

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following Management Discussion and Analysis ("MD&A") is a review of our financial condition and results of operations, based upon Canadian Generally Accepted Accounting Principles ("GAAP") and covers the period from April 1, 2008 to June 30, 2008. The financial results reported in the interim consolidated financial statements reflect the financial condition and results of operations of the Successor for the period April 1, 2008 to June 30, 2008, the Predecessor for the period of April 1, 2007 to June 19, 2007 and the Successor for the period of April 12, 2007 to June 30, 2007 that reflect the results of the business in the period following the Acquisition. Other than activities in connection with the Acquisition, the Successor had no activities prior to the Acquisition.

Effective March 31, 2008 the Company changed its fiscal year-end from December 31 to March 31.

Effective April 1, 2008, the Company's functional currency changed to the United States dollar (U.S. dollar). However, the Company has retained the Canadian dollar as its reporting currency. Unless otherwise stated, the figures included in this MD&A are stated in Canadian dollars.

The terms "Predecessor" or "Algoma Steel", as used in this MD&A, refer to Essar Steel Algoma Inc. (formerly Algoma Steel Inc.) and its subsidiaries on a consolidated basis, and the terms "Company", "we", "us" and "our" refer to combined Predecessor and Successor companies, unless the context otherwise requires or it is otherwise indicated. The Successor financial information may not be comparable to the Predecessor financial information as a result of the effect of the revaluation of assets and liabilities to their estimated fair market values at the date of Acquisition as a result of the application of accounting for business combinations. In addition, in this MD&A, we have provided comparative analysis for certain amounts for the quarters ended June 30, 2008 and June 30, 2007. The unaudited comparative results for the period from April 1, 2007 to June 19, 2007 were the results of the Predecessor in that period. Since the quarter ended June 30, 2008 is based on purchase accounting per Canadian GAAP as a result of purchase accounting, the fiscal 2009 results may not be directly comparable to the 2007 figures.

This MD&A is dated as of August 12, 2008 and should be read in conjunction with the June 30, 2008 unaudited Consolidated Financial Statements and accompanying Notes. This MD&A contains forward-looking statements with respect to market conditions, prices, operating costs and shipments. Some factors, among others, that could affect market conditions, steel prices, costs and shipments include global and North American product demand, product mix, level of contract sales, foreign exchange rates, global production levels, plant operating performance, North American steel production levels and capacity utilization, natural gas prices and usage, raw materials availability and prices, changes in environmental, tax and other laws, and North American and global economic performance and political developments. Steel shipments and prices could be affected by import levels and government actions or lack of actions with regard to imports.

This document has been reviewed by the Audit Committee and Board of Directors of Essar Steel Algoma Inc. and contains information that is current as of August 12, 2008. Events occurring after that date could render the information contained herein inaccurate or misleading in a material respect.

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## Overview of the Business

The Company is an integrated steel producer with operations located entirely in Canada. The Company produces sheet and plate products that are sold primarily in Canada and the United States.

The Company's profitability is correlated with the level of steel prices which is one of the major factors causing variation in operating results throughout a period. Raw material and energy costs have also emerged as significant factors in recent years. Industry pricing is largely dependent on global supply, the level of steel imports into North America and economic conditions in North America. Since U.S. markets establish pricing levels, the exchange rate of the Canadian dollar to the U.S. dollar significantly impacts pricing realizations for the Company.

The costs of raw materials and natural gas have escalated in recent years. Iron ore prices, under a long-term supply agreement denominated in U.S. dollars, increased in the great lakes region as well. The calendar 2008 price for iron ore has been settled in the great lakes region.

## Use of Non-GAAP Financial Measures

EBITDA and Adjusted EBITDA are non-GAAP financial measures utilized in the MD&A. As there is no generally accepted method of calculating these financial measures, they may not be comparable to similar measures reported by other companies. Readers are encouraged to consider these financial measures in the context of the Company's GAAP results, as provided in the attached consolidated financial statements.

EBITDA refers to earnings before interest, taxes, depreciation and amortization, foreign exchange and investment income. Adjusted EBITDA refers to EBITDA adjusted for the effects of Transaction related expenses, currency contract gains related to the Transaction and the inventory fair value adjustment as a result of applying purchase accounting. EBITDA and Adjusted EBITDA are not recognized measures for financial statement presentation under Canadian generally accepted accounting principles. EBITDA and Adjusted EBITDA are not intended to represent cash flow from operations, as defined by Canadian GAAP, and they should not be considered as alternatives to net earnings, cash flow from operations, or any other measure of performance prescribed by GAAP. The Company's EBITDA and Adjusted EBITDA may also not be comparable to EBITDA and Adjusted EBITDA used by other companies which may be calculated differently. The Company considers EBITDA and Adjusted EBITDA to be meaningful measures to assess its operating performance in addition to GAAP measures. They are included because the Company believes they can be useful in measuring its ability to service debt, fund capital expenditures, and expand its business. EBITDA and Adjusted EBITDA are also used by analysts and the Company's lenders as measures of the Company's financial performance.

## Change in Functional Currency

Effective April 1, 2008, the Company's functional currency changed to the United States dollar ("U.S. dollar") to reflect the increasing operational exposure to the U.S. dollar. The Company has continued to use the Canadian dollar as its reporting currency. In accordance with Canadian generally accepted accounting principles, all amounts presented for the period of April 1, 2008 to June 30, 2008 are translated to Canadian dollars using the current rate method whereby all revenues, expenses and cash flows are translated at the average rate that was in effect during the period or presented at their Canadian dollar transactional amounts and all assets and liabilities are translated at the prevailing closing rate in effect at the end of the period (Cdn. \$1.0197 per U.S. \$1.00 for June 30, 2008). Equity transactions have been translated at historical rates. The resulting net translation adjustment has been recorded in other comprehensive income. The currency exchange rates for quarter are given below.

Quarter	Average Rate	Period End Rate
April 1 - June 30, 2008	1.0100	1.0197

## **Sales**

Sales for the first quarter of 2009 were \$760.6 million as compared to the corresponding combined three month period ended June 30, 2007 of \$482.3 million, which is an increase of 57.7%. The higher sales in the first quarter of 2009 were due to higher steel shipments and higher selling prices. Shipments were 800,000 tons in the quarter, a 29% increase over the combined three month period in 2007. Average net sales realization per ton shipped in the first quarter of 2009 was \$890 compared to \$722 per ton for the combined three month period of 2007. Net sales realizations were impacted by product mix changes as incremental production led to higher sheet sales.

Sales to Canadian customers have remained approximately the same totaling 389,000 tons (2007 - 382,000 tons) while sales to U.S. and offshore customers have increased to 411,000 tons (2007 - 237,000 tons) representing 48.6% of total tons sold in the quarter. Sales to offshore customers totaled 19,000 tons (2007 - 7,000 tons) in the quarter.

Non-steel sales were \$10.4 million in the first quarter of 2009 as compared to \$4.4 million in the combined three month period of 2007. Non-steel sales include sales of various by-products generated in the manufacturing process.

## **Cost of Sales**

The costs of sales of the Company differs significantly from that of the Predecessor as a result of the change in accounting for inventory under Section 3031 of the CICA Handbook that was adopted in this period. The accounting change was adopted retrospectively to the June 20, 2007 acquisition date. Accounting results of the Predecessor were not restated for this change. In addition to the effect on earnings of adjustments to inventory and costs of sales, the classification of amortization expense has been changed in 2009 to be included in cost of sales. Included in the cost of sales for the three months ending June 30, 2008 is all amortization of production-related buildings and equipment of \$44.5 million. In the combined three month period ending June 30, 2007, this amortization was included in amortization expense as a separate component of operating expenses.

Cost of sales for the first quarter was \$585.5 million and cost of sales in the combined three month period ended June 30, 2007 was \$414.1 million. Excluding amortization, cost of sales in the first quarter of 2009 was \$541.0 million compared to \$414.1 million for the combined three month period of 2007. The cost of steel products sold (excluding profit-sharing and freight) during the first quarter of 2009 was \$482.2 million representing a 31.2% increase from the same period in 2007. On a percentage of sales basis, cost of steel products was 67.7% in the first quarter of 2009 as compared to 82.1% in the combined three month period of 2007. On a per ton basis, cost of steel sales was \$602.47 per ton in the first quarter of 2009 compared to \$592.77 per ton in the combined three month period of 2007.

The increase in cost of steel products per ton sold is due to higher raw material and fuel prices. Higher production volume and improved efficiency have contributed positively to steel costs and also partly offsets the impact of increased input pricing.

Profit sharing expense increased to \$15.2 million versus \$2.9 million in the combined three month period of 2007. Cost of non-steel products was \$10.4 million compared to \$4.4 million over the combined three month period in 2007 as a result of decreased sales of by-products.

