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COMMISSION OF THE EUROPEAN COMMUNITIES

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**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
PARLIAMENT**

First monitoring report on steel restructuring in Bulgaria and Romania

1. INTRODUCTION

1.1. The context

This report describes the progress in restructuring made by Bulgarian and Romanian steel companies that are subject to the requirements set out in the specific chapters of the Europe Agreement and the Treaty of Accession respectively. More specifically these obligations, both for the respective governments and for individual companies, are set out in:

- Protocol 2 to the Europe Agreement¹ which refers to the restructuring of the Bulgarian steel industry and EU-Bulgaria Association Council Decision 3/2006 dated 29 December 2006² amending the Protocol 2 to the Europe Agreement, and
- Annex VII of the Accession Treaty³ which refers to the restructuring of Romanian steel industry.

These provisions outline the conditions for a transitional regime for state aid given for steel restructuring. Although state aids for restructuring the steel industry are expressly forbidden under EU law, the European Union agreed on transitional arrangements for according certain aids which would allow these new Member States⁴ to complete this task while minimising social and market disturbance. Strict conditions are attached to the granting of this aid, notably the achievement of viability by the companies concerned.

The duration of the arrangements applicable to the transitional period lasts until 31 December 2008. The above mentioned Protocol and Annex also set out detailed provisions for monitoring and reporting on the associated obligations. This report to the Council is part of these provisions, and refers to the results achieved in the year 2006. Where the relevant information is available for 2007, this is also provided..

1.2. Major elements of the restructuring exercise

The exception to the EU rules on state aid was conditional on the fulfilment of certain obligations, negotiated between the EU and Bulgaria and Romania. The precondition for granting state aid was the preparation of National Restructuring Programmes (NRP) consisting of a national steel sector plan and individual business plans (IBP) for each benefiting company. The purpose of the steel restructuring programmes was to show that the conditions for granting of restructuring aid are observed and that the NRP leads to the viability of companies.⁵

In both countries, the NRP included also companies which had been in difficulties but were not beneficiaries of past or future state aid. In many cases non-beneficiary companies have completed their restructuring in 2006 and became viable and profitable.

¹ OJ L 358, 31.12.1994, p. 3–222

² UE-BG 1909/06 - Adoption decision 3/2006

³ OJ L 157, 21.06.2005, p. 3–393

⁴ Similar process has just been finished for Czech Republic and Poland, where the Commission monitored and reported on the restructuring until the end of 2006.

⁵ Viability implies that the companies return to sustainable profitability at the end of the restructuring period. According to longstanding practice the Commission considers that the companies should achieve:

- a reasonable operating margin: i.e. an EBITDA over turnover of at least 10% for non-integrated steel companies and 13.5 % for integrated mills);

- a minimum return of turnover on own capital: we are interpreting this as meaning a minimum return on sales, i.e. the EBIT must be at least 1.5% of the turnover).

Based on the information provided by Bulgarian and Romanian authorities in their 6-monthly reports, the Commission has assessed the progress in the implementation of measures envisaged in the NRPs and companies' IBPs. The scope of information provided includes data on production, capacity, investments, employment, productivity, financial results and the environment.

The steel sector in Bulgaria accounts for 2% of total industry employment and 3% of GDP, and in Romania for 4% of total industry employment and 4% of GDP⁶.

2. RESULTS OF THE MONITORING PROGRAMMES IN BULGARIA AND ROMANIA

2.1. Bulgaria

The only company to undergo the restructuring process with the help of public funding was Kremikovtzi AD. Two other companies included in the NRP managed to successfully complete the restructuring process in 2006 without recourse to state aid.

In 2006 Bulgaria indicated that Kremikovtzi AD, although it did not need more aid than previously authorised, would not be in a position to complete its restructuring plan before 31 December 2006. It therefore submitted a modified restructuring programme and business plan to the Commission, in which it proposed the extension of their implementation until the end of 2008. The assessment prepared by the Commission indicated that the implementation of the plan would allow the company concerned to reach viability and meet the requirements of Protocol 2. Based on this assessment, the EU-Bulgaria Association Council by its Decision 3/2006 of 29 December 2006 has amended the Protocol 2 accordingly.

