by

²⁴ See, e.g., *Producers Must Pay More*, China Daily, June 27, 2007.

²⁵ Baosteel 2003 Annual Report at 68; Baosteel 2004 Annual Report at 75.

the government, and that the credit will continue to benefit the company for many more years.

K. Environmental Subsidies

The Chinese government also provides indirect support to its steel industry by failing to enforce basic environmental standards. While a full discussion of environmental subsidies is beyond the scope of this paper, it is important to note that the Chinese steel industry has continued to pollute the environment with little concern for environmental regulations and with little enforcement from the government.²⁶ As detailed in *The China Syndrome*, the scale of pollution in China is staggering. For example, the Shougang mills in Beijing municipality alone discharge approximately 18,000 tons of particulates into the air each year.²⁷ Observers from the American Iron and Steel Institute and the Steel Manufacturers Association visiting China in 2005 noted steel mills that apparently lacked standard pollution control devices, such as baghouses, scrubbers, and precipitators. Notably, this was not limited to small producers; one of the mills visited belonged to Jiangsu Shagang, one of the largest producers in China.

A recent World Bank report on pollution in China confirms that the country's pollution woes continue to grow. It found, among other things, that China is now the largest sulfur dioxide emitter in the world²⁸ – a major air pollutant contributed to by China's

²⁶ See *The China Syndrome* at 53-65.

²⁷ David Eason, *Refiners Will Need Their Masks, There Are No More "Clear Air" Days*, Financial Times, Oct. 18, 2005.

²⁸ *Cost of Pollution in China: Economic Estimates of Physical Damage*, The World Bank, Feb. 2007, at xi.

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

steel producers. The research found that 750,000 people die prematurely in China each year, mainly from air pollution.²⁶⁸

L. Currency Undervaluation

As large as the subsidies described above are, they are potentially dwarfed by the largest subsidy of all – that bestowed by China's undervaluation of its currency. Because of this government intervention, economists and policymakers worldwide agree that the value of the RMB has remained well below what it would be if the RMB were allowed to float. Recent estimates of the extent of the RMB's undervaluation range from 35 to 56 percent.²⁶⁹

As the U.S. Treasury Department has explained,

The Chinese government's deliberate undervaluation of the renminbi makes U.S. products more expensive to Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the United States, and therefore U.S. consumers purchase more of them. The combination is a major contributor to the record high and still growing U.S. trade deficit. The undervalued Chinese currency harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.²⁷⁰

²⁶⁸ *Id.* See also 750,000 a Year Killed By Chinese Pollution, Financial Times, July 2, 2007.

²⁶⁹ See M. Goldstein, *A Lack Of Progress Report On China's Exchange Rate Policies*, July 2007, (40%); See also F. Bengtson, *Testimony Before the Subcommittee on Trade of the Committee on Ways and Means*, May 2007 (35%); The Economist, *Lost in Translation*, May 2007 (50%); Shanghai Univ. of Finance and Economics, 2006 (53.80%); Nat'l Ass'n of Mfrs., 2006 (40%); Economist Big Mac Index, 2007 (55%); Jeffrey Frankel, *On the Renminbi*, 2004 (36%). The average of these estimates is undervaluation of 42 percent.

²⁷⁰ 2006 Report to Congress of the U.S.-China Economic and Security Review Comm'n, 109th Cong., 2d Sess. at 43 (2006).

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

In 2006, China exported approximately US\$ 25 billion in iron and steel. If the RMB was undervalued by 42 percent, China's currency undervaluation provided a subsidy to its steel producers of US\$ 9.4 billion in 2006 alone.²⁷¹

²⁷¹ Calculated by multiplying the total value of Chinese steel exports by the average rate of currency undervaluation (42%), adjusting for the value of Chinese imports of iron and steel. It is important to note that only one of many possible ways that China's currency undervaluation could be quantified, and this paper does not endorse a particular approach.

