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REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

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

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1. INTRODUCTION

The finalisation of the steel restructuring in the new Member states and the full integration of the respective companies into the Internal Market remain a major challenge. Many companies in both countries did not achieve viability before accession on 1 May 2004, and the respective governments granted financial support on the basis that beneficiaries would become viable in the long term. For this reason, transitional periods were negotiated between the European Union and the Czech Republic and Poland to allow the granting of state aid to specific companies. This exemption from the state aid rules is subject to certain obligations, both for the respective governments and for individual companies, which are set out in Protocols incorporated in the Treaty of Accession. *Protocol 2*[1] refers to the restructuring of the Czech steel industry and *Protocol 8*[2] to the restructuring of the Polish steel industry.

The Protocols also set out detailed provisions for monitoring and reporting on these obligations, including that the Commission reports to the Council.

On the 7 July 2004, the Commission adopted its first Monitoring Report on steel restructuring in the Czech Republic and Poland for the year 2003[3]. In this report the Commission identified delays in the restructuring process, in particular in relation to investments. It recommended both countries to profit 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.

This second progress report, which is based on the national monitoring reports notified by the Member States authorities, as well as on independent evaluation and discussions with stakeholders, underlines the fact that steel companies are operating in an exceptionally good market that has shown levels of demand for steel and steel prices not seen for years. This has helped the companies to improve their sales and operational results considerably and should have facilitated the implementation of the restructuring programmes.

The evaluation of the results, however, shows that some companies are still underperforming and may fail to become viable by the end of the restructuring period on 31 December 2006. As there are only 18 months left until that target date, the Commission invites the beneficiary companies and the authorities to consider its recommendations with attention.

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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

The Commission emphasises that, if companies do not restore viability by the end of the restructuring period, it will analyse the reasons for this state of affairs. If failure to restore viability is due to the fact that the restructuring measures envisaged in the National Restructuring Programme and Individual Business Plans have not been carried out as planned, it is possible that action could be taken to recover aid which has been given.

This report describes the progress achieved during 2004 and contains the following elements:

- a description of developments in the global steel market, the background in 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);
- 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.

Progress reports to the Council will be prepared annually. The last report, covering progress in 2006, will be submitted in 2007. This last report will also provide an overall assessment of the results achieved throughout the restructuring process (2003-2006).

2. GLOBAL STEEL MARKET DEVELOPMENTS[4]

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

The global market context in which the companies operated in 2004 was exceptionally favourable. The world economy started to recover in the second half of 2003 and showed strong growth in 2004, especially in Asia and North America, with an annual growth rate of 5.5% on a year to year basis compared to an annual growth rate of 2.8% in 2003.

This had a very positive impact on steel demand and trade, after a two-year depressed cycle. The performance of the economy, driven by the buoyant growth of the Chinese market, showed an unexpected acceleration pushing world steel consumption to a new record of 967 million tonnes of finished products in 2004, an increase of 9 % compared to 2003. This upward trend is expected to continue throughout 2005 although at a much slower pace with forecasts predicting an increase of around 3.8%.

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[4] Sources : IISI and Eurostat

In the European Union, the economy recovered at a lower pace to achieve in 2004 a GDP growth of 2.4 % compared to 0.9% in 2003. At the same time, the demand of finished steel products in the EU, showed a significant increase in 2004 of 7 % compared to 1.5 % in 2003. Both Czech and Polish steel companies fully benefited from the growth of their main export markets. They also increased their sales on the even stronger growing domestic markets. Current forecasts, however, show a much lower increase in demand for 2005 as a result of an expected lower growth of the European economy of around 2 %.

Steel prices rocketed in 2004 showing an increase at world level of around 60 % in flat and long steel products. In the European Union the prices increased at a lower pace of around 30 %, which was influenced by the strength of the Euro. In the same period, the increase in revenues of steel makers was partially offset by the significant increases in the cost of raw materials, transport and energy. The outlook for 2005 forecasts a stabilisation of the prices.

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

3.1. Czech Republic

Despite overall positive market developments, which allowed all steel producers to significantly improve their financial performance, not all Czech steel companies are in a position to achieve sustainable viability. This is mainly a consequence of the delayed privatisation process, which is, however, expected to be concluded by mid 2005.

On the basis of available information obtained from various sources, the Commission concludes that the Czech Republic is, as regards the companies listed in Annex 1 of Protocol 2, meeting its commitments regarding state aid granted. As reported in the Commission's first Monitoring Report the total amount granted is below the ceiling. According to the Protocol, no more restructuring aid could be granted to the Czech steel sector after 31 December 2003.

The Protocol required the permanent closure of the hot rolling mills N° 1 & N° 2 at Valcovny Plechu Fridek-Mystek by 31 December 2005. However, the Commission pursuant to article 12 of the Protocol 2 accepted a change of the restructuring programme, by which the permanent closure has been postponed by six months until the 30 June 2006 (production will be stopped on 31 December 2005). The Commission accepted the change on the basis of a duly provided justification[5]. There were no other capacity reductions scheduled for 2004 and the Czech authorities confirmed the companies' commitments for the capacity changes scheduled till the end of the restructuring period.

