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Annex to the

**Report from the Commission to the Council and
the European Parliament**

“First monitoring report on steel restructuring in the Czech Republic and Poland”

{COM(2004)443 final}

1. INTRODUCTION

For many steel companies in the Czech Republic and Poland, up to now, viability could only be reached with the financial support of the Governments. For this reason, transitional periods were agreed with both countries to allow the granting of state aid to specific companies. The maximum amount of state aid permitted corresponds to the financial projections made in the National Restructuring Programmes and the Individual Business Plans of the companies, which were adopted by the Czech and Polish governments and agreed by the Commission during 2002 and 2003.

This exemption from the EU rules on state aid is conditional on the fulfilment of certain obligations, negotiated between the EU and the Czech Republic and Poland. These obligations, both for the respective governments and for individual companies, 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:

- each country provides to the Commission six-monthly reports concerning the restructuring of the benefiting companies and the fulfilment of the obligations and requirements contained in the Protocol;
- an independent evaluation be carried out in 2003, 2004, 2005 and 2006; and
- the Commission reports to the Council.

This working document describes the progress achieved during 2003, the first year of the restructuring process, and contains the following elements:

- country-specific evaluations referring to state aids and key restructuring benchmarks as defined in the annexes to the Protocols (productivity and employment, costs, capacity reduction and viability) as well as general information on the economic developments in the Czech Republic and in Poland;
- conclusions regarding steps necessary for benefiting companies to achieve viability by the end of the restructuring period.

A summary of the results and conclusions described in this working document will be communicated to the Council and to the European Parliament as provided for in the Protocols to the Treaty of Accession.

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

¹ OJ L 236 of 23.9.2003 p. 934

² OJ L 236 of 23.9.2003 p. 948

overall assessment of the results achieved throughout the restructuring process (2003-2006).

2. DETAILED PROGRESS REPORT ON THE RESTRUCTURING OF THE CZECH STEEL SECTOR

With an annual crude steel production of 6.5 million tonnes the Czech Republic is the second largest steel producing country among the new member states, behind Poland. It also has the largest per capita steel consumption, based on a dynamic manufacturing industry, with machinery and mechanical engineering sectors responsible for nearly half of the domestic steel consumption. The Czech Republic is a net exporter of steel. In 2003 exports reached a level of 4.6 million tonnes, an increase of 3 % on the previous year. Imports remained constant.

The Protocol specifies the restructuring conditions for the following three steel producers: Ispat Nova Hut a.s., Vitkovice Steel a.s. and Valcovny Plechu Fridek-Mystek a.s.

2.1. Main developments in the Czech Republic in 2003 and first-quarter 2004

On 21 January 2003 the Czech Government communicated to the Commission the updated version of the National Restructuring Programme and Individual Business Plans, which were amended to include the restructuring conditions specified by the EU.

On 31 January 2003, the privatisation of Nova Hut was concluded by the acquisition of the majority of shares by LNM. The name of the company was changed to Ispat Nova Hut (INH) in April 2003.

In February 2003, the Czech Government adopted a resolution on the privatisation of Vitkovice Steel a.s owned by Osinek, a subsidiary of the National Property Fund (FNM). The privatisation through a public tender is to be pursued during 2004.

In March and September 2003 and March 2004 the Czech Republic submitted its six-monthly monitoring reports as required by the Protocol.

2.2. Macroeconomic environment and market developments

The Czech economy showed a good overall performance in 2003. The real growth in gross domestic product (GDP) was 2.8 %. Industrial production registered growth of 6 %. The downward trend in inflation and interest rates continued, and both were lower than forecast.

This general upswing in the Czech economy resulted in increased domestic demand for steel products of 2.7 % compared to the previous year. The share of deliveries by domestic steel producers has also been increasing.

Furthermore, given that imported iron ore and scrap are dollar denominated, the stronger CZK/USD exchange rate and the revenue benefits from higher steel prices in the Euro-zone contributed positively to the economic performance of Czech steel companies.