IV. CONCLUSION

As this paper shows, the unprecedented growth of China's steel industry has been both financed and directed by the Chinese government. Indeed, governmental ownership and control of the steel industry in China is far greater than previously reported. When the convoluted ownership structures of China's major steel producers are examined in detail, it becomes apparent that virtually all of the industry remains solidly in governmental hands. More than 80 percent of the country's production remains government owned or controlled. Despite China's claims that it is progressing toward a more market-based economy, nothing could be further from the truth regarding the state ownership and control of the steel industry.

This report has attempted to identify and quantify the extent and amount of Chinese "money for metal" – subsidies to its steel industry. According to these producers' own financial documents, the Chinese government has bestowed at least RMB 393 billion of benefits, in an astonishing array of different programs: outright grants for construction, preferential loans, equity infusions and debt-to-equity swaps, government-mandated mergers, and many others.

It is important to remember, however, that the totals verified in this report only scratch the surface of the actual subsidization amounts. For several of these categories, the subsidies found are for only a handful of producers. And for several large subsidy categories (such as VAT rebates, raw materials, domestic preference programs, electricity and environment), this report does not attempt to quantify the benefits received at all. In short, the subsidies identified and quantified in this report are most assuredly only the tip of the iceberg.

The Chinese steel industry has benefited from massive direct and indirect subsidies, many of which violate China's World Trade Organization obligations. The result has been artificial growth of China's steel capacity and production, at the expense of its international competitors, including U.S. companies and their workers. The Chinese government should end its policy of control, direction and subsidization of its steel industry. If it does not, the United States and other trading partners should increase efforts to require China's compliance with its WTO commitments and international trade law.

APPENDIX 1

SUBSIDIES AND OTHER ASSISTANCE PROVIDED TO CHINA'S LARGEST STEEL PRODUCERS

Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry

SUBSIDIES AND OTHER ASSISTANCE PROVIDED TO CHINA'S LARGEST STEEL PRODUCERS

In the most recent ten-year period, many of China's top 20 producers have been the beneficiaries of billions of renminbi worth of WTO-illegal subsidies. The benefits derived from these subsidies have had a major impact on the steel industry in China, and consequently, on global commerce. For entities like the Anben Group, Baosteel, Maanshan, Shougang, the Laigang Group which owns TISCO, the subsidies have helped create vast steel-making empires – with approximately 98 million tons of steel making capacity for these seven groups alone. The subsidies include the provision of land at less than commercial rates, tax exemptions and other incentives, the provision of loans at extremely low interest rates, credits issued based upon the procurement of domestically produced machinery, and the outright provision of cash grants and infusions. The following section details how all of the various subsidy programs discussed above benefit individual Chinese producers.

A. *Anben Group*

The Anben Iron and Steel Group is currently the largest steel producer in China. The merger of Anshan Steel and Benxi Steel in 2005 created a conglomerate with a rated production capacity of over 22.5 million metric tons per year – nearly 25 percent of the total capacity of all U.S. mills combined. The group controls several large-scale subsidiaries including Angang Steel Co., Ltd., and Bengang Steel Plates Co., Ltd. With respect to Angang Steel, the company has been a major beneficiary of government subsidies in the past several years. In 2008, Angang Steel issued to its parent, Angang Holding, 2.970 billion shares as part of Angang's attempt to acquire all of the equity in-

interest in Angang New Steel and Iron Company Limited ("ANSI").²⁹² While the issuance of shares in the marketplace is common, what is uncommon is the fact that virtually all of these shares were issued to the state. The issuance of restricted shares to the state ballooned Angang's capital reserves from RMB 3.09 billion as of January 1, 2006, to a staggering RMB 12.847 billion at the end of 2006 – a four-fold increase in capital courtesy of the government.

Angang Holding, a government controlled entity, has provided guaranteed price discounts to Angang Steel with respect to the steelmaker's purchases of iron ore – the primary ferrous input in steelmaking.²⁹³ According to the company's annual report, Angang Holding has guaranteed to provide a ten percent price discount on the average import price paid by Angang for iron ore. As the average price is based upon the price "reported to the PRC customs," it is possible that the net effective discount is even larger than ten percent should the company be underreporting its purchase pricing to the customs authorities. In addition to iron ore, Angang obtains needed commodities such as electricity, railway transport services, and water based upon "state pricing."²⁹⁴ which as detailed above, are priced at below world market rates.