As regards the overall amount of aid allowed, according to the information provided by the Bulgarian authorities, for the period 1993 – 2005 the total amount of state aid overall, which was provided in Bulgaria is BGN 432,613,000 (222 million EUR⁷); no state aid was granted in 2006. The figure of total state aid granted is in line with the Protocol ceiling.

Most (BGN 393 556 517 (202 million EUR)) of the amount allowed was disbursed in 1999 to help the beneficiary company – Kremikovtzi AD - to continue production. The aid was focused primarily on financial restructuring to address the debt burden of the company. The rest of the allowed amount was granted to the company in 2004 in the form of rescheduled debts to gas and electricity suppliers.

2.1.1. Monitoring of the key restructuring benchmarks in the Bulgarian steel sector

According to the provisions of the EU Common Position – Chapter 6: Competition⁸ and EU-Bulgaria Association Council Decision 3/2006:

- the total net capacity reduction by the benefiting company shall be of 0.5 million tonnes,
- the progress of the restructuring of the companies shall be assessed by the Commission using its viability test,
- the restructuring shall lead to the improvement of efficiency and effectiveness of business management.

Capacity reduction

⁶ Eurostat, governments' reports

⁷ BGN/Euro exchange rate 1.9487 (average June 2004)

⁸ EU Common Position – Chapter 6: Competition, adopted in June 2004, 10232/04

The closure of the wire rod mill in Kremikovtzi which has been planned as a compensatory measure by the Bulgarian government for the restructuring aid granted, has been implemented. Production in the billet mill has been discontinued and the dismantling has been completed. The rod mill is expected to be permanently destroyed in compliance with relevant EU legislation⁹ by the end of the restructuring period.

Viability

The main goal of the restructuring process and of all actions envisaged under the NRP and Kremikovtzi's IBP is to achieve the viability of the company under normal market conditions. As regards results achieved compliance with EC viability test benchmarks at the end of 2006 was, in case of Kremikovtzi, very far from being reached.

On the basis of the assessment of the data available at the end of 2006, the Commission has identified that there have been serious delays in the completion of the investments planned in the company's IBP. This is likely to have a knock-on effect on the company's ability to produce higher added-value products. This ability is a condition to increase revenues from sales and generate profits. Therefore, the operational performance has resulted in a substantial loss and the company has achieved worse viability ratios than planned in the IBP. The financial performance has reached a critically low level.

Productivity

The productivity level in Kremikovtzi remains well below EU and international standards, as the low levels of capacity utilisation hamper advances in labour productivity in spite of gradual reductions in staff numbers. The productivity level is only 30% of that of comparable European steel plants. Although some improvements in productivity are still expected to take place as a result of the closure of the blooming mill during the second half of 2007 and the beginning of 2008, the current level of 30% is considered to be very low and will have a negative impact on the efficiency and effectiveness of the company's business. .

Cost reductions

In 2006 the results obtained by way specific cost reduction measures at Kremikovtzi were mostly offset by the increase in overall costs reflecting the general trend, which were higher than expected. In the case of Kremikovtzi for 2006 purchase prices and specific consumption of raw materials exceeded the IBP projections. In some areas such as energy and materials consumption, the necessary cost reductions can only be achieved in the longer term through investment in modernisation. Due to a lack of capital, amounts invested were below the expected values. In Kremikovtzi in 2006, taken together all the investments represented 80% of the IBP target for the year. At the same time environmental investments amounted to 75% of the IBP target.

2.1.2. *Environmental protection*

The Treaty of Accession specifies that by the time of accession Bulgarian steel companies need to comply with the relevant EU legislation in the field of environmental protection, and in particular to make the necessary investments to ensure such compliance. In that context Bulgaria applied for a transitional period for the application of the IPPC directive¹⁰. By way of derogation, Kremikovtzi should have obtained a fully coordinated permit by 30 October 2007 containing a binding timetable for the achievement of full compliance by 31 December

⁹ Decision 3010/91/ECSC OJ L 286, 16.10.1991, p. 20

¹⁰ Council Directive 96/61/EC of 24 September 1996, OJ L257, 10.10.1996, p.26

2011. This has not yet been obtained and therefore the company appears to be operating without an environmental permit after its last permit expired.