## **Administrative and Selling Expenses**

Administrative and selling expenses were \$15.3 million compared to \$16.5 million for the corresponding combined period ending June 30, 2007.

## **Amortization**

In conjunction with the Transaction, the Company applied purchase accounting and recorded the fair value of assets acquired and liabilities assumed as of June 20, 2007. The result was an increase to the historical

carrying amounts of property, plant and equipment of \$1,211.7 million and the recording of identifiable intangible assets of \$198.4 million. The increase in the carrying value of property, plant and equipment, in addition to the book value that existed at the close of the Transaction, is being amortized over periods ranging from 1 to 40 years. The identifiable intangible assets are being amortized over periods ranging from less than one year to 20 years. There were no intangible assets recorded in the books of either the Successor or the Predecessor prior to the Transaction and, accordingly, no amortization expense.

Due to the change in accounting policy for inventory noted previously, \$44.5 million of the amortization expense is included in cost of sales.

(in millions of dollars)	<b>Successor April 1 to June 30, 2008</b>	Combined three month period April 1 to June 30, 2007
Amortization of property, plant and equipment	\$ 44.5	\$ -
Amortization of identifiable intangible and non-production assets	8.7	15.4
<b>Total</b>	<b>\$ 53.2</b>	<b>\$ 15.4</b>

Amortization expense in the period of April 1, 2008 to June 30, 2008 was \$53.2 million compared to the combined amortization expense for the period of January 1, 2007 to June 30, 2007 of \$15.4 million.

#### **Income from Operations**

Income from operations grew from \$36.3 million for the combined period ending June 30, 2007 to \$151.1 million for the quarter ending June 30, 2008, an increase of 316%, due to improved margins as explained previously.

#### **Financial Income (Expense)**

Interest on long-term liabilities in the three months ended June 30, 2008 was \$15.5 million compared to \$2.7 million in the combined three months ended June 30, 2007. Interest on short-term liabilities in the three months ended June 30, 2008 was \$1.8 million compared to \$1.1 million in the combined three months ended June 30, 2007. Interest expense in the Successor period resulted from acquisition financing that was secured to finance the Transaction.

Investment income for the quarter ending June 30, 2008 was \$0.1 million compared to \$1.6 million for the combined three month period ending June 30, 2007. The cash and short-term investments of the Predecessor were used in the financing of the Transaction.

Foreign exchange losses in the period of April 1, 2008 to June 30, 2008 were \$4.7 million compared to losses of \$4.4 million in the combined three month period of April 1, 2007 to June 30, 2007. The losses in the period resulted primarily from losses on Canadian dollar denominated liabilities.

## Pension and Post-Employment Benefits

(in millions of dollars)	Successor April 1 to June 30, 2008	Combined three month period April 1 to June 30, 2007
Pension expense	\$ 12.6	\$ 10.6
Post-employment benefit expense	7.3	7.9
<b>Total</b>	<b>\$ 19.9</b>	<b>\$ 18.5</b>

Pension expense in the quarter ended June 30, 2008 was \$12.6 million compared to pension expense for the combined quarter ended June 30, 2007 of \$10.6 million. Post-employment benefit expense in the quarter ended June 30, 2008 was \$7.3 million compared to post-employment benefit expense for the combined quarter ended June 30, 2007 of \$7.9 million.

The pension and post-employment benefit expenses in the first quarter of 2009 also reflect pension and benefit enhancements resulting from the new collective bargaining agreements that became effective August 1, 2007 and expire on July 31, 2010. These enhancements resulted in an increased pension obligation of \$64.1 million and an increased post-employment obligation of \$6.0 million. The increase in obligations is being amortized to expense over the three year term of the collective agreements.

### Provision for Income Taxes

The following table provides a reconciliation of the statutory tax amounts and rate to the actual provision for each quarter:

(in millions of dollars)	Successor April 1 June 30, 2008	Combined three month period April 1 to June 30, 2007
Tax provision at the statutory manufacturing and processing rate of 31.3% (2007 – 34.1%)	\$ 42.6	\$ 4.5
Add (deduct):		
Impact of non-taxable portion of exchange gain	(0.8)	-
Impact of future Federal tax rate reductions	-	(4.4)
Impact of post-employment benefit expense	-	3.6
Impact of non-deductible stock-based compensation	-	2.4
Other		0.9
<b>Total</b>	<b>\$ 41.8</b>	<b>\$ 7.0</b>

The Company's 2002 and 2003 taxation years are presently under audit by the Canada Revenue Agency ("CRA"). The CRA has completed its review of the Company's assignment of \$160.0 million as the fair market value of the 16 million common shares issued as consideration in discharging debts under the 2002 financial reorganization. The CRA has proposed that the \$160.0 million be reduced to \$83.2 million and is awaiting the Company's response to their proposal. The Company intends to vigorously defend its position with respect to the valuation; however, if a reassessment is issued and the Company does not prevail through the objection process, the Company's available non-capital losses upon emergence from CCAA would be reduced by \$76.8 million. This would result in an income tax reassessment and cash taxes payable of approximately \$26.0 million plus applicable interest. The Company believes its valuation is supportable and

it is too early to assess the outcome of this issue. Consequently, no liability has been recorded in the financial statements.

For the years 2002 to 2007, the Company has filed scientific research and experimental development claims with CRA as follows:

2002	\$53.0 million
2003	\$43.4 million
2004	\$62.8 million
2005	\$68.9 million
2006	\$63.0 million
2007	\$34.5 million

These claims are currently under audit by CRA and prior to the 2002 claim, the Company had no history of filing claims of comparable size. The potential tax benefit of these claims is 20% of the claims or \$65.1 million. In order to recognize the tax benefit for accounting purposes, there must be reasonable assurance that the benefit will be realized. Since the claims have not had final audit assessment, the Company has only recognized part of the related tax benefit that the Company believes meets the threshold of “reasonable assurance”. The total tax benefit recognized to date is \$21.9 million. The determination of the amount of tax benefit to recognize requires judgement, and is subject to change based on CRA’s audit of the claims.

**EBITDA (i) and Adjusted EBITDA (i)**

The following table shows the reconciliation of EBITDA and Adjusted EBITDA to net income in accordance with GAAP:

(in millions of dollars)	Successor April 1 June 30, 2008	Combined three month period April 1 to June 30, 2007
Net income	\$ 89.0	\$ 6.3
Amortization	53.2	15.4
Interest expense	17.3	3.8
Income taxes	41.8	7.0
Foreign exchange loss	4.7	4.4
Change in the fair value of embedded derivatives	(1.6)	-
Investment income	(0.1)	(1.6)
<b>EBITDA</b>	<b>\$204.3</b>	<b>\$35.3</b>
Transaction related expenses	-	23.6
Currency contract gains, net	-	(7.2)
Inventory purchase accounting adjustment	-	5.2
<b>Adjusted EBITDA</b>	<b>\$204.3</b>	<b>\$56.9</b>

(i) EBITDA and Adjusted EBITDA are non-GAAP measures and are defined on page 3 of this report.

Adjusted EBITDA for the quarter ending June 30, 2008 was \$204.3 million as compared to \$56.9 million for the combined three month period ending June 30, 2007.

## Financial Resources and Liquidity

### *Summary of Cash Flows*

(in millions of dollars)	Successor April 1 to June 30, 2008	Combined three months April 1 to June 30, 2007
<b>Operating activities:</b>		
Cash flow from operations before changes in non-cash operating working capital	\$133.6	\$37.3
Changes in non-cash operating working capital	(174.8)	(19.0)
	<b>\$ (41.2)</b>	<b>\$ 18.3</b>
<b>Investing activities:</b>		
Acquisition of property, plant and equipment	\$ (57.3)	\$ (25.2)
Decrease in short-term investments	-	1.8
Proceeds on sale of capital assets	0.3	0.4
Business acquisition, net of cash acquired of \$41.2 million	-	(1,666.4)
Restricted cash	4.0	(7.8)
	<b>\$ (53.0)</b>	<b>\$(1,697.2)</b>
<b>Financing activities:</b>		
Bank indebtedness	\$ 114.5	\$ 98.6
Proceeds of long term notes and bank term loan	-	939.1
Redemption of 9.875% notes payable	(19.7)	
Issuance of shares	-	531.8
Advance from related parties	-	8.8
Financing Costs, bank indebtedness	-	(5.2)
Other	(0.1)	-
Effect of exchange	0.3	-
	<b>\$ 95.0</b>	<b>\$1,573.1</b>
<b>Change in cash during the period</b>	<b>\$ 0.8</b>	<b>\$ (105.8)</b>

#### *Cash Flow From Operating Activities*

Cash flow from operations in the quarter ending June 30, 2008, before changes in non-cash operating working capital, was \$133.6 million compared to \$37.3 million for the combined three month period ended June 30, 2007.