Angang Steel also enjoys favorable loan terms on its short- and long-term loans – issued in large part by state-owned banks such as the People's Bank of China and the China Construction Bank. The company's short-term loan interest rates decreased from a range of 5.22 to 5.58 percent in 2005 to a range of 4.86 to 5.508 percent in 2006. At the same time, the company's long-term loan interest rates fell from a range of 5.49 to

²⁹² Angang Steel Company Limited 2006 Annual Report at 18-19.
²⁹³ *Id.* at 74.
²⁹⁴ *Id.* at 66-70.

6.12 percent in 2005 to a range of 4.941 to 6.12 percent in 2006 for the "Group" and from 5.76 percent in 2005 to 4.941 to 5.76 percent for the "Company."²⁹⁵ These rates are well below the benchmark rates found by the U.S. Department of Commerce in its countervailing duty investigation of Coated Free Sheet From the People's Republic of China.

Finally, the government has subsidized Angang through generous tax relief and credits.²⁹⁶ The State Administration of Taxation, in accordance with Guoshuifa (2000) No. 13, granted tax exemptions relating to the company's investment in domestically-produced machinery. The Ministry of Finance, in accordance with Caishui (2003) No. 244, granted tax exemptions to Angang relating to its research and development activities. The Ministry of Finance also granted tax exemptions to Angang for the company's environmental protection activities. Additionally, according to the provisions of the "Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises," Angang's subsidiary ANSC-TKS did not have to pay any income tax in 2006, as the year represented the company's first profitable year. In fact, ANSC-TKS will be exempt from paying any income taxes in 2007 (assuming it is profitable), and will only have to pay 50 percent of its outstanding tax liability in the three subsequent years (assuming they are all profitable). Additionally, certain of Angang's subsidiaries, including ANSC-TKS, Changchun FAM and TKAS-SSC, are "foreign invested enterprises" and are therefore not required to pay any of three classes of local taxes.²⁹⁷

²⁹⁵ *Id.* at 122.
²⁹⁶ *Id.* at 103.
²⁹⁷ *Id.* at 103.

B. Baosteel

1. Makeup of Baosteel

As one of the "crown jewels" in China's state-owned industrial complex, Baoshan Iron & Steel (Baosteel) may indeed represent the prototypical state-owned steel company. Baosteel's growing capacity is truly massive; it has been the recipient of a host of government subsidies and tax breaks; its board members are affiliated with state-owned banks; and it benefits from subsidiaries involved in a range of businesses – from used car sales to cargo transport to iron ore. Indeed, the main business and operations statement of Baosteel's controlling shareholder, the Baosteel Group Corporation, notes:

As a governmental authorized investment vehicle and a state-owned holding company, Manage state-owned assets within the authorized scope set by the State Council. Involved in investments in the following areas: iron and steel manufacturing, metallurgy, mining, non-toxic chemicals, electricity, piers, warehousing, transportation, and steel-related businesses, development and transfer of technologies, technical service and management consulting, imports and exports approved by the Ministry of Foreign Trade & Economic Cooperation (MOTEC), domestic and international trading where allowed, and its related services.²⁸¹

This statement should come as no surprise. The Baosteel company is 78.35 percent owned by the Baosteel Group, which, in turn, is 100 percent owned by the Chinese government.²⁸² Moreover, even though Baosteel claims to be a public company, the nine largest shareholders (after the government) account for only four percent of total ownership.²⁸³

²⁸¹ Baosteel 2005 Annual Report at 7.

²⁸² *Id.*

²⁸³ *Id.* at 8.

