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

Second monitoring report on steel restructuring in Bulgaria and Romania

1. INTRODUCTION

This report describes the restructuring progress made in 2007 by Bulgarian and Romanian steel companies that are subject to the requirements set out respectively in the specific chapters of the Europe Agreement and the Treaty of Accession:

- 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 (extending the restructuring period until the end of 2008), and
- Annex VII of the Accession Treaty³ which refers to the restructuring of the Romanian steel industry.

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 States to complete this task while minimising social and market disturbance.

The above mentioned Protocol and Annex outline the conditions for a transitional (until the end of 2008) regime for state aid given for steel restructuring. These provisions also set out detailed obligations for the Commission for monitoring and reporting.

On 12 August 2008, the Commission adopted its first monitoring report referring to the year 2006⁴. This new report refers to the results achieved in the year 2007 and when appropriate also to important developments which occurred in 2008. The current report is based on the data provided by the respective authorities, as well as on evaluation carried out by independent consultant. It will be followed by a last report in 2009 covering the developments in 2008.

2. RESULTS OF THE MONITORING PROGRAMMES IN BULGARIA AND ROMANIA

2.1. Bulgaria

The only company covered by the National Restructuring Programme (NRP) and the monitoring scheme is Kremikovtzi.

a) Situation in 2007

2.1.1. Monitoring of the key restructuring benchmarks

State aid

Most of the amount allowed was disbursed in 1999 and the remaining was granted to the company in 2004 in the form of rescheduled debts to national gas and electricity suppliers. Kremikovtzi paid these liabilities regularly in 2007.

According to information made available to the Commission, no state aid was granted to steel companies other than Kremikovtzi.

Capacity reduction

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 COM/2008/511

The blooming/slabbing mill was expected to be closed in July 2007, but according to information provided by the Bulgarian authorities, operations were stopped in February 2008 and the mill is in the process of being dismantled. The rod mill was stopped in 2007 and is also being dismantled. It is expected that both mills will be permanently destroyed in compliance with relevant EU legislation⁵ by the end of the restructuring period.

Viability

The Commission encountered difficulties in obtaining appropriate and consistent financial data related to the company. Despite repeated requests, the company has not provided to the Bulgarian authorities and to the Commission final complete information related to the full year 2007, and also about the evolution of the operations in the first half of 2008. The incomplete financial statements showed however that the financial performance in 2007 has been negative, which constitutes non-compliance with the viability commitments⁶ adopted in the Individual Business Plan (IBP). The results -11.1% EBITDA and -20,7% EBIT are even worse than in 2006.

Productivity

The productivity level did not improve much compared to 2006 and reached only 30% of that of comparable European steel plants. This has a negative impact on the efficiency and effectiveness of the company's business.

Cost reductions

Even though actual raw materials' purchasing prices in 2007 were in accordance with market developments, they were negatively affected by the lack of financial resources and thus by stricter conditions imposed by raw materials suppliers. Actual values were on average 32% over the IBP estimations.

Due to low capacity utilisation in 2007 (average 50%) Kremikovtzi did not manage to reduce the consumption of raw materials per unit produced. In some areas such as energy and materials consumption, the necessary cost reductions could 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 2007 technological investments represented 38% of the IBP target for the year. At the same time environmental investments amounted to only 10% of the IBP target.

b) Developments in 2008

In August 2008 the Commission was informed by the Bulgarian authorities about the declaration of insolvency of Kremikovtzi.

2.1.1. 2.1.2. Environmental protection

Bulgaria applied for a transitional period for the application of the IPPC directive⁷. By way of derogation, Kremikovtzi should have obtained a fully coordinated permit by 30 October 2007

⁵ Decision 3010/91/ECSC OJ L 286, 16.10.1991, p. 20

⁶ 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 gross operating result: i.e. the % EBITDA (Earning before interest, tax, depreciation and amortization) of turnover of at least 10% for non-integrated steel companies and 13.5 % for integrated mills);
- a minimum return: i.e. the % EBIT (earnings before interest and taxes) of turnover of at least 1.5%

⁷ Council Directive 96/61/EC of 24 September 1996, OJ L257, 10.10.1996, p.26

containing a binding timetable for the achievement of full compliance by 31 December 2011. In April 2007 the EMEPA presented its decision to not issue an integrated permit to Kremikovtzi. The company resubmitted an application in May 2007. The official deadline to issue a permit is not later than 21.10.2008.

2.2. Romania

2.2.1. Monitoring of the key restructuring benchmarks

State aid

According to information made available to the Commission, no state aid granted to steel companies other than those listed in Annex VII of the Accession Treaty⁸ has been given.

Capacity reduction

It appears from the information at the Commission's disposal that capacity closures planned for 2007 – semis mill in Arcelor Mittal Hunedoara - have taken place as scheduled. Cessation of production on the light sections and wire rod mills in Hunedoara took place at the beginning of 2008, due to the change in the industrial strategy. Once the above installations are permanently destroyed⁹, Romania will have fulfilled its obligations on capacity closures stemming from the Treaty of Accession.

There was also an additional closure of obsolete capacity at TMK Resita, not provided for by the Treaty of Accession, namely the blooming mill, which was closed at the end of 2007.

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 beneficiary companies have been initiated, such as closure of inefficient capacities, changes in employment strategy (spin-off of auxiliary activities, outsourcing of non-core activities) and organisational and management modernisation.