Changes in non-cash operating working capital in the quarter was a use of cash of \$174.8 million compared to a \$19.0 use of cash in the same period of 2007. The changes in non-cash operating working capital were comprised of the following:

(in millions of dollars)	<b>Successor April 1 to June 30, 2008</b>	Predecessor April 1 to June 30, 2007
Accounts receivable	<b>\$(146.7)</b>	\$ 37.0
Inventories	<b>(113.2)</b>	(52.1)
Prepaid expenses	<b>(8.1)</b>	0.7
Accounts payable and accrued liabilities	<b>49.4</b>	29.6
Income and other taxes receivable/payable	<b>43.8</b>	(34.2)
<b>Total</b>	<b>\$ (174.8)</b>	<b>\$ (19.0)</b>

The increase of \$146.7 million in accounts receivable was primarily due to higher sales in the quarter. Days sales outstanding remained relatively unchanged from March 31, 2008 at approximately 44 days. The increase in inventories of \$113.2 million in the quarter was mainly due to an increase in iron ore, scrap and furnace coke purchases. The increase in prepaid expenses of \$8.1 was primarily due to advance payments under the Company's iron ore contract. The increase in accounts payable and accrued liabilities of \$49.4 million was primarily due to increased purchases of scrap, an increase in the profit sharing accrual and a large payable related to a purchase of furnace coke at June 30, 2008. These increases were offset by a decrease in the interest payable related to the Senior Subordinated Notes. The change in income and other taxes receivable/payable is a source of cash of \$43.8 million in the quarter.

#### *Cash Flow Used in Investing Activities*

Capital expenditures in the quarter ending June 30, 2008 totaled \$57.3 million, compared to \$25.2 million in the combined three month period ending June 30, 2007. Expenditures in the quarter ending June 30, 2008 included \$23.3 million on the cogeneration facility and \$19.3 million on the commissioning of #6 blast furnace. Expenditures in the combined three month period ending June 30, 2007 included \$9.1 million on the reline of #7 blast furnace which was completed in the third quarter of 2007, \$5.8 million on the cogeneration facility and \$3.3 million on the #9 coke battery. The combined three month period ending June 30, 2007 also included the business acquisition, net of cash acquired of \$41.2 million, of \$1,666.4 million.

#### *Cash Flow from Financing Activities*

Financing activities in the quarter ending June 30, 2008 included an increase in bank indebtedness totaling \$114.5 million and \$19.7 million on the purchase of U.S. \$20.0 million face value of the 9.875% Notes. Financing activities in the combined three month period ended June 30, 2007 included proceeds from the bank term loan and the Notes of \$939.1 million, proceeds on the issuance of shares of \$531.8 million and an increase in bank indebtedness of \$98.6 million. All of these financing activities related to the acquisition of the Company.

## Contractual Obligations

(millions of dollars)	Total	Less Than 1 Year	1 – 3 Years	4 – 5 Years	After 5 Years
Bank indebtedness (1)	\$242.0	\$242.0	-	-	-
Long-term debt (2)	744.2	2.5	\$ 6.5	\$ 6.5	\$728.7
Operating leases	9.5	3.0	4.2	1.8	0.5
Purchase obligations (2)	3,081.6	545.0	429.7	429.2	1,677.7
AELP purchase obligations (2)	18.9	15.7	3.2	-	-
Other obligations	7.1	1.2	1.8	0.6	3.5

(1) Assumes the outstanding balance on the revolving credit facility is repaid in full within the next twelve months.

(2) Assumes June 30, 2008 Canadian/U.S. dollar exchange rate remains constant.

### Financial Position and Liquidity

At June 30, 2008, the Company had \$155.0 million of unused availability under its revolving credit facility and unrestricted cash of \$10.7 million for total availability of \$165.7 million.

Required pension funding for fiscal 2009 is approximately \$54.4 million. The next actuarial valuation to determine funding requirements is required to be done effective August 1, 2010.

The Company anticipates that it will remain in compliance with its debt covenants and terms of its lending agreements throughout fiscal 2009.

### Outlook

#### *Sales*

The Company is anticipating continued volume growth in fiscal 2009 as it continues to execute its growth plans. Volume of shipments attained in fiscal 2009 will be affected by several factors including:

- (i) market conditions (inventory levels through the supply chain) and the start-up of #6 Blast Furnace;
- (ii) general economic conditions in Canada and the U.S. and the impact on demand of steel intensive products and industries such as automotive, heavy machinery, housing and non-residential construction.

Steel price increases have been announced in the second quarter of calendar 2008. This will result in higher average selling prices in the second quarter of fiscal 2009 compared to the previous quarter.

#### *Manufacturing Costs*

The calendar year 2008 price for iron ore has been finalized.

The Company has concluded contractual arrangements respecting 100% of its coal requirements for fiscal 2009.

Coke prices are showing increasing trends.

Rail and vessel freight costs are anticipated to increase, influenced by base price increases and fuel prices.

Employment levels are not expected to change significantly from calendar 2007 levels. Wage rates in calendar 2008 are expected to increase approximately 3.5% in accordance with the increase negotiated in the new collective bargaining agreements that became effective August 1, 2007 and expire on July 31, 2010.

## **Risks and Uncertainties**

### ***Overview***

The primary goals of managing risks are: (i) to ensure that risks are properly identified and controlled, (ii) to ensure that mechanisms exist to identify risks, analyze and assess their impact on the Company and, (iii) to monitor changes in those risks and communicate the risks to all levels of management, the Board of Directors and shareholders.

### ***Highly Competitive Nature of the Global Steel Industry***

In recent years, there has been a substantial increase in global steel capacity, particularly in China which has become the largest steel producer and consumer in the world. In addition, there has been consolidation of global steel producers and the emergence of an industry leader with global capacity exceeding 120 million tons representing approximately 10% of the global steel market and several other producers each producing in excess of 30 million tons of steel. A significant slowdown in growth and/or increases in capacity, which exceed consumption rates in China, could result in surplus steel which may be exported to world markets. In addition, an economic downturn which affects demand for the Company's products or an increase in the strength of the U.S. dollar or Canadian dollar relative to other currencies could increase imports. It is, therefore, possible that more unfairly priced imports could enter into the North American markets at a future date, resulting in price erosion, which would adversely affect the Company's ability to compete, its revenue and its profitability.

The Company competes with numerous foreign and domestic steel producers. Some of its competitors have greater financial and capital resources than the Company does and continue to invest heavily to achieve increased production efficiencies, increased capacity and improved product quality. The Company primarily competes with other steel producers based on the delivered price of finished products to its customers. The Company's labour, raw material and energy costs are higher than many foreign producers. Although freight costs for steel can often make it uneconomic for distant steel producers to compete with the Company, to the extent that they have lower cost of sales such as lower labour, raw material or energy costs or are government subsidized, they may be able to successfully compete. Although the Company is continually striving to improve its operating costs, it may not be successful in achieving labour, raw material and energy cost improvements or gaining operating efficiencies that may be necessary to remain competitive on a global scale.

The domestic steel industry has experienced lengthy periods of difficult markets due to increased foreign imports. Due to unfavourable foreign economic conditions, excess foreign capacity and a strong Canadian and U.S. dollar, imports of steel products to the U.S. and Canadian markets have reached high levels and, in some cases, have been sold at prices below their combined production and export costs.

Since the beginning of 1997, over 35 U.S. steel companies have sought protection under Chapter 11 of the *United State Bankruptcy Code*. Many of these companies continued to operate, while reducing prices to maintain volumes and cash flow and obtaining concessions from their labour unions and suppliers. Some companies have even expanded and modernized during these reorganizations. Upon emerging from reorganization, these companies, or new entities that purchased their facilities through this process, have been relieved of many obligations including environmental, employee and retiree benefits and other obligations, commonly referred to as legacy costs. As a result, they may be able to operate with lower costs than the Company.

### ***Low Priced Imports and Trade Regulation***

The Company's business has historically been affected by both Canadian and United States trade legislation intended to limit "dumping", a practice employed by certain foreign competitors that have sold steel into the United States or Canadian markets at prices below their costs or below prices prevailing in their own domestic markets. Such practices may result in injury to companies producing goods in Canada or the U.S. in the form of suppressed prices, lost sales, lower profits and reductions in production, employment levels and the ability to raise capital. Although in a number of cases Canadian trade laws have been successfully employed in the past, they may be inadequate to prevent future unfair import pricing practices which individually or collectively could materially adversely affect the Company. If current and future trade cases do not provide relief from such trade practices, relevant Canadian trade laws are weakened, world demand for steel decreases, or the U.S. or Canadian dollars strengthen against foreign currencies, an increase in the market share of imports into Canada may occur,

which could have a material adverse effect on the Company. Moreover, trade regulations in other countries, particularly the United States, could materially adversely affect the Company to the extent that they reduce or eliminate the Company's access to certain steel markets. There can be no assurances that the Company will be able to compete effectively in the future.