2. Size

The most recent edition of the International Iron and Steel Institute's "World in Steel Figures" ranked Baosteel as the fifth largest steel-producing company in the world with approximately 22.5 million metric tons of production in 2006.²⁸⁴ To appreciate the size of this company, the country of South Korea produced 48.5 million metric tons of steel in the same year. In other words, Baosteel single-handedly produced almost half as much steel as the entire country of South Korea.²⁸⁵ Due to the current consolidation initiative by the Chinese government, the size and operations of Baosteel will only continue to increase. Indeed, recent news articles report the takeover of smaller mills, in addition to joint ventures and partnerships, in Baosteel's effort to increase steel output to between 50 million and 80 million tons by 2010.²⁸⁶

3. Cash Infusions

Baosteel has been the recipient of numerous cash infusions in the government's effort to promote the domestic steel industry. The most recent cash infusion assumed the form of the sale of five billion shares of stock. Of the five billion shares sold, three billion were sold directly to the government for over RMB 15.2 billion in proceeds. These proceeds – along with RMB 10.24 billion gained from the sale of the remaining two billion shares – in turn supported a flurry of intra-group activity in the form of asset transfers and acquisitions. Simply put, Baosteel returned the entire RMB 25.4 billion

²⁸⁴ Int'l Iron and Steel Institute, *World Steel in Figures*, available at <http://www.worldsteel.org/pdfs/2006/2006worldsteelfigures.pdf>.

²⁸⁵ *Id.*

²⁸⁶ See, e.g., Shougang Builds 2.5 Million Tpy Flat Steel Plant in Hebei, *American Metal Market*, June 22, 2007; Baosteel, Fendian Steel Start Mill Construction, *American Metal Market*, June 7, 2007; Baosteel, Fendian Steel Start Mill Construction, *American Metal Market*, June 7, 2007; Baosteel Links Advance Deal With Domestic Steel Maker Xinhua, *American Metal Market*, June 18, 2007, http://news.xinhuanet.com/2007-07/23/content_6184900.htm (recent articles).

(\$3.1 billion) in proceeds gained from the stock issuance to the Group in exchange for the steel related assets and operations of associated subsidiaries. This exchange included the physical assets of other steel mills, land, equipment, and even a port. Of course, heavy government investment also served to create a sense of stability for the shareholders who purchased the remaining two billion shares of stock. Beyond these government infusions, Baosteel has received more than RMB 71.5 million in cash subsidies just within the past three years.³⁰⁴

4. Loans

According to Baosteel's 2005 annual report, the group had over RMB 10.7 billion worth of short-term loans – mostly in the form of unsecured loans – at interest rates ranging from 4.7 percent to 6.3 percent.³⁰⁵ As a comparison, the U.S. Department of Commerce has estimated that the market rate for short-term loans in China should be approximately 13 percent.³⁰⁶ The Group's long-term loan portfolio totaled over RMB 16 billion at interest rates as low as 2.125 percent. Given that several of Baosteel's board members are closely affiliated with institutions such as the Bank of China and the Industrial and Commercial Bank,³⁰⁷ it is not surprising that these banks are large lenders to the Group. These long- and short-term loans are in addition to assorted loans between the Group, the Company, and various other subsidiaries that are often interest free.³⁰⁸

³⁰⁴ Baoshan 2003 Annual Report at 46; Baoshan 2005 Annual Report at 46; Baoshan 2006 Annual Report at 58.

³⁰⁵ Baosteel 2005 Annual Report at 101.

³⁰⁶ *Coated Fine Steel*, 72 Fed. Reg. at 17,492-494.

³⁰⁷ Baosteel 2005 Annual Report at 9.

³⁰⁸ *Id.* at 109.

5. Land and Electricity

Baosteel has been the recipient of significant land-use grants and electricity subsidies. As discussed previously, it is highly likely that Baosteel has been the recipient of large quantities of land that were essentially transferred to the Company from the local governments at no cost. Because Baosteel was founded almost three decades ago, and because the steel industry has been historically targeted for government-led growth, it has undoubtedly been a beneficiary of free land-use rights. Indeed, it appears that Baosteel – one of China's largest steel producers – paid less than \$50,000 for its land and electricity for the entire year of 2004.³⁰⁹

C. Shougang Steel

Shougang Steel, otherwise known as Capital Steel, is one of the flagship steel producers in China and is controlled directly by the central government SASAC. The government's control of the company is most clearly demonstrated in the decision to move the entire steelmaking operations of Shougang out of the western suburbs of Beijing and to neighboring Hebei province,³¹⁰ in order to improve Beijing's air quality levels ahead of the 2008 Summer Olympic games.

