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COMMISSION OF THE EUROPEAN COMMUNITIES

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

Third monitoring report on steel restructuring in the Czech Republic and Poland

1. INTRODUCTION

This report describes the progress made by Czech and Polish steel companies in restructuring their operations and in line with the requirements set out in the specific chapters of the Treaty of Accession. As a consequence of national and international development of the economies, the Czech and Polish steel producers faced a challenging situation in 2005 marked by decreased sales and prices compared to the previous year. Despite this trend, companies in both countries generated a reasonable level of income, but the efforts to finalise the restructuring process need to be continued in order to allow steel mills to reach sustainable viability.

Transitional periods were negotiated between the European Union and the Czech Republic and Poland to allow their steel companies to finalise their restructuring and their full integration into the internal market. This measure was necessary in order to allow the new Member States to grant the necessary financial support on the basis that beneficiaries would become viable in the long term. This exemption from the general state aid rules is conditional on the fulfilment of certain obligations, both by the respective governments and by individual companies. The obligations are set out in Protocols incorporated in the Treaty of Accession with *Protocol 2*¹ referring to the restructuring of the Czech steel industry and *Protocol 8*² to the restructuring of the Polish steel industry.

The duration of the restructuring period is limited until 31 December 2006 by which date all companies shall be viable. The Protocols also set out detailed provisions for monitoring and reporting on these obligations, including that the Commission report to the Council.

On 7 July 2004, the Commission adopted its first Monitoring Report on steel restructuring in the Czech Republic and Poland for the year 2003³. In this report the Commission identified delays in the restructuring process, in particular in relation to investments. It recommended that both countries benefit from the positive market conditions and to accelerate the restructuring process in the coming years so that the relevant companies would be able to achieve viability by the end of the restructuring period.

In its second Monitoring Report adopted on 3 August 2005⁴, the Commission identified improved operational results for most beneficiary companies, which was mainly the result of significantly improved market conditions. At the same time it underlined that not all beneficiary companies were able to fully benefit from the exceptionally good market environment and had not implemented the required restructuring measures with the consequence that they remained underperforming and could fail to become viable by the end of the restructuring period. The Commission invited beneficiary companies and the authorities to consider its recommendations with attention.

¹ OJ L 236 of 23.9.2003 p. 934

² OJ L 236 of 23.9.2003 p. 948

³ COM(2004)443 final

⁴ COM(2005)359 final

This third monitoring report describes the progress achieved during 2005 and some trends in 2006; it contains the following elements:

- a description of developments in the global steel market, the background against which the restructuring process is taking place;
- a country-specific report on the main monitoring results referring to state aid and key restructuring benchmarks as defined in the annexes to the Protocols (capacity reduction, investments, productivity, costs and viability). This chapter also includes a reference to Commission decisions adopted with regard to the beneficiary companies within the framework of EU competition law.
- conclusions and recommendations regarding measures to be taken and the necessary follow-up regarding beneficiary companies to achieve viability by the end of the restructuring period.

The Commission will prepare a progress report to the Council in 2007 which will cover progress made in 2006. This final report will also provide an overall assessment of the results achieved throughout the restructuring process (2003-2006).

2. GLOBAL STEEL MARKET DEVELOPMENTS⁵

The steel restructuring process is affected by a number of factors including the measures put in place by companies and public authorities, general economic developments and the market situation. Consequently, a good understanding of these elements is necessary to appreciate the performance of the benefiting steel companies in the Czech Republic and Poland. The basic assumptions on developments in the global steel market are summarised below.

On the international steel market, the high rate of expansion observed in 2004 continued in certain regions in 2005. Unprecedented production growth in China, but also in India, pushed the world steel output up by 6% to 1.129 billion tonnes in 2005. In the EU however, after a slight increase during the first quarter of 2005, production was cut back in response to falling demand, and at 186 million tonnes, crude steel production was 3.2% lower compared to 2004.