2.3. Monitoring of state aid to the steel sector in Czech Republic

Accession Treaty provisions

The Protocol stipulates that state aid granted to the three beneficiary companies is limited to a maximum of CZK 14.14 billion (€ 437³ million) in the period 1997-2003. It also specifies the maximum amounts which may be granted individually to each of the three beneficiary companies.

Assessment of monitoring findings

According to the information at the Commission's disposal, the Czech Republic granted a total amount of CZK 12 000 million (€ 371 million) of restructuring aid in the period 1997-2003, of which CZK 4 400 million (€ 136 million) were granted in 2003. The figures of total state aid granted and the specific figures for aid granted to individual beneficiary companies are below the ceilings specified in the Protocol. It should be noted that the outstanding amount of state aid, representing 15 % of the Protocol ceiling, cannot be granted in the future.

The amount of state aid played a significant role in the implementation of the Czech National Restructuring Programme and is an important element to assist the companies in achieving viability. The aid was 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 assessment shows that although the amount of aid granted appears to be lower than envisaged, this will not have a critical effect on the financial projections of the beneficiary companies. The aid granted is deemed to be sufficient to help the companies to achieve viability by the end of the restructuring period.

2.4. Monitoring of the key restructuring benchmarks in the Czech steel sector

2.4.1. Productivity and employment

Accession Treaty provisions

The Protocol specifies that “employment restructuring shall be implemented; levels of productivity comparable to those obtained by the EU steel industry shall be reached by 31 December 2006.”

Assessment of monitoring findings

The Czech steel industry has experienced a significant reduction in employment over the last decade. Total employment was reduced by approximately 65 000 employees between 1990 and 2000. This led to a significant increase in productivity levels, which in 2003 were comparable to those of EU steel producers. The trend towards lower employment levels will continue to the end of the restructuring period, although progress will be much lower than experienced during the 1990s.

³ CZK/Euro Exchange rate 32.329 (average December 2003)

The monitoring shows that in 2003 the total productivity rate of the beneficiary companies increased by 11 % compared to the previous year. This positive trend is expected to continue in the coming years.

In order to deal with the social impact of restructuring of the Czech steel sector, regular consultations are held with the stakeholders involved, including the Metals Workers Trade Union (KOVO) and the authorities. Regional development programmes are stimulating the creation of new jobs in the regions affected by the steel restructuring. It is suggested that the Associated Social Programme, a specific steel sector related action, be prolonged until the end of the restructuring period.

2.4.2. *Cost reduction*

Accession Treaty provisions

It is envisaged that the companies will implement a costs savings programme.

The reduction of manufacturing costs should be achieved through various methods: modernisation of facilities, reductions in employment, reduction of material and energy costs, improvements in production management, as well as lowering of the cost of external services such as maintenance and transport.

Assessment of monitoring findings

In 2003 the results obtained in cost reduction varied greatly between the beneficiary companies, but in line with the general trend experienced outside the Czech Republic, the overall costs were globally higher than expected. Employment costs showed a general upward trend as a result of increased salaries as determined by the collective agreements for 2003. The increases in other cost factors, such as material and energy costs, was partially offset by increased operational efficiency, despite the strong growth in input prices.

All beneficiary companies were actively managing and controlling their financial, overhead and purchasing costs. It will be necessary to continue these efforts over the coming years.

In some areas, however, such as energy and material consumption, the necessary cost reductions can only be achieved through investment in modernisation. In 2003, most of the investments scheduled in the Individual Business Plans of all three beneficiary companies were delayed due to a lack of investment capital and changes in ownership or re-evaluation of market conditions. The cost reduction strategies and the related investments need to be continued.

2.4.3. *Capacity reduction*

Accession Treaty provisions

The Protocol specifies that the net capacity reduction to be achieved by the Czech Republic for finished products (hot rolled and cold rolled) during the period 1997–2006 shall be 590 000 tonnes.

A timetable for the closure and dismantling of installations, as well as new capacities to be installed, is specified. The reduction in production capacity must be achieved by physical destruction of facilities.

Assessment of monitoring findings

No capacity closures were planned for 2003. Companies have confirmed that the closures scheduled for the years 2004-2006 will be realised.