The interplay between the Chinese government and Shougang is explained in the company's financial reports. In most years since 2000, Shougang has been given direct subsidy income – cash infusions which represent direct and tangible benefits from the Government to a steelmaker.

In addition, Shougang has been the recipient of several tax benefit schemes which have helped reduce the company's tax liability. In the years immediately follow-

³⁰⁹ Baosteel 2004 Annual Report at 75.

³¹⁰ *Steel Giant Shougang To Move Out Of Beijing*, Xinhua News Service, Feb. 8, 2005.

ing 2000, Shougang participated in a program whereby the official income tax rate of 33 percent was reduced such that any taxes paid over the 15 percent threshold were refunded back to the company.³¹¹ Shougang's subsidiary Beijing Shougang Jiahua Building Materials Ltd. ("BSJBLM"), an entity with some foreign ownership interests, has been relieved of any tax burden in 2005 and 2006 (if the company earns a profit during both of those two years) and will be required to pay only 50 percent of its tax liability in the subsequent three years in which a profit is realized.³¹² In addition, owing to local Beijing government tax relief programs, BSJBLM will not be required to pay any local business income tax for the period 2005 to 2009, and will be responsible for only 50 percent of its tax liability from 2010 to 2014.

The Bank of China, a state-owned bank, has issued loans in the amount of RMB 3.2 billion to Shougang. One loan, which matures in November 2013, carries an interest rate of 6.12 percent – well below the benchmark interest rate found by the U.S. Department of Commerce in its countervailing duty investigation of Coated Free Sheet From the People's Republic of China.

D. *Laiwu Steel*

With nearly 11 million metric tons of capacity, Laiwu is one of China's largest producers of carbon steel products – primarily long products including rebar and structural steel shapes.³¹³ Like other Chinese steel producers, Laiwu has enjoyed a broad range of subsidies that have enabled the company to increase its capacity and to oper-

³¹¹ Indeed, according to company filings, Shougang may have been exempt from paying income taxes through calendar year 2004. See Shougang 2005 Annual Report at 72.
³¹² Shougang 2006 First Half Report at 79-80.

³¹³ Arcelor Mittal is seeking regulatory approval to buy a 38 percent stake in Laiwu. Approval has yet to be granted by China's National Development and Reform Commission, and no price has yet been established. See Arcelor Mittal *Expresses Modest For Laiwu Steel*, People's Daily Online, Mar. 27, 2007.

ate outside the parameters of normal enterprises. Laiwu has also enjoyed significant tax relief from the State and from the provincial government. Specifically, while Laiwu was required to pay corporate income taxes amounting to 33 percent, official government policy allowed all but 15 percent of that income tax to be refunded back to the company.³¹⁴

Since before 2000, Laiwu steel has enjoyed preferential interest rates on loans issued by government-owned banks – namely the Industrial and Commercial Bank of China, the Bank of China, and the Construction Bank of China.³¹⁵ The interest rates from these banks ranged from 4.85 percent to 5.175 percent and covered more than RMB 200 million in secured loans in 2000 and in later years. The value of Laiwu's long-term loans increased to more than RMB 2.3 billion by 2005, with the vast majority being issued by state banks such as the Industrial and Commercial Bank of China and the Bank of China.³¹⁶ Even with a substantially larger portfolio of long-term debt, Chinese government banks continued to offer loan packages at favorable rates – from as low as 5.54 percent to 6.12 percent.

