

# Secrets, Spies and Steel: The Rio Tinto Case

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Despite Rio Tinto and Canberra's expression of "surprise" over the espionage charges initially levelled at Australian mining executive Stern Hu (Hu Shitai) and three of his colleagues, there have been forebodings of trouble in the iron ore trade for some time. China's Minister for Industry and Information Technology lamented in a State Council news conference last year, "We cannot make the same mistake a second time," referring to the disorganization and trouble among China's iron ore purchasers in the previous round of annual negotiations. The government's unexpected intervention in the name of national security demonstrates not only how gravely it views its disadvantage in the iron ore trade but also the murkiness of its laws regarding state secrets. Such a determined intrusion from Beijing, especially through the medium of Chinese intelligence services, could only happen with the blessing of top echelons of China's political process. But what has made the Chinese government take such dramatic action at a highly sensitive time in the iron ore negotiations?

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## ESPIONAGE OR REVENGE?

The Chinese press has generally accepted the line that Stern Hu and his colleagues engaged in espionage that inflicted grievous damage to China's national economic interest amounting to billions of dollars. Many commentators in Australia, on the other hand, see it as a calculated insult designed to express China's displeasure over the rejection of state-owned aluminum giant Chinalco's bid to acquire a strategic stake in Rio in early June.<sup>1</sup> This is no doubt part of the context of China's actions. However, an overriding consideration appears to have been the Chinese authorities' determination to consolidate and restructure China's large and highly fragmented steel-making industry and combat skyrocketing iron ore prices through a united front.

Unlike the highly consolidated Japanese and Korean steel industries, the Chinese steel industry consists of hundreds of small and medium-sized firms, built to satisfy its insatiable demand for steel during the heyday of China's economic boom. Baosteel, the large **Shanghai-based producer, accounts for less than 5 percent of national production**, and the top national state-owned mills account for little more than 10 percent altogether.<sup>2</sup> Firms compete intensely with each other for supplies of iron ore, especially the prized long-term benchmark-priced iron ore, which came into China at two-thirds the price of other supplies through the boom. Competition and disunity within the industry spelt disaster for the Chinese iron ore negotiating position in the past. Chinese sources estimate that the price of iron ore increased by over 400 percent over the last six years, and as a result Chinese steel mills paid an extra RMB 700 billion (US\$ 103 billion).<sup>3</sup> This figure is hotly disputed in Australia, as industry analysts point out that the alleged RMB 700 billion overcharge surpasses the total amount that Chinese mills paid Rio during the six-year period. Regardless of their accuracy, these figures have been widely circulated and accepted in China.

This year, in an effort to unite steel producers and collectively bargain for better prices, the government sidelined Baosteel from its usual lead in iron ore negotiations and replaced it with the China Iron and Steel Association (CISA). Determined to prove itself, CISA took a hardline approach, demanding a 40 percent price cut from last year's agreements. Mining firms refused to accept this sharp reduction, especially as they had already settled at a 33 percent discount with major Japanese and South Korean mills. Neither side budged and negotiations dragged on well beyond their deadline.

Despite their public support of CISA, many Chinese steel mills grew frustrated with the protracted bargaining. Rio and other mining companies allegedly took advantage of their impatience, pursuing a "divide and conquer" strategy by offering them the attractive long-term benchmark prices negotiated earlier with the Japanese and Korean mills. These prices were higher than CISA's bottom line, but lower than the spot market price. Many jumped at the opportunity to purchase lower priced ore, having long been victims of a parallel pricing system through which larger firms brokered contracts for long-term benchmark prices, while they were left to purchase supplies at much higher spot market prices. Firms forced into the spot market for ore could

pay up to twice as much as the long-term benchmark price. Private steel mills were often forced to purchase ore at inflated prices from large state-owned steel mills and traders with import permits.

Watching its unified front disintegrate, CISA pled for the government to intervene and put a stop to unauthorized transactions. The Secretary-General of CISA said in an interview that it was useless for small and medium-sized firms to sign agreements with the miners when they could not get custom clearance without import permits. CISA urged the regulatory authority to close down the newly opened Rizhao International Iron Ore Trade Centre in a bid to clamp down on speculation in iron ore. It also released a statement alleging that unauthorized trade and speculation in iron ore was in direct contravention of the State Council's new "Guideline on Restructuring and Revival of Steel and Iron Industry."<sup>4</sup> The guideline strongly encouraged industry bodies such as CISA to take a lead role in price negotiations, implying that the government took a dim view on any negotiation outside the officially mandated platform. However, this appears to have done little to bolster CISA's control over the industry.