2.4.4. *Viability*

Accession Treaty provisions

The Protocol envisages that “taking into account the special accounting rules applied by the Commission each benefiting company shall achieve a minimum annual gross operating result of turnover (10 % for non-integrated steel undertakings and 13.5 % for integrated steel mills) and a minimum return of 1.5 % of turnover on own capital, no later than 31 December 2006”.

Assessment of monitoring findings

The main goal of the restructuring process and of all actions envisaged under the National Restructuring Programme and the Individual Business Plans is to achieve the viability of the companies under normal market conditions. The viability test developed by the Commission’s services is a tool to measure the financial effects of the different restructuring measures planned in the companies’ business plans. The viability indicators are to be considered in the appropriate time framework. In the first year of the monitoring, the assessment on the viability projections should take into account that the goals are not to be achieved in a single year, but companies are to achieve viability only by the end of 2006.

On the basis of the assessment of the data available at the end of 2003 it appears that one company is on track to achieve viability by the end of 2006. For the other two companies there have been delays in the investments planned in the Individual Business Plans of the companies, which may have a knock-on effect on the companies’ ability to reduce costs and to generate increased revenues from the sales of higher added-value products.

Both beneficiary companies need to increase their restructuring efforts and press ahead with the planned investments, in particular those referred to in the Protocol. These are key factors to assure that viability can be reached by the end of the restructuring period. It also underlined the important role of a possible strategic investor, not only to facilitate access to credit and the related financial transparency, but also to benefit from a wider sales organisation and to increase direct sales.

2.5. Other Protocol requirements

2.5.1. *Environmental protection*

The Protocol specifies that beneficiary companies need to comply by the time of accession with the relevant EU legislation in the field of environmental protection, and in particular to make the necessary investments to ensure such compliance.

In accordance with Czech environmental laws stipulating emission thresholds in compliance with Community legislation, Czech steel companies had to invest in the abatement installations such as sinter plant de-dusting, steel mill waste water treatment stations or the construction of new solid wastes landfills. In 2003 new legislation came into force fixing reinforced emission limits, which in some cases go beyond current EU standards. The Czech Republic must prepare for the enforcement of EU law and in particular the Directive on integrated pollution prevention and control (IPPC directive)⁴ whereby companies are required to have obtained an integrated permit before October 2007. The Czech Republic did not apply for a transitional period for the application of the IPPC directive.

The beneficiary companies applied for an integrated permit and are making investments in the Best Available Technologies necessary to comply with the IPPC directive. Each company has also adopted an Environmental Management System based on ISO 14 000 series so as to facilitate compliance with the legislation. There is a clear signal from all beneficiary companies of their readiness to undertake the necessary steps to obtain the integrated permits in line with the EU legislation by 2007.

2.5.2. *The liberalisation of the coal market*

The Protocol provide that “the Czech Republic shall remove trade barriers in the coal market in accordance with the ‘acquis’ by accession so as to allow Czech steel companies to obtain access to coal at international market prices”.

During 2003 imports of coal were limited to 2.44 million tonnes. In line with the relevant provision of the Protocol, the Czech Republic has prepared the liberalisation of its coal market as from 2004, which will contribute to lower production costs for the Czech steel sector.

2.5.3. *Vysoké Pece Ostrava*

The Protocol specifies that “Vysoké Pece Ostrava shall be brought into the organisation framework of Nova Huta (INH) by acquisition of full ownership”.

In February 2003 the formerly independent Vysoké Pece Ostrava (i.e. Blast Furnaces of Ostrava), which produces the hot iron for INH and VS, was incorporated into INH which acquired all the shares of this company.

3. DETAILED PROGRESS REPORT ON THE RESTRUCTURING OF THE POLISH STEEL SECTOR

Poland is the biggest steel producer among the new member states, with a crude steel output of 9.1 million tonnes in 2003. The country is a net exporter of steel. Exports showed a slight increase of 1 % in 2003, amounting to 3.5 million tonnes.

The steel sector plays a key role in the national economy. It shows a strong regional concentration. There are 17 steel companies. The main steel group is Poslkie Huta

⁴ OJ L 257, 10.10.1996, p 26

Staly (PHS), which accounts for 69 % of total production and 58 % of total employment in the sector.