Two companies, ArcelorMittal Hunedoara and Mechel Campia Turzii, incurred major losses in 2007, worse than their 2006 performances. The remaining four companies increased their operating revenues as compared to 2006. All six have EBITDA situated between -2.2% and 12.8%, the target being 10.0% and EBIT between -6.0% and 7.3%, the target being 1.5%. The degree of compliance with the viability benchmarks, for all companies, was still falling behind the committed targets adopted on the respective IBPs.

Productivity

The actual and forecast employment levels in the steel industry were achieved on schedule. The employment level in the steel sector in 2007 (38.186 persons) represented 85% of the NRP forecast, taking into account the average annual staff level. According to the information provided by the companies monitored, the workforce level in 2008 would account for 78% of the year's objective. However the average productivity of beneficiary companies is still only 50% of international standards¹⁰. The productivity achieved by companies differs widely. Only Tenaris Donasid is on track with its commitments and almost reaching international

⁸ OJ L 157, 21.06.2005, p. 3–393

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

¹⁰ over 600 Hot Rolled Tm/man/year in integrated mills, over 800 Hot Rolled Tm/man/year in non-integrated steel mills

standards. The main reason for productivity not evolving in line with employment levels is lower production levels compared to 2006.

For all companies, efforts to increase production still need to be intensified if the necessary increase in productivity is to be achieved as required by the Protocol. With the exception of TMK Resita and Tenaris Donasid, there appears to be scope for further improvement in employment levels.

Cost reductions

In some areas such as energy and raw materials consumption, the necessary cost reductions can only be achieved in the longer term through investment in modernisation. In 2007, technological investments represented between 110% and 1500% (in the case of TMK Resita) of the target for the year. At the same time environmental investments amounted to between 75% and 2500% (in case of Tenaris Donasid) of the target. Although Mittal Steel Hunedoara almost reached its target for 2007, its environmental investments in the period 2004-2007 just accounted for 54% of the IBP forecast.

Although beneficiary companies introduced and implemented their investment programmes, most of them still reported cost values which do not show operational improvements stemming from the investment programmes. In most of the plants, raw materials' consumption yields, the share of labour cost in total cost and energy consumption are much higher than international standards. Selling prices made up for the operational inefficiencies of certain plants.

2.2.2. *Environmental protection*

The Treaty of Accession specifies a transitional regime 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 Mittal Steel Galati, Mittal Steel Hunedoara, Mechel Targoviste and Mechel Campia Turzii already obtained transitional integrated permits according to IPPC directive in 2007 or 2006 (Mittal Steel Hunedoara). These transitional authorisations are valid until 31 December 2014 (2012 for Mechel Targoviste) and include the environmental investment programme to be undertaken during the validity period of the authorisation.

Other companies not included in the list of beneficiaries of such a transitional period have had to comply with this legislation by the date of accession.

3. PRINCIPAL CONCLUSIONS

3.1. Bulgaria

The situation in 2007 did not improve the already unsatisfactory developments in Kremikovtzi in 2006. The results in 2007 showed further non-compliance with restructuring objectives listed in the Protocol concerning viability, technological and environmental investments, sales, cost reduction and productivity. This situation was confirmed by the Bulgarian authorities who informed the Commission that the implementation of IBP for Kremikovtzi was terminated on 6 August 2008 following the announcement of insolvency and opening of bankruptcy procedure by Sofia City Court.

The decision of the EU-Bulgaria Association Council of 29 December 2006 amending Article 3 of the Additional Protocol to the Europe Agreement provides that "*In case monitoring of the implementation of the restructuring programme and the plans shows that the relevant conditions of Protocol 2 to the Europe Agreement and key restructuring measures, including all investments implemented, have not been fulfilled [...], Bulgaria shall recover from the*

beneficiary any aid granted in breach of these conditions before or after its accession to the European Union."

Under the above mentioned decision of the EU-Bulgaria Association Council, Bulgaria will be obliged to claim the reimbursement of the aid if the relevant conditions of Protocol 2 to the European Agreement and key restructuring measures, including all investments implemented, are not fulfilled. The declaration of insolvency is a strong indication that the firm has not restored its viability and will probably not do so before the end of 2008. In this respect, the Commission should be kept informed about developments in the insolvency procedure and in particular the claim for the reimbursement of state aid.

3.2. Romania

The financial performance achieved in 2007 has not yet fully satisfied the objectives of the IBPs, since four of the six companies have not reached the percentage of EBITDA established by their respective targets for this year.

The results in 2007 and forecasts for 2008 offered by the companies show increasing growth in revenues and improvements in profitability for all six beneficiaries. The major profitability changes (from loss to profit) expected in ArcelorMittal Hunedoara and Mechel Campia Turzii are particularly challenging. As regards the EC viability test, all the companies expect to comply with the EBIT criterion in 2008, but only two of them, ArcelorMittal Galati and TMK Resita, have forecast reaching the EBITDA benchmark. Therefore, the year 2008 requires increased efforts of sustainable improvement in efficiency to overcome the recent uncertainties perceived on the markets.

In spite of the potential improvement expected by beneficiaries in the first half of 2008, sustainable viability can only be achieved when efforts in all companies are intensified, in particular with regard to the implementation of the cost reduction strategies and development of coherent strategies for the future.

The Commission recalls that the provisions of Protocol to the Accession Treaty with Romania clearly stipulate that 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.