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*Chinese steel mills' embrace of Rio's tempting offer may have been the straw that broke the camel's back.*

The small and medium-sized Chinese steel mills' embrace of Rio's tempting offers may have been the straw that broke the camel's back. With CISA's bargaining position looking increasingly weak, rumors swelled that it was ready to abandon its hardline 40-percent price reduction and accept a face-saving deal based on the 33-percent discount offered to Japanese and Korean steel mills. Many on the Chinese side of the bargaining table believed that Rio's confidence and aggressive demands derived from its intimate knowledge of the Chinese negotiators' bottom-line and details about production and storage in Chinese steel mills. Reports from China's state media assert that this information was found on computers seized from the Rio Tinto office in Shanghai.

The arrest of Stern Hu and his colleagues might be seen as part of a larger effort to stem the perceived leakage of sensitive information from the Chinese steel mills, which was undermining China's position during iron ore price negotiations. It is also a very powerful warning from Beijing to the Chinese steel mills that it is determined to bring order back into the iron ore import market and crack down on any unauthorized dealings with miners that weaken the negotiating position of big state-owned steel mills.

However, the arrests carry with them a perception of retaliation. There is a general feeling of frustration and anger in China amongst government officials over dealings with Rio. No special status has been accorded to China, which, as the largest customer, imports more than 70 percent of all seaborne trade in iron ore. The rumored demand by Rio for compensation over delayed and cancelled ore shipments only rubbed salt into an open wound. Rio's decision to invoke a *force majeure* clause in the supply contract to divert ore from long-term supply contracts to the spot market during the height of the mining boom earned it additional enmity. The outburst

from the Chinalco executive that “Rio has no business credibility as a company” may have been an expression of a wider feeling in China.<sup>5</sup>

What remains unclear is exactly who instigated the proceedings against the mining company. Given the collateral impact on China’s commercial standing more broadly, why and how was the case allowed to proceed at this time? Assessing these questions will be critical to understanding the fallout from the affair and properly managing Sino-Australian relations in the future.

### SPOOKS, SECRECY AND THE BIGGER MESSAGE

The most alarming and bizarre aspect of Stern Hu’s arrest is the involvement of the Ministry of State Security. This domestic counterintelligence outfit is charged with safeguarding the party and the state from foreign operatives, separatists and other “enemies of state.” Its role in the affair shows that Beijing has elevated the hotly-contested negotiations beyond a commercial or economic perspective to the sacrosanct level of national security. This action mirrors the broader shift in China’s resource security strategy.

As China became a net energy importer in the early 1990s, it grew conscious of the need to secure strategic raw materials. After its global shopping spree was thwarted by regulators in the United States and Australia on national security grounds, it dawned on China that resources cannot always be fairly procured on the global market. Thus it has moved to an integrated strategy involving the collaboration of government ministries and agencies to secure vital resources. Security services are likely playing an increasingly large role in this plan, from the more innocuous protection of overseas Chinese assets and interests, to more secretive economic information gathering and counterintelligence activities.

Regardless of the government’s internal justifications, many foreign enterprises operating in China question the legal basis for the espionage charges initially brought against the Rio employees. The answer can be traced to the vagaries of China’s 1989 State Secrecy Law,<sup>6</sup> which loosely defines secrets as matters concerning “national security and interests.” What may constitute state secrets, apart from the usual inclusion of political, military and diplomatic matters and decisions, are “secret matters relating to national economic and social developments.” According to both the letter and spirit of this legislation, it is highly probable that matters relating to iron ore negotiations, such as figures for current iron ore stockpiles at state-owned mills in China, procurement plans, and net profits made by steel mills can all be regarded as state secrets. The strategic importance of the steel industry in China’s national economy strengthens the argument that these matters can be seen as protected data. Importantly, Article 11 of the State Secrecy Law also empowers the state entities that produce these secrets to classify them accordingly. State-owned steel mills and CISA would have the authority under the law to classify their production details as state secrets.