The Protocol specifies the restructuring conditions for the following eight steel producing companies: PHS, Huta Andrzej, Huta Bankowa, Huta Batory, Huta Buczek, Huta Lucchini-Warszawa (HLW), Huta Labędy and Huta Pokój.

3.1. Main developments in Poland in 2003 and first quarter 2004

The final version of the National Restructuring Programme was adopted by the Polish government on 25 March 2003. This new plan was positively assessed by the Commission⁵, which proposed the prolongation of the grace period, i.e. the period during which state aid for restructuring of the steel sector could be granted. On 21 July 2003 the Council adopted a decision⁶ authorising the Polish government to extend the grace period until accession.

Huta Andrzej went into receivership on 21 February 2003. The Polish authorities excluded it from the group of beneficiaries of state aid specified in the National Restructuring Programme.

The privatisation of the PHS group is a core element of the National Restructuring Programme. The privatisation agreement with the purchaser, LNM was signed on 27 October 2003 and finalised on 5 March 2004 after the Commission had approved the transaction on 5 February 2004⁷ considering it in line with the EU Merger Regulation. After the conclusion of the privatisation the name of PHS has changed to Ispat Polska Stal (IPS). The privatisation process delayed the restructuring of the company for almost a year.

In September 2003 and March 2004 Poland submitted the first and second six-monthly monitoring reports as required by the Protocol.

3.2. Macroeconomic environment and steel market developments

The positive trend in the Polish economy begun in 2002 continued into 2003, when gross domestic product increased by 3.7 %, while industrial production registered growth of 7.7 %. The downward trend in inflation and interest rates continued. The PLN exchange rate has been stronger than forecast against the dollar and weaker against the Euro.

The country's economic performance was reflected in growth in steel consumption of 7.2 %, in spite of a decrease in the construction sector output. This increased demand was mainly met by imports, which grew by 10 %. The share of imports in consumption rose to 43 %.

The higher steel price in the Euro-zone was a positive factor for Polish companies. The weaker PLN/Euro exchange rate reduced the competitive strength of imported

⁵ SEC(203)621

⁶ OJ L 199 of 7.08.2003 p.17

⁷ Commission Decision of 05/02/2004 declaring a concentration to be compatible with the common market (Case No IV/M.3326 - LNM / PHS) according to Council Regulation (EEC) No 4064/89

products and increased that of exports. The stronger PLN/USD exchange should have had a positive effect on the prices of iron ore and imported scrap that are USD denominated.

3.3. Monitoring of state aid to the steel sector in Poland

Accession Treaty provisions

The Protocol sets the maximum amount of state aid which may be granted up to 31 December 2003 at PLN 3 387 millions (€ 727 million⁸). The National Restructuring Programme identifies the maximum state aid allowed for each of the steel companies.

Assessment of monitoring findings

According to the information at the Commission's disposal, Poland granted a total amount of PLN 2 750 million (€ 590 million) of restructuring aid in the period 1997-2003, of which PLN 2 100 million (€ 450 million) were granted in 2003. The figures of total state aid granted are below the ceiling specified in the Protocol. It should be noted that the outstanding amount of state aid, representing 20 % of the Protocol ceiling, cannot be granted in the future.

The amount of state aid played a significant role in the implementation of the Polish National Restructuring Programme and is an important element to assist the companies in achieving viability. The aid focused primarily on financial restructuring to address the debt burdens of the companies so as to facilitate their access to financing and their acquisition by a strategic investor.

The assessment shows that although the amount of state aid granted appears to be lower than envisaged, this will not have a critical effect on the financial projections of the beneficiary companies. The aid granted is deemed sufficient to help the companies to achieve viability by the end of the restructuring period.

3.4. Monitoring of the key restructuring benchmarks in the Polish steel sector

3.4.1. Productivity

Accession Treaty provisions

It is envisaged that "employment restructuring shall be implemented; levels of productivity comparable to those obtained by the EU steel industry shall be reached by 31 December 2006."