The independent evaluation of the progress achieved during the restructuring of the Czech steel sector did confirm a major area of concern for two beneficiary companies listed in Annex 1 of the Protocol 2 with regard to their investment

5 For details see the decision which is publicly available under: http://europa.eu.int/comm/competition/state_aid/decisions/n600_2004/en.pdf.

programmes, which are behind schedule. Both companies could not until now secure loans for the purpose of making investment, especially in quality improvements. As a consequence, the companies were not able to fully benefit from the excellent domestic and global market conditions. Other profit improvement opportunities such as cost reduction and increased sales on the domestic market only partly compensated for the loss of income and in both cases the operating margins remained below threshold. This means that under normal market conditions, both companies would fail to pass the Commissions' viability test at the end of the restructuring period.

The analysis above is however expected to be favourably influenced over the coming months by the announced finalisation of the privatisation process of the Czech steel sector. So far the Commission concludes from previous experience that the full acquisition by a strategic investor has a significant impact on the operational results of a company, which is the consequence of the combination of key determinants such as improved management structures and its consequences of cost reduction, yield improvements and marketing reorientation, as well as the improved possibility to secure investment loans.

The coming months are thus decisive for the Czech steel sector to reach sustainable viability. In order to facilitate the expected developments it will be crucial for the Czech authorities to successfully conclude the privatisation process as early as possible. In parallel all companies need to continue their restructuring efforts, in particular those aiming at reducing costs and producing higher quality products.

3.2. Poland

According to the information at the Commission's disposal, Poland is, as regards the companies listed in Annex 1 of Protocol 8, respecting the commitments outlined in the Protocol, concerning state aid granted, which is below the maximum ceiling. In the period 1997-2003, Poland granted a total amount of PLN 2 750 million (€ 590 million[6]), which is approximately 80 % of the total amount allowed under the Protocol. The beneficiary companies to which state aid could be granted in accordance with the Protocol are: Polskie Huty Stali (PHS), Huta Andrzej, Huta Bankowa, Huta Batory, Huta Buczek, Huta Lucchini-Warszawa, Huta Labędy and Huta Pokój. According to the Protocol no more 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 Huta Buczek Poland is currently clarifying some remaining inconsistencies.

According to available information, the commitments related to capacity reductions in 2004 have been respected. It appears from the information at the Commission's disposal that the physical liquidation of the cold strip mill in Huta Lucchini-Warszawa (30 000 tonnes) has taken place as scheduled in December 2004. Huta Bankowa stopped production of its medium section mill (60,000 tonnes) in December 2004.

[6] PLN/Euro Exchange rate 4.6595 (average December 2003)

The European Commission also notes that the beneficial market conditions have resulted in a significant increase in sales, improved operational results and high levels of profits of most companies. This has had a positive effect on the companies' viability prospects but in some cases it seems insufficient for them to achieve viability by the end of 2006.

The second year of monitoring of restructuring of the Polish steel industry continues to show delays, sometimes significant, especially in relation to investments, which in the case of some companies could affect their future viability if there were to be a significant market slowdown. In other cases the financial situation of the companies raises concerns despite the exceptionally favourable market situation.

The Commission concludes that the improved operational results of the companies are a positive factor, but are mainly the result of the exceptionally favourable market, which is expected to stabilise this year. The privatisation of the main Polish steel company, which was concluded in March 2004 is contributing to improve the performance of the company. However, further efforts are still needed.

Therefore, the Commission recommends all companies to intensify their restructuring efforts in the two remaining years, profiting from the increased turnover and availability of cash, in particular in relation to investments, employment reduction and cost reduction in order to be able to face a possible slowdown and to achieve viability by the end of 2006 as planned.

4. FOLLOW-UP

Based on the findings of the monitoring of the restructuring process of the steel sector in the Czech Republic and in Poland during 2004, the Commission identifies improved operational results of most companies. This is mainly the result of the significantly improved market, both domestically and globally. At the same time it underlines that the monitoring shows in some cases significant delays in the implementation of the restructuring obligations and requirements as specified in the respective Protocols.

The Commission considers that it is crucial for the beneficiary companies covered by the restructuring programmes, to intensify the restructuring process in 2005 and 2006 so as to allow them to catch up with the delays accumulated last year in the implementation of their business plans. Major emphasis should be given to investments, necessary to foster the sale of higher value-added products, thereby increasing revenues. Efforts for reducing costs and improving yields need to be continued. Furthermore, the authorities are invited to successfully complete the remaining privatisations.

The Commission will continue to closely monitor the restructuring process and in particular those areas where delays were identified and will report accordingly in its future progress reports.

As it did in its previous progress report, the Commission reiterates that the provisions of the Protocols clearly stipulate that, apart from the aid foreseen in the Protocol, no further restructuring aid shall be granted by the Czech Republic and Poland to their respective national steel industries. 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. The Commission has already in two cases commenced the necessary measures to verify whether any state aid has been illegally granted and needs to be recovered[7].

7 The Commission opened on 19 May 2004 a formal procedure under Article 88 (2) EC-Treaty regarding a restructuring aid to Huta Czestochowa, a Polish steel producer not listed in Annex 1 of the Protocol N° 8 (case C20/04 ex NN 25/2004 OJ C 204 of 12.8.2004, p. 6). Moreover, the Commission on 14 December 2004 opened another formal procedure regarding the restructuring aid to Třinecké Železárny, a Czech steel producer not listed in Annex 1 of the Protocol N°2 (case C45/04 OJ C 22 of 27.1.2005)