2.2. Romania

Annex VII of the Accession Treaty identifies the maximum state aid allowed for each of the following six steel producing companies: Mittal Steel Galati, accounting for about 60% of crude steel production in Romania, Mittal Steel Hunedoara, Mechel Targoviste, Mechel Campia Turzi, TMK Resita and Tenaris Donasid Calarasi.

According to the information at the Commission's disposal, Romania granted a total amount of ROL 49 985 billion (€1 270 million¹¹) of restructuring aid in the period 1993-2004. These amounts of total state aid granted are in line with the ceiling specified in Annex VII of the Accession Treaty.

The Romanian government prepared the NRP to structure and limit the state aid granted to steel companies to the absolute minimum. The implementation of the NRP was an important element to assist the companies in achieving viability. The aid focused primarily on financial restructuring to address the debt burden of the companies so as to facilitate their access to financing and their acquisition by a strategic investor. The aid granted is deemed sufficient to help the companies to achieve viability by the end of the restructuring period.

As regards potential additional state aid elements investigated by the Romanian Competition Council with reference to Mittal Steel Galati, it should be noted that the company reimbursed in March 2006 all the contested amounts corresponding to the principal and interest concerned. Thereafter, the Romanian Competition Council, by Decision Nr. 56/13.03.2006, closed the investigation and declared Mittal Steel Galati free of any doubtful state aid.

2.2.1. Monitoring of the key restructuring benchmarks in the Romanian steel sector

The provisions of the Treaty of Accession for Romania established that:

- state aid shall lead to viability of the companies under normal market conditions and shall be limited to what is necessary,
- the total net capacity reduction by the benefiting companies shall be a minimum of 2.05 million tonnes,
- the progress in the restructuring of the companies shall be assessed by the Commission using the restructuring benchmarks set out in the appendix to the Treaty of Accession (viability, productivity and cost reductions)

Capacity reduction

It appears from the information at the Commission's disposal that capacity closures planned for 2006 – the medium and special sections rolling mill in TMK Resita - have taken place as scheduled. The same company stopped production one year earlier than required by the Treaty in the case of the heavy sections rolling mill. In Mittal Steel Hunedoara the closure of the medium section mill took place in 2006 ahead of planned in the 1st quarter of 2008. Once the above installations are permanently destroyed¹², Romania will fulfil its obligations on capacity closures stemming from the Treaty of Accession.

There were also additional closures of obsolete capacity at three companies, not provided for by the Treaty of Accession, namely, the blooming rolling mill at Mittal Steel Hunedoara , the

¹¹ ROL/Euro Exchange rate 39358.0 (average December 2004)

¹² Decision 3010/91/ECSC OJ L 286, 16.10.1991, p. 20

rolling mill for semi finished heavy sections and rails at Tennaris Donasid Calarasi,, and the roughing rolling mill at Mechel Campia Turzii.

Viability

The main goal of the restructuring process and of the measures envisaged in the NRP is to achieve the viability of the beneficiary companies to enable them to operate under normal market conditions. So far, the monitoring has shown that some of the measures envisaged to achieve viability of the benefiting companies have been initiated, such as closure of inefficient capacities, changes in employment strategy and organisational and management modernisation.

In 2006 while one company, namely, Mittal Steel Galati had already met the two benchmarks developed by the Commission, the sustainability of the company can only be assessed in a longer term perspective.

In the two cases of Mechel Campia Turzii and TMK Resita the forecasts prepared by companies and regularly updated have shown that the companies do not expect full compliance with the viability criteria at the end of the restructuring period. Those two companies should, accordingly, consider the implementation of specific remedial action plans to redress the situation.

Productivity

The total productivity rate in 2006 in the companies under analysis was below EU standards. Although the level of employment in the whole sector was much lower than the provisions of the NRP, the level of productivity in the beneficiary companies was only about 50% of the similar indicator in an average efficient European plant. According to the companies IBPs, the aggregated forecast for 2008 is still only about 60% of the average efficient European plant productivity. Efforts still need to be intensified if the necessary increase in productivity is to be achieved as required by the Protocol.