A change in the situation in China could have a significant impact on steel markets in the rest of the world. China is presently increasing steel producing capacity by millions of tons every year. They are also importing large volumes of raw materials and some finished steel. China's imports of raw materials are driving up prices in the rest of the world, particularly for iron ore, coal and scrap. Chinese demand for vessels to import raw materials and export finished products has also caused increasing ocean freight rates. The combination of these factors has provided support for steel prices. As the Chinese supply of steel is brought into balance with the demand, countries presently exporting to China will be searching for alternative markets. Since Canada and the U.S. are the largest "open market" in the world, imports from these other countries could impact the North American market resulting in a loss of sales volume, price and profitability for the Company.

#### ***Cyclicalities of the North American Steel Industry***

The North American steel industry is cyclical in nature and sensitive to general economic conditions. The financial condition and results of operation of companies in the steel industry are generally affected by macroeconomic fluctuations in the Canadian, U.S. and global economies. Due mainly to its product mix, Algoma has a higher exposure to spot markets than most of its North American competitors and is, therefore, subject to more volatility in its selling prices. In addition, steel prices are sensitive to trends in cyclical industries such as the North American automotive, construction, appliance, machinery and equipment, and transportation industries, which are significant markets for the Company's products. In addition, many of its customers are affected by North American and worldwide economic downturns, which have resulted, and may in the future result, in defaults in the payment of accounts receivable owing to the Company and reduced sales levels. Although the Company has fixed-price customer contracts which typically range between 25% and 30% of total shipments, the majority of the contracts do not exceed one year in duration and may be difficult to enforce if a customer does choose to breach the contract.

#### ***Supply and Cost of Raw Materials and Energy***

The Company's operations require substantial amounts of raw materials and energy including coal, iron ore, alloys, scrap, oxygen, natural gas, electricity and other inputs. The price and availability of such raw materials and inputs are subject to market forces and, in some cases, government regulations and accordingly, are subject to change. The Company could be particularly adversely affected during a period of declining selling prices for steel without a corresponding decline in raw material costs. The Company's results of operations could be adversely affected by supply interruptions or further increases in the cost of materials. The Company's iron ore, coal, alloy and scrap costs would be adversely affected by a decrease in the relative value of the U.S. dollar. There can be no assurance that adequate supplies of oxygen, electricity, natural gas, coal, iron ore or alloys will be available in the future or that future increases in the cost of such materials will not adversely affect the Company's operations.

#### ***Currency Fluctuations***

The prices for steel products sold in Canada are derived mainly from price levels in the U.S. market in U.S. dollars converted into Canadian dollars at the prevailing exchange rates. As a result, a stronger Canadian dollar relative to the U.S. dollar reduces the Company's Canadian dollar selling prices for sales in both Canada and the U.S.

Increases in the value of the Canadian dollar relative to the U.S. dollar make Canadian steel products and Canadian customers less competitive in U.S. markets and also encourage imports from the U.S. Therefore, a significant increase in the value of the Canadian dollar could materially and adversely affect the Company's results of operations and financial condition.

There is a high correlation between U.S. dollar exchange rates, as compared to global currencies, and the price of steel, especially commodity grades. Weakness in the U.S. dollar will generally provide support to increased steel prices. To the extent that the Canadian to U.S. dollar exchange rate moves consistently with U.S. dollar to global

exchange rates, the impact of the U.S. dollar to Canadian dollar exchange rate may be offset by changes in steel prices.

Increases in the value of the Canadian dollar relative to the home currencies of global steel producers would also increase the probability of increased imports.

#### ***Under-funding of Pension Plans***

The Company has an unfunded pension liability which could increase due to changes to the collective bargaining agreements, a decline in interest rates, investment returns at less than the actuarial assumptions, or changes to the governmental regulations governing funding and other factors. The Company could be adversely affected by the resulting increases in annual funding obligations.

#### ***Post-Employment Benefits***

The Company provides certain post-employment benefits to its retirees. These benefits include drug, life insurance and hospitalization coverage. The Company does not pre-fund these obligations. At the measurement date of June 30, 2008, the unfunded actuarial liability for these obligations was \$391.6 million. The cash paid in the quarter ending June 30, 2008 to fund these benefits was \$3.7 million. Expected benefit payments for the 2009 fiscal year are \$18.4 million. The Company's obligation for these benefits could increase in the future due to a number of factors including changes in interest rates, changes to the collective bargaining agreements, increasing costs for these benefits, particularly drugs, and any transfer of costs currently borne by government to the Company.

#### ***Substantial Capital Investment, Capital Commitments and Maintenance Expenditures Required***

The Company's operations are capital intensive. Algoma expects to be required to make ongoing capital expenditures in an effort to achieve and maintain competitive levels of capacity, cost, productivity and product quality. Capital expenditures in fiscal year 2009 are currently projected at approximately \$170.0 million and are primarily related to the commissioning and start up of #6 Blast Furnace and the completion of the construction of the cogeneration facility. For the first quarter of 2009, the total capital spending was \$57.3 million.

The Company may not generate sufficient future operating cash flow and external financing sources may not be available in an amount sufficient to enable it to make anticipated capital expenditures, service or refinance its indebtedness, or fund other liquidity needs.

#### ***Variability of Financial Results***

The Company's financial results may fluctuate substantially, not only due to the cyclicity of the steel industry and fluctuations in foreign exchange rates, but also due to other factors such as the Company's higher exposure to spot markets than most of its North American competitors, specific product competition, operating performance, uncontrollable increases in prices of raw materials and energy, and difficulties or delays in capital projects. The Company experienced a period of low selling prices for its steel products in the second half of 2007. Although selling prices have improved at the beginning of fiscal 2009 and there have been further announced increases, no assurance can be given that these improvements will be sustained in the future.

#### ***Adverse Impact of the Company's Level of Indebtedness***

The Company has significant debt obligations. If the Company is unable to meet its debt obligations, it may need to consider refinancing or adopting alternative strategies to reduce or delay expenditures, selling assets or seeking additional equity capital.

The Company's high degree of leverage could have important consequences, including the following:

- it may limit the Company's ability to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions and general corporate or other purposes;
- a substantial portion of the Company's cash flows from operations must be dedicated to the payment of interest on the Company's indebtedness and is not available for other purposes, including its operations, capital expenditures and future business opportunities;
- borrowings under the term loan agreement are at variable rates of interest, exposing the Company to the risk of increased interest rates;

- it may limit the Company's ability to adjust to changing market conditions and place it at a competitive disadvantage compared to its competitors that have less debt; and
- the Company may be vulnerable in a downturn in general economic conditions or in its business, or it may be unable to carry out capital spending that is important to its growth.

### ***Financial Restrictions***

The Company's senior secured credit facilities contain restrictive covenants that require the Company to maintain a maximum leverage ratio and a minimum EBITDA to interest expense ratio. In addition, the facilities contain certain restrictive covenants which, among other things, limit the incurrence of additional indebtedness, limit investments, capital expenditures and dividends and restrict transactions with affiliates, permitted acquisitions, asset sales, liens and encumbrances and other matters customarily restricted in such agreements. The Company's ability to comply with these restrictions may be affected by events beyond its control. The Company may not achieve operating results that will permit it to meet these restrictive covenants or may need to take business actions prohibited by these covenants. These covenants may also limit the Company's ability to obtain additional or more favourable financing. In addition, substantially all of the Company's receivables and inventories have been pledged to secure its Revolving Facility.

### ***Labour Matters***

The Company has approximately 3,400 active employees, of which approximately 3,300, representing 97% of the Company's employees, are represented by two locals of the United Steelworkers of America under two collective bargaining agreements. The collective agreements expire July 31, 2010. The Company may be unable to successfully negotiate new collective bargaining agreements without any labour disruption.

The Company's customers, or companies upon which the Company is dependent for raw materials, transportation or other services, could also be affected by labour difficulties. Any such activities, disruptions or difficulties could result in a significant loss of production and sales and have a material adverse effect on the Company's financial condition or results of operations.