This reflects the weakness of demand experienced on the EU market in 2005 which was mainly due to inventory cycle factors, and an initially high supply. As a result of the decreased offer of EU steel producers, stocks were reduced and consequently contributed to steel price levels being maintained.

In 2005, steel imports into the EU reached 26 million tonnes, about the same level as experienced the previous year, with a decrease during the second half as a result of weakening prices. The main exporting countries to the EU remained Russia, followed by Ukraine and Turkey, while China moved up into the fourth position. Steel exports from the EU reached 31.7 million tonnes which represents an increase of 6% compared to 2004. This increase was partly supported by a temporary depreciation of the Euro against the US Dollar. The deliveries to China, the EU's

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Sources : IISI and Eurostat

third largest export market, decreased by 3% in 2005, a trend that intensified and reached a 31% decrease during the first quarter of 2006.

During the first quarter of 2006, EU steel production registered an upwards trend reflecting positive developments in the EU economy supported by internal demand and investments. Apparent steel consumption, which shrank by 4.6% in 2005, is expected to increase by 4% in 2006. Steel prices increased again during the first quarter of 2006 due to higher raw materials costs and stronger demand from the main consuming sectors.

In 2005 there was a clear difference between the results in the former EU15 and those registered in the new Member States: while the steel output of EU15 decreased by 1.9% compared to the previous year, the decrease of output in the new Member States was much steeper with a decrease of 12% for the Czech mills and 18.7% for the Polish ones. However, this situation needs to be seen in the context of the exceptional increase in steel production in both countries during 2004 as well as the initially high stocks and a decline in demand during the first half of 2005. Some key figures for the Czech and Polish steel markets are provided in the annex, tables 1A, 1B, and 2.

Despite this negative development, the operational benefits of Czech and Polish steel companies remained high and the mills were generally able to reduce their indebtedness and speed up investments. This positive trend is expected to continue in 2006. The most recent economic and industrial surveys for 2006 indicate that the expected recovery in the economy and steel consuming sectors should translate into further improvement in steel market conditions in the EU.

3. RESULTS OF THE MONITORING PROGRAMMES IN THE CZECH REPUBLIC AND POLAND

3.1. Czech Republic

Information obtained from various sources shows that the Czech Republic granted a total of CZK 8 166 million (€ 256.6 million⁶) of restructuring aid to the national steel sector, which is approximately 58% of the ceiling of CZK 14 147 million as established in Protocol 2. The independent assessment shows that for the period covered, no further restructuring aid was granted to the Czech steel sector after 31 December 2003. The Commission concludes on this basis that the commitments regarding the granting of a maximum amount of state aid to the companies listed in Annex 1 of Protocol 2 are met. The beneficiary companies to which state aid was granted were Mittal Steel Ostrava (MSO - previously Nova Hut), Valcony Plechu Fridek-Mystek (VPFM) and Vitkovice Steel (VS).

With regard to the investments, the independent assessment of the progress achieved in implementing the restructuring measures highlights the overall low level of expenses and in particular the delay in some key investments being made and which are essential to allow the beneficiary companies to reduce costs and to operate the

⁶ CZK/Euro exchange rate 32.329 (average Dec. 2003)

shift towards a higher added value. However the assessment shows at year end the implementation of the investment plans accelerating, a trend which is expected to continue. In the meantime, the major sources of delay, namely the sluggish privatisation process and the impossibility of securing loans, have been overcome by the beneficiary companies, which are therefore expected to achieve most of the planned investments by the end of the restructuring period, except in the case of VPFM, as is reported in detail below.

The Czech government executed its plan for privatising VS, which consisted initially of the sale of the shares of OSINEK s.a to VS, followed by a public tender. In July, the government approved the sale of VS to Mastercraft Ltd, owned by the Russian steel and mining group Evraz Holding. This privatisation was achieved by the transfer of shares in November 2005.

In 2005, the Czech authorities also finalised the privatisation process of VPFM, which was completed by the full integration of the company into MSO. The integration legally entered into force in the second quarter of 2006. VPFM also updated its business plan in order to adjust it to the final industrial structure within MSO and to address the new market requirements.