According to internal research conducted by the Internal Affairs and Judicial Committee of the National People’s Congress (NPC), many state bureaucracies and

corporations arbitrarily classify documents as state secrets for fear of being accused of leaking sensitive information. This is a reflection of China's poorly defined secrecy law, which authorizes almost all of officialdom to label documents as secret. This authority is strengthened by the sweeping provisions of Article 8, under which normal social and economic statistics may be labeled as state secrets. Apart from the obvious legal ambiguity, China is also hampered by the surviving Mao-era paranoia regarding official documents, which extends to even openly published materials. A legal expert from Peking University commented that the traditional guiding principle for the protection of state secrets is: "Keep everything secret. Disclosures are exceptions."

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The Chinese government is conscious that its catch-all secrecy law needs some serious fine-tuning. Xinhua News Agency commented that according to research and surveys undertaken by the NPC, the current secrecy law suffers from arbitrary classification, an absence of prompt declassification after the expiry of a time limit and a very broad scope of what can be rightfully regarded as state secrets.<sup>7</sup> There have been some incremental changes in this regard: the normally secretive Foreign Ministry is opening up part of its archive to the public, and the Bureau of State Secrets Protection also announced on Aug. 8, 2005 that death tolls in natural disasters will no longer be treated as state secrets.

Ironically, 10 days before the arrest of Stern Hu, the NPC released the long-awaited, newly amended "State Secrets Protection Law of the People's Republic of China" for public consultation. The amended law hardly represents a breath of fresh air. According to legal expert Tian Weimin of the China University of Politics and Law, who was involved in the drafting process of the amended law, there is no fundamental change in the new law with regard to what constitutes state secrets and who has the power to classify information. In the amended law, relevant state entities still retain the power to deem whatever they want as secret. The old principle of secrecy by default remains operational.

Both the existing and the amended secrecy laws run contrary to the spirit of transparency and openness embedded in the newly promulgated "Regulations concerning the disclosures of government information of the People's Republic of China."<sup>8</sup> Section 3 of Article 10 of the regulations mandates that "statistics concerning national economic and social developments" should be made public in the absence of reasonable demand to do otherwise. It appears that state secrecy law does not embody the new spirit of openness envisioned by Beijing.

If there is any silver lining to the dark cloud surrounding Stern Hu's case, it is that lawyers may be able to probe the boundaries of what constitutes state secrets, establishing a litmus test for China's professed progress towards greater transparency and openness. For the time being, however, Mr. Hu and his colleagues have assumed the unfortunate mantle of being sacrificial lambs on the altar of China's national security. ☹️

## NOTES

- <sup>1</sup> John Garnaut, "Trade Secrets: Iron Ore War," *The Age*, Aug. 22, 2009.
- <sup>2</sup> Peter Drysdale, interview with the author, July 2009.
- <sup>3</sup> Michael Stutchbury, "A Pact with China as it pursues growth," *The Australian*, July 21, 2009.
- <sup>4</sup> The Central People's Government of the People's Republic of China, "Guideline on Restructuring and Revival of Steel and Iron Industry," July 2009, <[http://www.gov.cn/zwggk/2009-03/20/content\\_1264318.htm](http://www.gov.cn/zwggk/2009-03/20/content_1264318.htm)>.
- <sup>5</sup> John Garnaut and Matthew Murphy, "Rio Tinto has business credibility, says Chinaclo," *The Age*, July 10, 2009.
- <sup>6</sup> US Congressional Executive Commission on China, "Law of the People's Republic of China on Guarding State Secrets," Oct. 2009, <<http://www.cecc.gov/pages/newLaws/protectSecretsENG.php>>.
- <sup>7</sup> Zhong guo ren da shen yi xiu ding bao mi fa [China National People's Congress amends the Secrets Protection Law] <<http://www1.voanews.com/chinese/news/a-21-w2009-06-23-voa37-61278357.html?moddate=2009-06-23>>.
- <sup>8</sup> The China Law Center, Yale Law School, "Regulations of the People's Republic of China on Open Government Information," <[www.law.yale.edu/documents/pdf/Intellectual\\_Life/Ch\\_OGI\\_Regualtions\\_Eng\\_Final\\_051607.pdf](http://www.law.yale.edu/documents/pdf/Intellectual_Life/Ch_OGI_Regualtions_Eng_Final_051607.pdf)>, Oct. 2009.