Finally, like other companies, Laiwu has received direct subsidy income in the course of its operations. According to the company's 2006 third quarter financial statement, the company received RMB 30 million in the quarter ending September 30, 2006,³¹⁷ and an additional RMB 30 million in the period between January 1, 2006 to June 30, 2006 from a fund called the "Yinshenglian District" fund.³¹⁸

³¹⁴ Laiwu 2000 Annual Report at 38.

³¹⁵ See, e.g., Laiwu 2000 Annual Report at 42.

³¹⁶ Laiwu 2005 Annual Report at 41.

³¹⁷ Laiwu 2006 Third Quarter Report at 5.

³¹⁸ Laiwu 2006 First Half Report at 38.

E. Wuhan Steel

Wuhan Steel is a large producer of carbon and alloy steel products headquartered in Hubei Province. The company has the capacity to deliver approximately 13.8 million tons of wire rod, structural shapes, and sheet products every year. Wuhan, the nation's fifth largest producer of steel, is controlled directly by the central government SASAC. Like other SASAC-controlled entities, Wuhan has been the beneficiary of billions of RMB in subsidies and WTO-illegal benefits.

For several years, Wuhan has benefited from a generous tax rebate scheme that placed millions of RMB back into the coffers of the company. During the early part of this decade, Wuhan enjoyed the benefits of tax rebate programs where it was required to pay only 15 percent of the required 33 percent standard income taxes.³¹⁹ The extent of the tax savings was demonstrated in the company's financial statement covering the first half of 2000. Due to the 18 percent tax rebate, Wuhan Steel saved over RMB 72.5 million in unpaid taxes – a 20 percent savings in terms of net profit in the first half of 2000 alone.³²⁰

Wuhan has also been a major beneficiary of loans and grants from the government. During 1999, Wuhan had outstanding loans of RMB 1.127 billion owed to Chinese government-owned banks (Bank of China and the Industrial and Commercial Bank of China).³²¹ The Bank of China loan, valued at RMB 827 million, was used for the company's silicon electric steel mill;³²² the ICBC loan, valued at RMB 300 million and

³¹⁹ See, e.g., Wuhan 1999 Annual Report at 21; see also Wuhan 2000 Annual Report at 28-29.

³²⁰ Wuhan 2000 First Half Report at 5, 14. In 2000, Wuhan received a tax rebate of RMB 145.7 million based upon the reduced income tax rate. See Wuhan 2000 Annual Report at 28-29.

³²¹ Wuhan 1999 Annual Report at 22.

³²² Wuhan 2000 First Half Report at 13-14.

payable at an interest rate of 6.21 percent,³²³ was issued for improvements relating to the company's cold-rolling mill.³²⁴ Several years later, Wuhan embarked on an ambitious set of projects which required significant amounts of capital – all from loans. Between May 2003 and December 2004, Wuhan took out nearly RMB 4 billion in loans from the Bank of China and the Industrial and Commercial Bank of China at interest rates ranging from 5.2155 to 5.49 percent for RMB denominated loans and loans as low as 1.248 percent for yen-denominated loans.³²⁵ The loans all related to steel-making operations and related facilities including: new loans for the improvement of the company's cold rolled steel plant;³²⁶ iron-making coal injection, the company's Number Two and Number Three steelworks, the Number Two hot mill, and other items.³²⁷ Additional loans were taken in 2005 – bringing the company's total outstanding long-term debt to RMB 6.585 billion.³²⁸

As with other companies, Wuhan has received direct subsidy income from various government agencies. According to the company's 1999 annual report, the company received over RMB 126 million in subsidy income.³²⁹ This income represents nearly 20 percent of the company's total net profit for the calendar year.

³²³ The ICBC reduced the interest rate to 5.76 percent on Nov. 22, 2002. See Wuhan 2002 Annual Report at 40.

³²⁴ Wuhan 1999 Annual Report at 27.

³²⁵ Wuhan 2004 Annual Report at 53. Some loans were partially financed by offshore banks including the Spanish National Association of Credit and Spanish Central American Bank, but were always guaranteed by Chinese bank funding.

³²⁶ Wuhan 2003 Annual Report at 53.