The application of the Commission's viability test shows that the operational performance of VPFM is below forecast and would not, under normal market conditions, achieve viability before the end of 2007. This is a consequence of the 18 months delay in finalising the privatisation of VPFM, which is therefore not on track with its implementation of the restructuring measures. As, however, this company is now fully integrated into MSO, the Commission has agreed that its financial results need no longer be evaluated independently. In applying this approach, the independent assessment concludes that the integrated company MSO has a very healthy operating margin and comfortably achieves viability.

In relation to changes of capacities, as stated in the previous report and pursuant to article 12 of Protocol 2, the Commission decided not to object to the postponement of the permanent closure of the hot rolling mills N°1 and N°2 of VPFM⁷ (70,000 tonnes) by six months until 30 June 2006 with production being stopped on 31 December 2005. The independent assessment shows that the requirement to cease production has been respected by the beneficiary company and that a dismantling plan is being prepared.

The Czech authorities informed the Commission by the end of 2005 also of the technical details of the required capacity reduction at MSO. The company envisages achieving the capacity reduction provided for in Protocol 2 (270,000 tonnes) by means of a substantial overhaul of its heavy section mill instead of a greenfield investment. MSO also revised its investment plans and notified the new plans to the Commission for approval, which was recently confirmed⁸.

As a general recommendation, the Commission invites the Czech companies to continue their efforts in restructuring their production facilities with the main

⁷ Commission Decision of 2.3.2005, OJ of 16.07.2005, C176/12

⁸ Commission Decision of 13.09.2006, OJ of 18.11.2006, C280/4

emphasis being put on investment related yield and energy efficiency improvement as well as changes in working practices and increased productivity.

3.2. Poland

As previously reported and according to the information obtained by the Commission, Poland is, as regards the companies listed in Annex 1 of Protocol 8, respecting the commitments outlined in the Protocol, concerning state aid granted, in so far as the maximum ceiling is respected. In the period 1997-2003, Poland granted a total amount of PLN 2 750 million (€ 590 million)⁹, which is approximately 80 % of the total amount of PLN 3 387 million allowed under the Protocol. The beneficiary companies to which state aid could be granted in accordance with the Protocol are: Mittal Steel Poland (MSP - previously Polskie Huty Stali/PHS), Huta Bankowa, Huta Buczek, Arcelor Huta Warszawa (AHW - previously Huta Lucchini-Warszawa), Huta Labędy and Huta Pokój¹⁰. According to the Protocol no further state aid could be granted to the Polish steel sector after 31 December 2003. According to the information available to the Commission to date, this condition has been fulfilled. However, as regards the operation of Technology Buczek, the Commission is currently clarifying some remaining inconsistencies in a formal investigation procedure under Article 88 (2)¹¹.

For Huta Czestochowa, which was not included in the list of beneficiary companies as specified in Annex 1 of Protocol 8 and considered bankrupt under the Polish National Restructuring Programme as approved in 2003, the Commission launched an investigation into illegally granted state aids and concluded¹² in June 2005 that the amount of EUR 5 million must be reimbursed. In October 2005 the Polish authorities approved the transfer of 100% of shares from Huta Czestochowa to Ukraine's Industrial Union of Donbass.

The difficult market conditions in 2005 resulted in most beneficiaries' sales volumes falling significantly below forecast. Consequently, the operating margins of most companies were lower than planned. Nevertheless, despite lower demand, some companies saw a price rise reflecting the higher processed nature of their products. The financial results did, however, allow most companies to pursue and accelerate their restructuring efforts during 2005.