Assessment of monitoring findings

The monitoring shows that the total productivity rate in 2003 in the companies under analysis was below forecast. The total productivity of the sector has been influenced by the delay in the privatisation process of PHS, where the productivity rate has been mainly affected by the evolution of indirect employment. Now that the privatisation

⁸ PLN/Euro Exchange rate 4.6595 (average December 2003)

of PHS is concluded it is expected that the spin-offs strategy will be revised in order to obtain a positive effect.

Overall productivity level remains low compared to the EU average. Efforts need to be intensified if an increase in productivity is to be achieved as required by the Protocol.

3.4.2. *Cost reduction*

Accession Treaty provisions

It is envisaged that the companies will implement a costs savings programme.

The Polish National Restructuring Programme envisages a total reduction in production costs during the period 2002-2006 of PLN 2 332 million (€ 500 million). Of this a reduction of PLN 118 million (€ 25 million) i.e. 5 % of total forecast reduction, was to be achieved in 2003.

The reduction of manufacturing costs should be achieved through various methods: modernisation of facilities, reductions in employment, reduction of material and energy costs, improvements in production management, as well as lowering of the cost of external services such as maintenance and transport.

Assessment of monitoring findings

Monitoring shows that in 2003 all companies together showed a significant increase in total costs as against the same period last year, despite a low inflation environment in Poland.

The main causes of this increase in costs are the rise in world prices of raw materials and the strategy of externalising services of PHS. Additionally, the delay in investments scheduled for many companies, in particular those aiming at reducing energy and materials consumption, also impacted negatively in the costs.

It is necessary that the companies will revise their strategy of externalising services, in order to achieve a positive effect on costs. Investments projects need to be accelerated in order to catch up and meet the original completion. This is especially important in view of the mentioned increase in raw materials prices that is expected to continue in 2004. The cost reduction strategy should be intensified in other costs categories to offset this increase.

3.4.3. *Capacity reduction*

Accession Treaty provisions

The Accession Treaty specifies that the net capacity reduction to be achieved by Poland for finished products during the period 1997-2006 shall be a minimum of 1 231 000 tonnes. This overall amount includes net capacity reduction of at least 715 000 tonnes in hot rolled products and 716 000 tonnes in cold rolled products, as well as an increase of at most 200 000 tonnes of other finished products. Actual net capacity reductions to be achieved and the time frame for doing so were established

on the basis of Poland's final restructuring programme and the Individual Business Plans under the Europe Agreement.

The reduction in production capacity must be carried out by physical destruction of facilities.

Closure of capacity envisaged for 2002 and 2003 were 901 000 tonnes.

Assessment of monitoring findings

It appears from the information at the Commission's disposal that capacity closures for 2002 and 2003 have taken place as scheduled.

3.4.4. Viability

Accession Treaty provisions

The Accession Treaty envisages that "taking into account the special accounting rules applied by the Commission each benefiting company shall achieve a minimum of annual gross operating result of turnover (10 % for non-integrated steel undertakings and 13 % for integrated steel mills) and a minimum return of 1.5 % of turnover on own capital, no later than the 31 December 2006".

Assessment of monitoring findings

The main goal of the restructuring process and of the measures envisaged in the National Restructuring Programme is to achieve the viability of the beneficiary companies to enable them to operate under normal market conditions. The viability test developed by the Commission's services is a tool to measure the financial effects of the different restructuring measures planned in the companies' business plans. The viability indicators are to be considered in the appropriate time framework. In the first year of the monitoring, the assessment on the viability projections should take into account that the goals are not to be achieved in a single year, but companies are to achieve viability only by the end of 2006.

So far, the monitoring shows that some of the measures envisaged to achieve viability of the benefiting companies have been initiated, such as closure of inefficient capacities, debt restructuring through planned state aids or organisational changes.

However, significant delays in the restructuring have been identified that could affect future viability by 2006. In order to achieve viability, restructuring efforts for all companies should be intensified in the coming years, particularly with regard to implementation of the investment and cost reduction strategies. It is also important that the companies improve their business management and sales strategy in order to profit from the good market situation to maximise sales turnover.