### ***Environmental Matters***

The Company's operations are required to comply with an evolving body of environmental laws concerned with, among other things, emissions into the air, discharges to surface and ground water, the investigation and remediation of contaminated property, noise control, waste management and disposal, mine closure and rehabilitation, and the generation, handling, storage, transportation, presence and disposal of hazardous substances. These laws and regulations vary depending on the location of the facility and can fall within federal, provincial or municipal jurisdictions.

In the United States and Canada, certain environmental laws and regulations impose joint and several liabilities on certain classes of persons for the costs of investigation and remediation of contaminated properties. Liability may attach regardless of fault or the legality of the original management or disposal of the substance or waste. Some of the Company's present and former facilities have been in operation for many years and, over such time, have used substances and disposed of wastes that may require investigation and remediation. Algoma could be liable for the costs of such investigations and remediation. Costs for any remediation of contamination, on or off site, whether known or not yet discovered, or to address other issues relating to waste disposal, mine closure, emissions into the air or water, or the storage of materials, could be substantial and could have a material adverse effect on the Company's results of operations.

Pursuant to an order by the Ontario Ministry of Labour, the Company is required to install, by December 31, 2008, certain equipment in the No. 7 Blast Furnace to reduce casthouse emissions. The cost of this equipment and its installation is currently estimated at \$20-\$25 million. The actual cost of the equipment and its installation could vary significantly due to cost escalation, design changes, regulatory policies, or other factors.

Pursuant to a Certificate of Approval issued by the Ontario Ministry of Environment, the Company is required to apply technology or process changes to mitigate noise levels from identified sources within the Sault Ste. Marie operations. It is estimated that the capital cost associated with the noise abatement plan is in the order of \$10 million to be completed by 2013.

The Company is required to fund the capital and operating cost of a mine closure in Wawa involving capital costs of approximately \$2 million during the period of 2010 to 2020. Future operating costs for the mine closure program are estimated at \$50,000 - \$100,000 annually until 2020, and then \$200,000 to \$300,000 commencing in 2020 for the foreseeable future. Financial assurance in the order of \$7.4 million has been provided to the Province of Ontario in the form of a letter of credit.

The Company's Environment, Health and Safety Department regularly reviews and audits the Company's operating practices to monitor compliance with Essar Steel Algoma environmental policies and legal requirements. The Company's environmental management system is ISO14001 registered.

No assurance can be given that unforeseen changes, such as new laws or stricter enforcement policies, or a crisis at one of the Company's properties or operations, will not have a material adverse effect on the business, estimated capital or operating costs, financial condition, or results of operations of the Company. The Company's operations are required to have governmental permits and approvals. Any of these permits or approvals may be subject to denial, revocation or modification under various circumstances. Failure to obtain or comply with the conditions of permits or approvals may adversely affect the Company's operations and may subject the Company to penalties. In addition, if environmental laws are amended or are interpreted or enforced differently, or if new environmental legislation is enacted, the Company may be required to obtain additional operating permits or approvals and incur additional costs. There can be no assurance that the Company will be able to meet all applicable regulatory requirements. In addition, the Company may be subject to fines, penalties or other liabilities arising from its actions imposed under environmental laws, including as a result of actions or other proceedings commenced by third parties, such as neighbors or government regulators.

#### ***Technology and Competition***

There is ongoing research and technological developments with respect to the various processes associated with steel production which have the potential to reduce costs and improve quality. It is possible that certain developments could substantially impair the Company's competitive position if other companies implement new technology and the Company does not or cannot.

#### ***Competition of Products with Other Materials***

In the case of certain product applications, steel competes with a number of other materials such as plastic, aluminum, and composite materials. Improvements in the technology, production, pricing or acceptance of these competitive materials relative to steel or other changes in the industries for these competitive materials could cause net sales to decline.

#### ***Unexpected Equipment Failures***

The Company's manufacturing processes are dependent upon critical steelmaking equipment such as furnaces, continuous casters, rolling mills, and electrical equipment (such as transformers), and this equipment may incur downtime as a result of unanticipated failures. The Company has experienced, and may in the future experience, plant shutdowns or periods of reduced production as a result of such equipment failures. Unexpected interruptions in production capabilities would adversely affect productivity and results of operations for the affected period. No assurance can be given that a significant shutdown will not occur in the future or that such a shutdown will not have a material adverse effect on the business, financial condition or results of operations of the Company. In addition, an unexpected failure in the Company's computer system may have the same result.

#### ***Dependence on Senior Management***

The Company's operations and prospects depend, in large part, on the performance of its senior management team. The Company cannot assure that such individuals will remain as employees. In addition, the Company can make no assurance that it would be able to find qualified replacements for any of these individuals if their services were no longer available. The loss of the services of one or more members of senior management or difficulty in attracting, retaining and maintaining additional senior management personnel could have a material adverse effect on the Company's business, financial condition and results of operations.

## Insurance

To date, the Company has been able to obtain liability insurance for the operation of its business. However, there can be no assurance that the Company's existing liability insurance will be adequate, or that it will be able to be maintained, or that all possible claims that may be asserted against the Company will be covered by insurance.

## Tax Loss Carry-forwards

The Company's income tax loss carry-forwards were reduced by approximately \$180 million under the financial reorganization as a result of debts being discharged for less than their principal amount. The Company had substantial amounts of Federal and Ontario non-capital loss carry-forwards, but fully utilized these losses by the third quarter of 2005. The Company's estimate of non-capital loss carry-forwards is currently under review by the Canada Revenue Agency and could be reduced, subjecting the Company to a tax liability if it is unsuccessful in supporting its positions.

## Supplementary Data

### SELECTED QUARTERLY INFORMATION

For the quarter ended	Successor June 30, 2008	Successor Mar. 31, 2008	Successor Dec. 31, 2007	Successor Sept. 30, 2007	Combined Predecessor And Successor June 30, 2007	Predecessor Mar. 31, 2007	Predecessor Dec. 31, 2006	Predecessor Sept. 30, 2006
Sales	\$760.6	\$ 502.3	\$ 514.8	\$ 368.5	\$ 482.3	\$ 479.5	\$ 418.4	\$ 516.9
EBITDA (i)	204.3	71.4	48.9	(37.2)	28.1	53.8	65.7	111.8
Income (loss) from operations	151.1	20.5	(3.0)	(92.8)	32.8	37.8	50.4	97.2
Income (loss) before income taxes	130.8	(27.3)	(19.2)	(62.8)	9.8	37.6	57.4	100.2
Net income (loss)	89.0	\$ (25.3)	\$ 21.3	\$ (30.8)	\$ 3.9	\$ 23.1	\$ 50.4	\$ 59.5

### OPERATING PERFORMANCE

EBITDA %	26.9%	14.2%	9.5%	(10.1)%	5.8%	11.2%	15.7%	21.6%
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(i) EBITDA is a non-GAAP measure and is defined on page 3 of this report.

## Supplementary Data

### SELECTED QUARTERLY SALES INFORMATION (in thousands of tons)

For the quarter ended	Successor June 30, 2008	Successor Mar. 31, 2008	Successor Dec. 31, 2007	Successor Sept. 30, 2007	Combined Predecessor And Successor June 30, 2007	Predecessor Mar. 31, 2007	Predecessor Dec. 31, 2006	Predecessor Sept. 30, 2006
Sheet	633	534	628	306	480	516	420	486
Plate	167	149	131	130	140	127	114	136
Total	800	683	759	436	620	643	534	622

**ESSAR STEEL ALGOMA INC.**

**Formerly Algoma Steel Inc.  
Consolidated Financial Statements  
For the period ended June 30, 2008**

**ESSAR Steel Algoma Inc.**
**Consolidated Statements of Income (Loss) and Comprehensive Income (Loss) and Retained Earnings**
*(Unaudited)*