During 2005, Poland informed the Commission of the intention to change the individual business plans of all beneficiary companies in order to adapt them to the new market needs and to the new industry structures. In this context, the Commission launched a preliminary investigation as regards the changes proposed by MSP which mainly focussed on the installation of a new hot strip mill instead of substantial modernisation of the existing one. With the undertaking of dismantling the existing mill and maintaining the capacity level, the Commission concluded that the changes were compatible with the protocol obligations and decided on the basis of point 10 of

⁹ PLN/Euro Exchange rate 4.6595 (average December 2003)

¹⁰ Huta Andrezj and Huta Batory have been taken off the list of beneficiary companies due to liquidation proceedings

¹¹ Commission Decision C(2006) 2093, OJ 2006 C196/23

¹² Commission Decision C(2004) 1962

Protocol N°8 to approve¹³ the changes. Moreover, the Commission did not investigate further the updated plans of Huta Bakowa, Huta Labedy and Huta Pokój, but will, in view of the minor changes in the plans, continue to monitor the restructuring on the basis of the updated business plans. Only in the case of AHW was the Commission not yet able to approve the plan and a decision is still pending.

According to the available information, the commitments related to capacity reductions in 2005 have been respected. The independent evaluation shows that Huta Bankowa stopped production of its medium section mill (60,000 tonnes) in December 2004 and that the mill was physically liquidated in December 2005, a year ahead of the planned date. The hot strip mill at MSP-Krakow (700,000 tonnes) which stopped operations in 2002 was permanently dismantled in the first quarter of 2005. In the same plant, the cold sheet mill (650,000 tonnes) was reported to have ceased production in December 2005, while the cold strip mill at the MSP-unit in Swietoclowice (36,000 tonnes) was dismantled by December 2005. Numerous other non viable and obsolete production facilities not mentioned in the Protocol were closed or dismantled by beneficiary companies during 2005.

Due to delays in the realisation of the investment programme, MSP did not finalize the changes in production capacities, which should occur by modernising the wire rod mill in Sosnowiec (200,000 tonnes) and constructing an organic sheet coating line in Swietoclowice (100,000 tonnes).

The independent evaluation shows that two beneficiary companies may not reach viability by the end of the restructuring period. The first one concerns AHW which has been owned by Arcelor since September 2005 following the transfer of shares from Lucchini. On the basis of its own assumptions, it is not on track to pass the EC viability test in 2006. The reorientation of the company's investment plan will not allow it to significantly improve its yield and efficiency in the short term. This is why the Commission is still considering how best to deal with the revised investment. Secondly, Technology Buzek will not be viable by the end of 2006. Despite the fact that it has realised parts of its investment plan, the company has failed to reduce costs and outstanding liabilities.

On the basis of the elements provided above, the Commission recommends that all beneficiary companies intensify their restructuring efforts in the remaining months. The emphasis shall be put on investments related cost reduction as well as improved working practices in the field of purchase and sales; productivity increases need to be continued.

4. FOLLOW-UP

The steel intense economies of the Czech Republic and Poland, as well as access to the EU market, are substantial advantages and should guarantee the success of beneficiaries over the coming years. However the restructuring measures as defined in the restructuring programmes and business plans will allow beneficiary companies in Czech Republic and Poland to concentrate on necessary improvements and to

¹³ Commission Decision C(2005) 2687 OJ 2006 C12/2

strengthen their operational performance. Therefore these measures need to be fully implemented so as to make the companies more resistant to a possible economic downturn. This concerns in particular those companies which failed to pass the EC viability test as reported above.

The Commission will continue to monitor the implementation of the transitional arrangements in close cooperation with the respective authorities and companies. In 2007, it will proceed with an extended evaluation of the results achieved and the extent to which the National Restructuring Programmes and Individual Business Plans have been implemented. In this assessment it will check in particular the intensity and relevance of state aid granted against the restructuring measures implemented. As previously indicated, should the findings be unsatisfactory, it will invite the respective authority to reclaim the reimbursement of appropriate amounts of state aid. A final report will be presented to the Council in 2007.

The Commission also recalls that any additional restructuring aid to beneficiary companies included in the Protocol, or to any other steel company not covered by the restructuring programmes, would be incompatible with the Treaty of Accession.