Cost reductions

Monitoring shows that in 2006 many beneficiary companies were not able to achieve a significant decrease in total costs, in spite of investment programmes introduced and implemented. This could be as a result of the rise in world prices of raw materials and in most of the companies' high consumption raw materials that had the direct impact on costs. Values for 2006 and revised update exceed international standards of energy and materials consumption. Progress has been achieved in the reduction in employment costs in almost all beneficiary companies. However, in Mittal Steel Galati and Hunedoara there appears to be scope for further improvement.

2.2.2. *Environmental protection*

The Treaty of Accession specifies a transitional regime in the case of environmental legislation for Romania and establishes a list of installations for which derogation from compliance with the IPPC directive has been granted until December 2014. The steel companies listed are Mittal Steel Galati, Mittal Steel Hunedoara, and Mechel Campia Turzii. The other companies are not included in the list of companies to benefit from such a transitional period and therefore have had to comply with this legislation by the date of accession.

Companies given the benefit of deferral of compliance under the IPPC directive have carried out the environmental investments according to the programme, with the exception of Mittal Steel Hunedoara.

The amount invested in 2006 for environmental purposes represents over 120% of the forecast level of the NRP thanks to bigger than planned environmental investments in Mittal Steel Galati and TMK Resita. Two other companies, Mechel Targoviste and Mittal Steel Hunedoara, did not fulfil their IBP targets and invested in environmental protection much less than planned.

3. PRINCIPAL CONCLUSIONS

Following the presentation of NRPs, important steps in the restructuring of the steel industry in both countries have been taken. Existing plants are being modernised so as to adapt production to the quality of steel required by the EU and export markets. Changes in management structures took place in parallel with the ongoing concentration processes, especially in Romania.

However, in spite of these efforts, the Commission has identified delays, sometimes significant, in the implementation of the obligations and requirements as specified in the respective Decisions and Protocols. The Commission will in its next and final monitoring report thoroughly analyse whether the problems identified regarding the implementation of the restructuring plans are mainly due to the firms themselves or whether they have to be attributed to exceptional and unforeseeable circumstances for which the company is not responsible. This will include a further assessment of the possible impact of recent raw materials price increases.

3.1. Bulgaria

At the moment, the only beneficiary company concerned, Kremikovtzi, is entering into a situation of serious non-compliance with its commitments to the Bulgarian government and to the Commission. The non-compliance concerns technological and environmental investments, sales, cost reduction and productivity which affect the viability, efficiency and effectiveness of the business management.

Moreover, the Commission encountered difficulties in obtaining appropriate and consistent data related to the restructuring of the company.

Even in the exceptionally favourable current world steel market conditions, achievement of viability under the conditions prescribed by the end of 2008 looks a very difficult challenge for the company. The Commission will closely monitor the areas where delays and lack of compliance were registered and will report accordingly in its future progress reports.

3.2. Romania

In Romania the monitoring process is being carried out with sufficient respect for the mutual obligations of the government and the companies concerned. Focusing on 2006 results, all six companies have improved their results comparing to the previous year. Nevertheless, the degree of compliance with the viability benchmarks is falling behind the commitments adopted in the respective IBPs.

In order to achieve viability, restructuring efforts for all companies should be intensified in particular with regard to implementation of the cost reduction strategies, improvement of their business management and sales strategies in order to profit from favourable market conditions. These are fundamental requirements for achieving the objectives of the IBPs in 2007 and in 2008.

3.3. Follow up

The Commission considers it necessary to intensify the restructuring process so as to enable the beneficiary companies to achieve viability in 2008.

The Commission recalls that the provisions of the EU-Bulgaria Accession Council and Protocol to the Accession Treaty with Romania clearly stipulate that, other than the aid planned, no further state aid for restructuring shall be granted. Any additional restructuring aid would, therefore, be incompatible with their respective provisions. In the case of non-compliance with the conditions applicable to state aid already granted, namely, non-compliance with EC viability benchmarks, the Commission will take the necessary measures to recover any such aid.