Expressed in millions of Canadian dollars

	Successor April 1 to June 30 2008	Successor April 12 to June 30 2007 (Restated - see note 2)	Predecessor April 1 to June 19 2007
<b>Sales</b>	<b>\$ 760.6</b>	<b>\$ 50.4</b>	<b>\$ 431.9</b>
<b>Operating expenses</b>			
Cost of sales excluding amortization	541.0	43.2	370.9
Amortization	44.5	-	-
	<u>585.5</u>	<u>43.2</u>	<u>370.9</u>
Administrative and selling	15.3	1.8	14.7
Amortization of intangibles and non-production assets	8.7	1.2	14.2
	<u>609.5</u>	<u>46.2</u>	<u>399.8</u>
<b>Income from operations</b>	<b>151.1</b>	<b>4.2</b>	<b>32.1</b>
<b>Transaction related expenses</b>	<b>-</b>	<b>2.4</b>	<b>21.2</b>
<b>Financial expense (income)</b>			
Interest on long-term liabilities	15.5	2.7	-
Change in the fair value of embedded derivatives (note 6)	(1.6)	-	-
Interest on short-term liabilities	1.8	0.2	0.9
Foreign exchange loss (gain)	4.7	(7.5)	11.9
Currency contract gains (note 4)	-	(17.0)	-
Currency contract premiums (note 4)	-	9.8	-
Investment income	(0.1)	-	(1.6)
	<u>20.3</u>	<u>(11.8)</u>	<u>11.2</u>
<b>Income (loss) before income taxes</b>	<b>130.8</b>	<b>13.6</b>	<b>(0.3)</b>
<b>Income taxes (note 10)</b>			
Current expense (recovery)	49.2	(7.0)	12.6
Future expense (recovery)	(7.4)	6.0	(4.6)
	<u>41.8</u>	<u>(1.0)</u>	<u>8.0</u>
<b>Net income (loss)</b>	<b>\$ 89.0</b>	<b>\$ 14.6</b>	<b>\$ (8.3)</b>
Unrealized gain (loss) on foreign exchange translation	(3.1)	-	-
<b>Comprehensive income (loss) for the period</b>	<b>\$ 85.9</b>	<b>\$ 14.6</b>	<b>\$ (8.3)</b>
<b>Retained earnings</b>			
Balance, beginning of period	\$ (11.4)	\$ -	\$ 416.0
Net income as previously reported	-	12.2	(8.3)
Change in accounting for inventory	-	2.4	-
Net income (loss), as restated	89.0	14.6	(8.3)
Balance, end of period	<u>\$ 77.6</u>	<u>\$ 14.6</u>	<u>\$ 407.7</u>

See accompanying notes to consolidated financial statements

**ESSAR Steel Algoma Inc.**  
**Consolidated Balance Sheets**

*(Unaudited)*

Expressed in millions of Canadian dollars

	Successor June 30 <u>2008</u>	Successor March 31 <u>2008</u>
<b>Assets</b>		
<b>Current</b>		
Cash and cash equivalents	\$ 10.7	\$ 9.9
Restricted cash	3.9	8.0
Accounts receivable	388.2	241.7
Inventories	455.0	345.5
Prepaid expenses	12.8	4.7
Future income taxes (note 10)	3.3	3.3
	<u>873.9</u>	<u>613.1</u>
Property, plant and equipment	1,765.7	1,791.8
Assets held for sale (note 12)	123.6	101.1
Receivable from non-controlling interest (note 12)	16.2	7.0
Intangible assets, net	116.0	120.3
Other assets	3.9	4.1
	<u>\$ 2,899.3</u>	<u>\$ 2,637.4</u>
<b>Liabilities and shareholder's equity</b>		
<b>Current</b>		
Bank indebtedness (note 5)	\$ 242.0	\$ 127.3
Accounts payable and accrued liabilities	250.5	206.7
Accounts payable related to assets held for sale (note 12)	10.5	5.8
Income and other taxes payable	34.8	0.5
Accrued pension liability and post-employment benefit obligation (note 7)	45.9	49.4
Payable to related parties (note 12)	8.2	8.2
Current portion of long-term debt (note 6)	2.5	2.4
Future income tax liability (note 10)	6.4	6.7
	<u>600.8</u>	<u>407.0</u>
Long-term debt (note 6)	741.7	767.8
Deposit from related party (note 12)	43.8	44.1
Accrued pension liability (note 7)	106.6	111.6
Accrued post-employment benefit obligation (note 7)	387.0	383.6
Other long-term liabilities	7.1	8.8
Future income tax liabilities on assets held for sale (note 12)	4.2	4.2
Future income tax liabilities (note 10)	291.8	299.0
	<u>1,582.2</u>	<u>1,619.1</u>
<b>Non-controlling interest (note 12)</b>	<u>54.5</u>	<u>45.3</u>
<b>Shareholder's equity</b>		
Capital stock (note 9)	531.8	531.8
Contributed surplus	55.5	45.6
Accumulated other comprehensive income (loss) (note 8)	(3.1)	-
Retained earnings (deficit)	77.6	(11.4)
	<u>661.8</u>	<u>566.0</u>
<b>Total liabilities and shareholder's equity</b>	<u>\$ 2,899.3</u>	<u>\$ 2,637.4</u>

See accompanying notes to consolidated financial statements

**ESSAR Steel Algoma Inc.**  
**Consolidated Statements of Cash Flows**

(Unaudited)

Expressed in millions of Canadian dollars

	Successor April 1 to June 30 2008	Successor April 12 to June 30 2007  (Restated - see note 2)	Predecessor April 1 to June 19 2007
<b>Operating activities</b>			
<b>Net income (loss)</b>	\$ 89.0	\$ 14.6	\$ (8.3)
Adjustments and items not affecting cash:			
Amortization	53.1	1.2	14.2
Future income tax expense (recovery)	(7.4)	6.0	(4.6)
Pension expense in excess of (less than) current funding	(7.8)	0.6	9.9
Post-employment benefit expense in excess of payments	6.3	0.1	4.0
Foreign exchange gain on long-term debt and accrued interest	-	(6.7)	-
Change in the fair value of embedded derivatives (note 6)	(1.6)	-	-
Unrealized foreign exchange loss on future income taxes	2.0	-	-
Loss (gain) on disposal of property, plant and equipment	0.2	(0.4)	0.4
Stock-based compensation	-	-	6.3
Gain on redemption of 9.875% notes	(0.1)	-	-
Other	(0.1)	0.3	(0.3)
	<u>133.6</u>	<u>15.7</u>	<u>21.6</u>
Changes in non-cash operating working capital	<u>(174.8)</u>	<u>(44.3)</u>	<u>25.3</u>
	<u>(41.2)</u>	<u>(28.6)</u>	<u>46.9</u>
<b>Investing activities</b>			
Acquisition of property, plant and equipment	(57.3)	(7.5)	(17.7)
Proceeds on sale of property, plant and equipment	0.3	0.2	0.2
Business acquisition, net of cash acquired of \$41.2 million (note 4)	-	(1,666.4)	-
Restricted cash	4.0	(7.8)	-
Decrease (increase) in short-term investments	-	142.1	(140.3)
	<u>(53.0)</u>	<u>(1,539.4)</u>	<u>(157.8)</u>
<b>Financing activities</b>			
Bank indebtedness, net	114.5	98.6	-
Proceeds of long-term notes and bank term loan, net (note 4)	-	939.1	-
Redemption of 9.875% notes payable	(19.7)	-	-
Issuance of shares	-	531.8	-
Advances from related parties, net (note 12)	-	8.8	-
Financing costs, bank indebtedness	-	(4.9)	(0.3)
Other	(0.1)	-	-
	<u>94.7</u>	<u>1,573.4</u>	<u>(0.3)</u>
Effect of exchange	0.3		
<b>Cash and cash equivalents</b>			
Change during period	0.8	5.4	(111.2)
Balance, beginning of period	9.9	-	152.4
<b>Balance, end of period</b>	<u>\$ 10.7</u>	<u>\$ 5.4</u>	<u>\$ 41.2</u>
<b>Changes in non-cash operating working capital</b>			
Accounts receivable	(146.7)	(4.9)	41.9
Income and other taxes receivable / payable	43.8	(7.8)	(26.4)
Inventories	(113.2)	(6.6)	(45.5)
Prepaid expenses	(8.1)	5.9	(5.2)
Accounts payable and accrued liabilities	49.4	(30.9)	60.5
	<u>\$ (174.8)</u>	<u>\$ (44.3)</u>	<u>\$ 25.3</u>
<b>Supplemental information</b>			
Income taxes paid	\$ 2.9	\$ 17.3	\$ 17.2
Interest paid (received)	\$ 31.7	\$ -	\$ (1.3)

See accompanying notes to consolidated financial statements

# ESSAR Steel Algoma Inc.

## Notes to Interim Consolidated Financial Statements (Unaudited)

June 30, 2008

(Expressed in millions of Canadian dollars, except as noted)

### 1. Basis of Presentation

On June 20, 2007, pursuant to a plan of arrangement (the "Transaction" or "Acquisition"), Algoma Steel Inc. (the "Predecessor") was acquired by Algoma Acquisition Corp. (the "Successor"), which was an indirect wholly-owned subsidiary of Essar Steel Holdings Limited ("Essar"), incorporated on April 12, 2007 solely for the purpose of the Acquisition. On June 23, 2007, Algoma Steel Inc. and Algoma Acquisition Corp. were amalgamated and continued operating as Algoma Steel Inc. The term "Predecessor" refers to Algoma Steel Inc. and its subsidiaries on a consolidated basis prior to the Acquisition, and the term "Company" refers to the Predecessor prior to the Acquisition and to the combined Predecessor and Successor companies after the Acquisition. The Company is a wholly owned subsidiary of Essar Group.