Table 1A

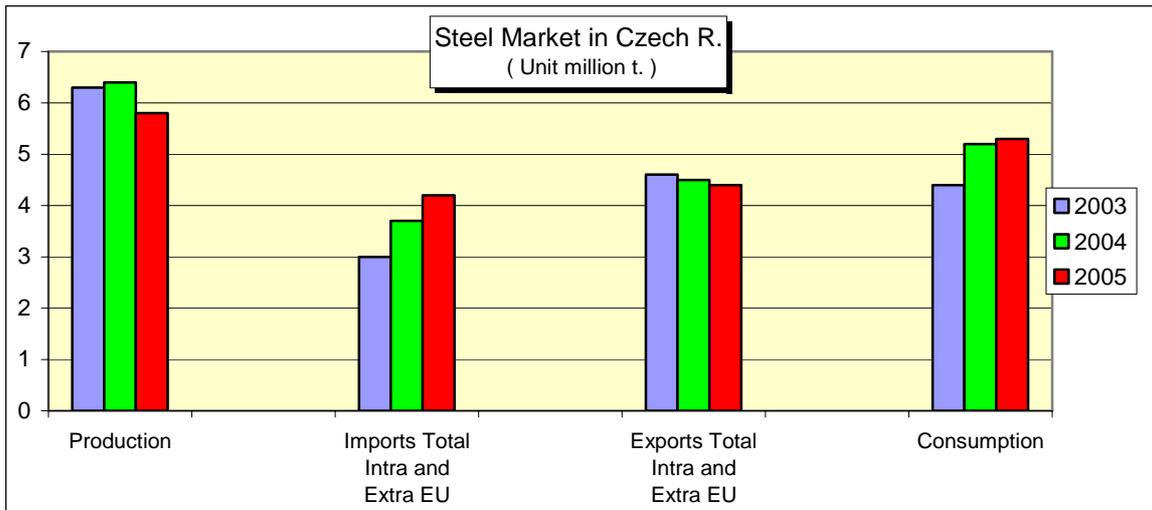


Table 1B

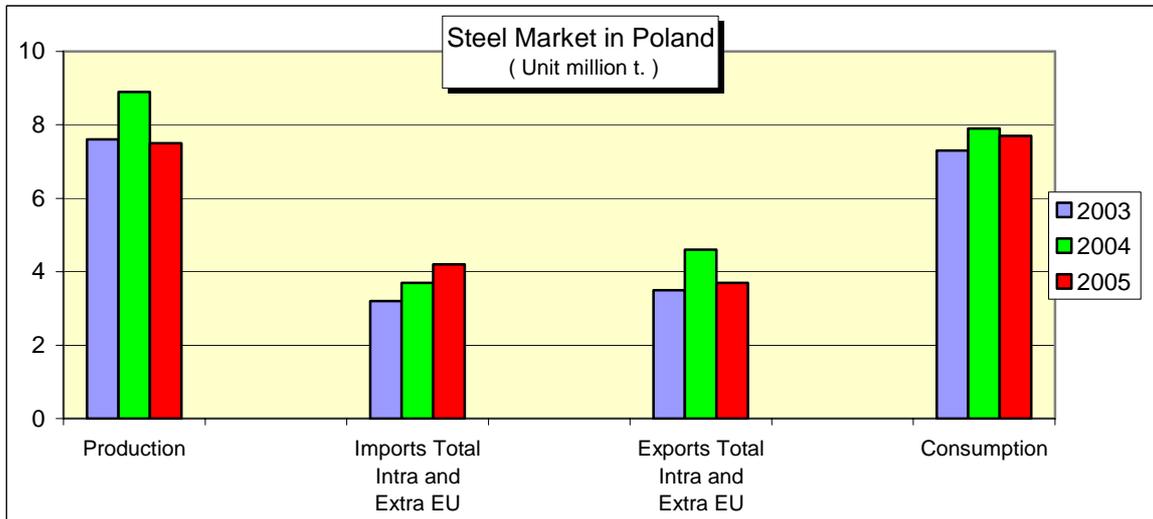


Table 2