³²⁷ *Id.*

³²⁸ Wuhan 2006 First Half Report at 15.

³²⁹ Wuhan 1999 Annual Report at 2-3.

F. *Maanshan*

Maanshan is one of the larger steel producers in China. Its main products include steel plate and sheet, steel sections, and wire rod. In 2006, Maanshan produced 10.9 million tons of crude steel.³²⁸ It continues to add capacity, and plans to produce 20 million tons of steel by 2010.

Maanshan has issued both A and H shares, so that its shares are publicly traded on the Shanghai and Hong Kong stock exchanges. The state, however, continues to own 62.5 percent of the company (as well as 100 percent of the holding company, Ma-gang Group). In 2006, the company had sales of RMB 34.3 billion, and after-tax profits of RMB 2.45 billion.³²⁹

Like the other major Chinese steel producers, Maanshan has received substantial subsidies from the Chinese government over the past 15 years. In 2006 alone, for example, Maanshan showed RMB 116.6 million in "government subsidies granted for specific projects"³³⁰ and RMB 86.5 million in tax concessions.³³¹ Maanshan benefited from preferential income tax rates as well.³³² The Maanshan group did not receive any tax credits for purchases of domestic machinery in 2006, but it did receive a credit of RMB 19.9 million in 2005.³³³ It also had outstanding bank loans of RMB 16.5 billion at interest rates of 5.76 percent and lower.³³⁴

³²⁸ Maanshan 2006 Annual Report at 10.

³²⁹ *Id.* at 65.

³³⁰ Maanshan 2006 Annual Report at 70.

³³¹ *Id.* at 121.

³³² *Id.* at 102.

³³³ *Id.* at 103.

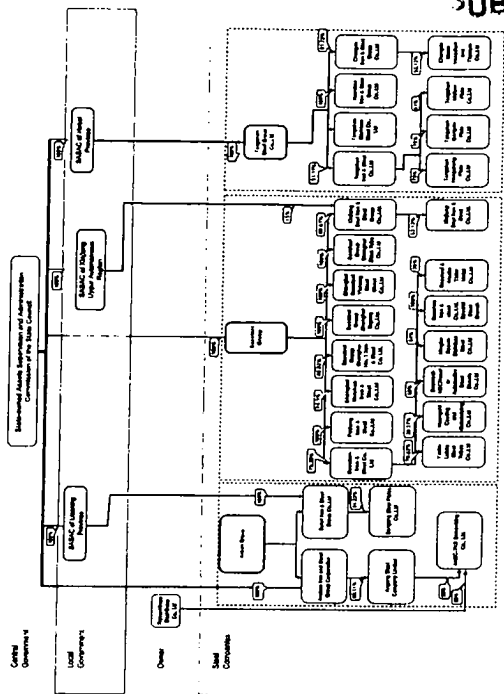
³³⁴ *Id.* at 128.

The following summarizes the types and amounts of subsidies Maanshan has received over the last decade. The amounts are indicative rather than comprehensive; nonetheless, they indicate the magnitude of the support Maanshan has received from the Chinese government:

- grants for construction projects: RMB 801 million
- subsidy income for exports
- equity infusions: RMB 18 billion
- debt-to-equity conversions: RMB 600 million
- policy loans at preferential interest rates: RMB 6 billion
- tax credits for purchases of Chinese-made machinery: RMB 3.698 billion
- income tax reductions and exemptions.

APPENDIX 2

OWNERSHIP FLOWCHART FOR CHINA'S TWENTY LARGEST STEEL GROUPS



PUBLIC FILE 362

Wong Ming Yek, Head of Research

45

Published and Printed by

HWANGGBS Vickers Research Sdn Bhd (128540 U)

Suite 26.03, 26th Floor Menara Kech Seng, 203, Jalan Bukit Binang, 55100 Kuala Lumpur, Malaysia
Tel : +603 2711-2222 Fax : +603 2711-2333 email : general@hwangbottle.com.my



HHWANGDOLS
Vertical Logo