Effective March 31, 2008, the Company changed its fiscal year-end from December 31 to March 31. Effective June 23, 2008 Algoma Steel Inc. changed its name to ESSAR Steel Algoma Inc.

These interim consolidated financial statements include the results of operations and cash flows of the Successor for the period from April 1, 2008 to June 30, 2008 and the results of operations and cash flows of the Successor for the period from April 12, 2007 to June 30, 2007. Other than activities in connection with the Acquisition, the Successor had no activities prior to the Acquisition. The interim consolidated financial statements of the Predecessor are provided for the period from April 1, 2007 to June 19, 2007.

The interim consolidated financial statements of the Predecessor for the comparative period of 2007 are not comparable in all respects to the interim consolidated financial statements of the Successor for the period ended June 30, 2008 as a result of the Transaction which resulted in a comprehensive revaluation of the Predecessor's assets and liabilities at June 20, 2007, as a result of the application of business combinations accounting and the significant acquisition financing.

These interim consolidated financial statements have been prepared using the same accounting principles and methods as were used for the consolidated financial statements for the period ended March 31, 2008. Management is required to make estimates and assumptions that affect the amounts reported in the interim financial statements. Management believes that the estimates are reasonable; however, actual results could differ from these estimates. The disclosures in these interim consolidated financial statements do not meet all disclosure requirements of Canadian generally accepted accounting principles ("GAAP") for annual financial statements and should be read in conjunction with the consolidated financial statements of the Company for the period ended March 31, 2008 and the notes thereto.

### 2. Change in Accounting Policy

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants (CICA) Handbook Section 3031, "Inventories". The standard provides guidance with respect to the determination of inventory cost and requires inventories to be measured at the lower of cost and net realizable value. The cost of inventories includes the costs to purchase and other costs incurred in bringing the inventories to their present location. Costs such as storage costs and administrative overheads that do not contribute to bringing the inventories to their present location and condition are specifically excluded from the cost of inventories and expensed in the period incurred. Reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of the inventories is now required. The cost of the inventories should be based on a first-in, first-out or a weighted average cost formula. The new standard also requires additional disclosures including the accounting policies used in measuring inventories, the carrying amount of the inventories, amounts recognized as expense during the period, write-downs and the amount of any reversal of any reversal of write-downs recognized as a reduction in expenses.

Prior to the adoption of this standard, the Company did not include the amortization of property, plant and equipment in production overheads allocated to inventory cost. This standard was adopted retrospectively to the date of the Transaction with a restatement of the Successor period of April 12, 2007 to June 30, 2007. Reported amounts of the Predecessor were not restated. As a result of the restatement, cost of sales in the Successor period of April 12, 2007 to June 30, 2007 did not change, amortization expense decreased by \$ 3.5 million, the recovery of income taxes decreased by \$1.1 million and net income increased by \$ 2.4 million.

# ESSAR Steel Algoma Inc.

## Notes to Interim Consolidated Financial Statements (Unaudited)

June 30, 2008

(Expressed in millions of Canadian dollars, except as noted)

### 3. Change in Functional Currency

Effective April 1, 2008, the Company's functional currency changed to the United States dollar ("U.S. dollar") to reflect the increasing operational exposure to the U.S. dollar. The Company has continued to use the Canadian dollar as its reporting currency. In accordance with Canadian generally accepted accounting principles, all amounts presented for the period of April 1, 2008 to June 30, 2008 are translated to Canadian dollars using the current rate method whereby all revenues, expenses and cash flows are translated at the average rate that was in effect during the period or presented at their Canadian dollar transactional amounts and all assets and liabilities are translated at the prevailing closing rate in effect at the end of the period (Cdn. \$1.0197 per U.S. \$1.00 for June 30, 2008). Equity transactions have been translated at historical rates. The resulting net translation adjustment has been recorded in other comprehensive income.

### 4. Acquisition of the Company

The Company accounted for the Transaction as a business combination using the purchase method. All consideration for shares and other equity instruments was paid in cash. The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition:

	<u>Acquisition of Predecessor</u>
Current assets, including acquired cash of \$41.2	\$ 895.6
Current future income taxes	3.5
Property, plant and equipment	1,847.6
Intangible assets:	
Customer asset	99.6
Technology	10.4
In-process research and development	4.5
Supply agreements	76.7
Order backlogs	<u>7.2</u>
	<u>198.4</u>
Total assets acquired	2,945.1
Current liabilities assumed	(206.2)
Pension and other post-employment benefits	(500.0)
Other long-term liabilities	(7.3)
Long-term future income taxes	<u>(393.2)</u>
Total liabilities assumed	<u>(1,106.7)</u>
Net assets acquired	<u>\$ 1,838.4</u>

The values of assets, liabilities and contingent liabilities recognized on acquisition are their estimated fair values.

The total cost of the acquisition was \$1,838.4 million, including amounts paid or payable to shareholders and holders of stock options and other equity-based awards of \$1,827.0 million and acquisition costs of \$11.4 million. At the closing of the Transaction, a shareholder of the Predecessor, holding approximately 2.3 million common shares, exercised their dissent rights in opposition to the Transaction. As a result, an amount due to this shareholder pursuant to the Transaction totaling approximately \$130.8 million was not distributed at close. In July 2007, the shareholder withdrew their dissent and accordingly, the Company paid the amount outstanding related to the Transaction.

To fund the Transaction, the Successor entered into various debt facilities as described in notes 3 and 4. The total amount drawn on the long-term debt facilities at the close of the Transaction consisted of \$482.75 million (U.S. \$450 million) on the bank term loan facility and \$482.75 million (U.S. \$450 million) from Senior Subordinated Notes, less total related financing costs of \$26.4 million. Drawings on the Revolving Credit Agreement of \$82.8 million less related financing costs of \$4.7 million, cash from equity financing of \$531.8 million and \$142.1 million from short-term investments of the Predecessor were also used to fund the Transaction.

Prior to the Acquisition, Algoma Acquisition Corp. entered into foreign exchange forward and option contracts to purchase Canadian dollars with U.S. dollars in order to manage the currency exchange risk associated with funding the Canadian dollar purchase price with

U.S. dollars. These contracts were not accounted for as hedges and, for the period April 12 to June 30, 2007, the Successor recorded a gain of \$17.0 million and related premium expense of \$9.8 million on these foreign exchange option and forward contracts.

# ESSAR Steel Algoma Inc.

## Notes to Interim Consolidated Financial Statements (Unaudited)

June 30, 2008

(Expressed in millions of Canadian dollars, except as noted)

### 5. Banking Facilities

In order to facilitate the Transaction and refinance the Company, on June 20, 2007, the Successor entered into a five-year Revolving Credit Agreement ("Agreement"). The Agreement provides the Company with a revolving credit facility ("Revolving Facility") equal to the lesser of U.S. \$425 million and a borrowing base determined by the levels of the Company's accounts receivable and inventories, less certain reserves. The Revolving Facility is secured by substantially all of the Company's assets. Under the General Security Agreement, the Revolving Facility has priority claim on the accounts receivable and inventory of the Company, while the bank term loan has priority claim on the rest of the Company's assets. Borrowings can be made in either Canadian or United States funds. Canadian borrowings bear interest at either the Canadian bankers' acceptance rate plus a margin of 1.25 – 2.0% or Canadian prime rate plus a margin of 0.25 – 1.0%. United States borrowings bear interest at either London Inter-Bank Overnight Rate ("LIBOR") plus a margin of 1.25 – 2.0% or the lender's corporate base rate plus a margin of 0.25 – 1.0%. The applicable margin is dependent on the average excess availability under the Revolving Facility for the preceding fiscal quarter.

The Revolving Facility also provides for payment to the lenders of an unused line fee on the average daily excess availability of 0.25% per annum, a commitment fee of 0.25% of the full amount of the Revolving Facility, a funding fee of 0.75% of the full amount of the Revolving Facility and a letter of credit fee ranging from 1.25% to 2.00%, depending on the average excess availability under the Revolving Facility. Fees totaling \$4.7 million were incurred to establish the Revolving Facility and are being amortized to expense over its term.

At June 30, 2008, there was \$242.0 million outstanding under the Revolving Facility and \$155.0 million of unused availability after taking into account \$25.0 million of outstanding letters of credit.

Under the terms of the Agreement, the Company is required to be in compliance with various restrictive covenants, including a maximum leverage ratio and a minimum interest coverage ratio.

### 6. Long-term Debt

	<u>Successor June 30 2008</u>	<u>Successor March 31 2008</u>
Bank term loan denominated in U.S. dollars, bearing interest at LIBOR plus 2.5% or the lender's corporate base rate plus 1.5%, due June 15, 2013	\$ 325.2	\$ 327.3
Senior Subordinated Notes denominated in U.S. dollars, bearing interest at 9.875%, due June 15, 2015	<u>441.1</u>	<u>466.5</u>
	\$ 766.3	793.8
Less unamortized financing costs	<u>22.1</u>	<u>23.6</u>
	\$ 744.2	770.2
Less current portion	<u>2.5</u>	<u>2.4</u>
	<u>\$ 741.7</u>	<u>\$ 767.8</u>

The aggregate amount of principal repayments in each of the next five years and thereafter at current exchange rates is as follows:

2009	\$ 2.5
2010	3.3
2011	3.3
2012	3.3
2013	3.3
Thereafter	<u>750.6</u>
	<u>\$ 766.3</u>

On December 28, 2007 the Company made a payment on the bank term loan of U.S. \$130.0 million. The term loan has a remaining principal amount of U.S. \$318.9 million (Cdn. \$325.2 million) is secured by substantially all of the Company's assets and is subject to various restrictive covenants, including a maximum leverage ratio and a minimum interest coverage ratio. It is repayable in quarterly payments of U.S. \$0.8 million beginning September 30, 2008, with the balance of U.S. \$303.6 million due at maturity.

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(Expressed in millions of Canadian dollars, except as noted)

Financing costs related to the bank term loan and the Senior Subordinated Notes totaled \$26.4 million and are recorded as a component of the carrying amount of the related debt and are amortized to income using the effective interest rate method. The unamortized balance at June 30, 2008 was \$22.1 million.

On June 30, 2008, the Company purchased and cancelled U.S. \$20.0 million in Notes, leaving a remaining balance of U.S. \$430.0 million. The Notes are unsecured and are subordinated in right of payment to all existing and future secured indebtedness of the Company to the extent of the assets securing such indebtedness.

Subject to certain conditions, at any time prior to June 15, 2010, the Company may redeem up to 35% of the principal amount of the Notes at a redemption price of 109.875% of the principal amount plus accrued and unpaid interest with the proceeds of a public equity offering. At any time prior to June 15, 2011, the Company may also redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of Notes redeemed plus accrued and unpaid interest and a specified premium. On or after June 15, 2011, the Company may redeem all or a part of the Notes at the following redemption prices, plus accrued and unpaid interest:

2011	104.938%
2012	102.469%
2013	100.000%

Under Canadian generally accepted accounting principles, the prepayment options in the Notes are required to be accounted for as embedded call option derivative instruments which require bifurcation and are accounted for at fair value. The embedded call options were included in the carrying amount of the Notes, had an estimated fair value of \$4.9 million on issuance of the Notes, have an estimated fair value of \$1.6 million at June 30, 2008 and had a fair value of nil at March 31, 2008.

### 7. Pension and Other Post-Employment Benefits

Pension expense for the Successor for the period from April 1 to June 30, 2008 was \$12.6 million (Successor - April 12 to June 30, 2007 - \$0.6 million). Pension expense for the Predecessor for the period from April 1 to June 19, 2007 was \$10.0 million.

Pension funding for the Successor for the period from April 1 to June 30, 2008 was \$21.4 million (Successor - April 12 to June 30, 2007 - nil). Pension funding for the Predecessor for the period from April 1 to June 19, 2007 was \$0.1 million.

Post-employment benefits expense for the Successor for the period from April 1 to June 30, 2008 was \$7.3 million (Successor - April 12 to June 30, 2007 - \$0.8 million). Post-employment benefits expense for the Predecessor for the period from April 1 to June 19, 2007 was \$7.1 million.

Post-employment benefits funding for the Successor for the period from April 1 to June 30, 2008 was \$3.7 million (Successor - April 12 to June 30, 2007 - \$0.7 million). Post-employment benefits funding for the Predecessor for the period from April 1 to June 19, 2007 was \$3.1 million.

### 8. Accumulated Other Comprehensive Income (Loss)

	Successor June 30 2008	Successor March 31 2008
Balance, beginning of period	\$ -	\$ -
Other comprehensive loss for the period	<u>(3.1)</u>	<u>-</u>
Balance, end of period	<u><u>\$(3.1)</u></u>	<u><u>-</u></u>

**ESSAR Steel Algoma Inc.**  
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**June 30, 2008**  
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**9. Capital Stock**

Authorized - Unlimited common shares

The following table summarizes the share capital transactions of the Successor since incorporation on April 12, 2007:

	Common shares Issued and Outstanding	
	# shares	Stated capital
Common shares issued on incorporation	10,000	-
Common shares issued in June 2007	<u>500,000,000</u>	<u>\$ 531.8</u>
Balance at June 30, 2008	<u>500,010,000</u>	<u>\$ 531.8</u>

**10. Income Taxes**

The following table explains the variation between the Company's provision for income taxes and the statutory income tax rate:

	Successor April 1 to June 30 2008	Successor April 12 to June 30 2007	Predecessor April 1 to June 19 2007
Income tax provision (recovery) at the statutory manufacturing and processing rate of 31.3% [2007 - 34.1%]	\$ 42.6	\$ 4.6	\$ (0.1)
Add (deduct):			
Impact of non-taxable portion of exchange gain	(0.8)	-	-
Impact of future Federal tax rate reductions	-	(4.4)	-
Impact of post-employment benefit expense	-	-	3.6
Impact of non-deductible stock-based compensation	-	-	2.4
Other	-	(1.2)	2.1
Provision for (recovery of) income taxes	<u>\$ 41.8</u>	<u>\$ (1.0)</u>	<u>\$ 8.0</u>

The Company's estimate of non-capital losses available subsequent to the 2002 financial reorganization is currently under review by the Canada Revenue Agency and may be subject to change.

**11. Commitments and Contingencies**

A portion of the Company's property is licensed as a private landfill that is subject to a Certificate of Approval ("COA") with the Ontario Ministry of the Environment ("MOE") which outlines the Company's ongoing operating and site closure obligations. Under the terms of the Certificate of Approval that was renewed in 2007, the Company is required by December 31, 2008 to prepare a report outlining the estimated costs of performing the Company's ongoing operating and site closure obligations under the COA, and the amount of Financial Assurance that is to be provided to the MOE under their guidelines. Following acceptance of the Company's report by the MOE, the Financial Assurance may be provided in the form of cash, letters of credit or other security. The Company has not yet completed the estimate of future costs or Financial Assurance requirements.

**12. Related Party Transactions**

The Company's major shareholder, Essar, and its commonly controlled affiliates are related parties.

Prior to the Acquisition, the Successor entered into foreign exchange forward and option contracts to purchase Canadian dollars with U.S. dollars. The cost of these contracts was paid by Essar, resulting in a payable to Essar by the Company of \$8.2 million at June 30, 2008. This liability is unsecured and non-interest bearing with no specific repayment terms.

## ESSAR Steel Algoma Inc.

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On December 28, 2007, one of Essar's affiliates purchased 49.9% of the Company's interest in Algoma Energy LP ('AELP') for consideration of \$82.8 million. AELP is constructing an electricity co-generation facility for an estimated total capital cost of \$120 million. The affiliate also provided the Company an irrevocable deposit of \$44.1 million for the potential future purchase of the remaining 50.1% of AELP.

Net assets of AELP at the date of the transaction (in \$ millions):

Proceeds of the sale	\$ 82.8
Net assets of AELP at the date of the transaction:	
Other receivables	0.4
Construction in progress, including capitalized interest of \$0.7	32.4
Intangible asset – customer contract	56.6
Accounts payable and accrued liabilities	(8.5)
Future tax	(4.2)
	<u>\$ 76.7</u>
Portion sold	<u>49.9%</u>
Non-controlling interest	<u>\$ 38.3</u>
Excess of proceeds over carrying amount	<u>\$ 44.5</u>
Current and future tax effects of the transaction	<u>1.1</u>
Amount recorded in contributed surplus	<u>\$ 45.6</u>

The related party transaction has been accounted for at the carrying amount and the excess of the \$82.8 million consideration paid over the 49.9% share of net assets of AELP has been recorded as contributed surplus. The income tax effects arising from the transaction have also been recorded as a capital transaction consisting of \$9.9 million of current taxes, offset by an adjustment to the future tax liability of \$11.0 million.

The assets and liabilities of AELP are shown as held for sale in the consolidated balance sheet and the 49.9% interest is shown as non-controlling interest of \$54.5 million (March 31, 2008 - \$45.3 million). The amount of the non-controlling interest's share of capital expenditures that are being funded by the Company is recorded as receivable from non-controlling interest of \$16.2 million (March 31, 2008 - \$7.0 million)