3.5. Environmental protection

The Treaty of Accession specifies a transitional regime on environmental 'acquis' for Poland and establishes a list of installations for which a derogation from compliance with IPPC directive has been granted until December 2010. The companies listed are

Huta Szendzimira (part of PHS), Huta Andrej, Huta Częstochowa, Huta Batory, Huta Jedność and Huta Laziska. The companies not listed will have to obtain an integrated permit by May 2007.

Monitoring shows some achievements in the planned environment-related tasks. As a positive element it can be underlined that most of the companies have adopted an Environmental Management System based on ISO 14.000 series.

Compliance with the EU environmental 'acquis' will have to be realised within the given timeframe.

4. KEY FIGURES ON TRADE IN STEEL PRODUCTS FOR THE CZECH REPUBLIC AND POLAND

Source: European Commission, International Iron and Steel Institute

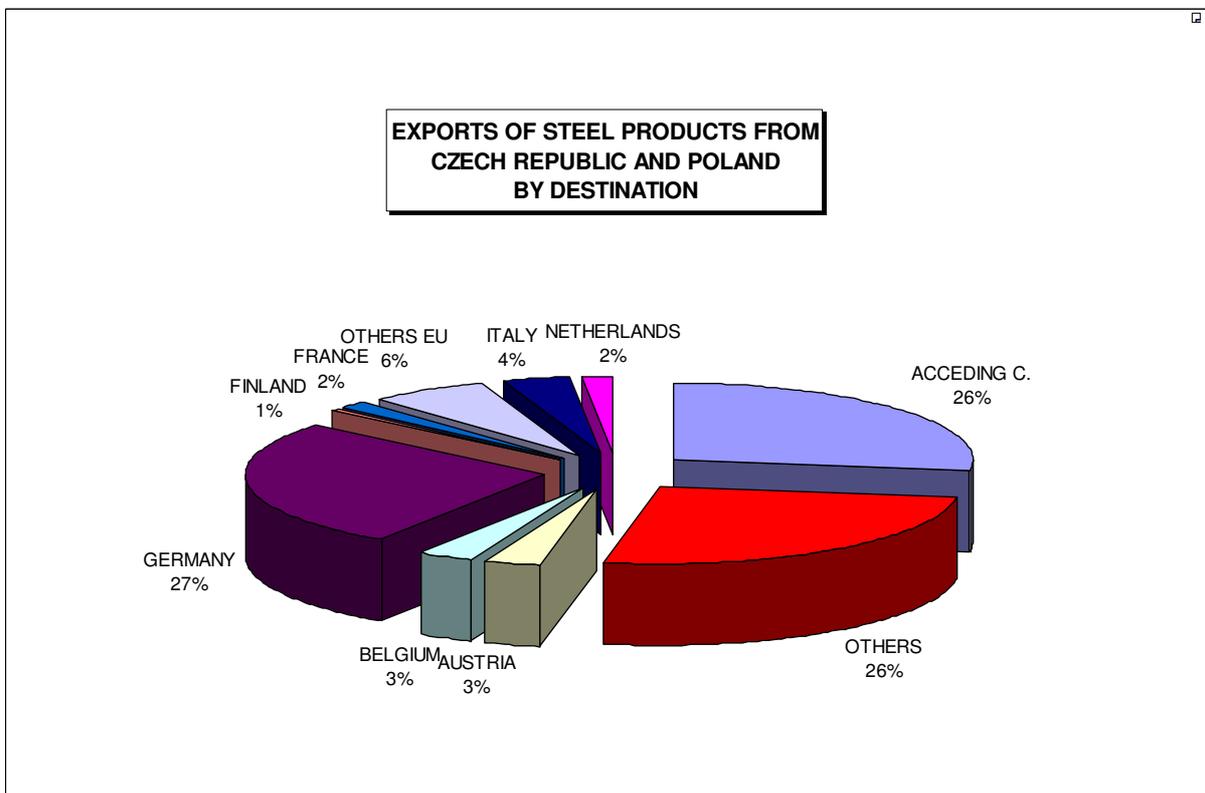
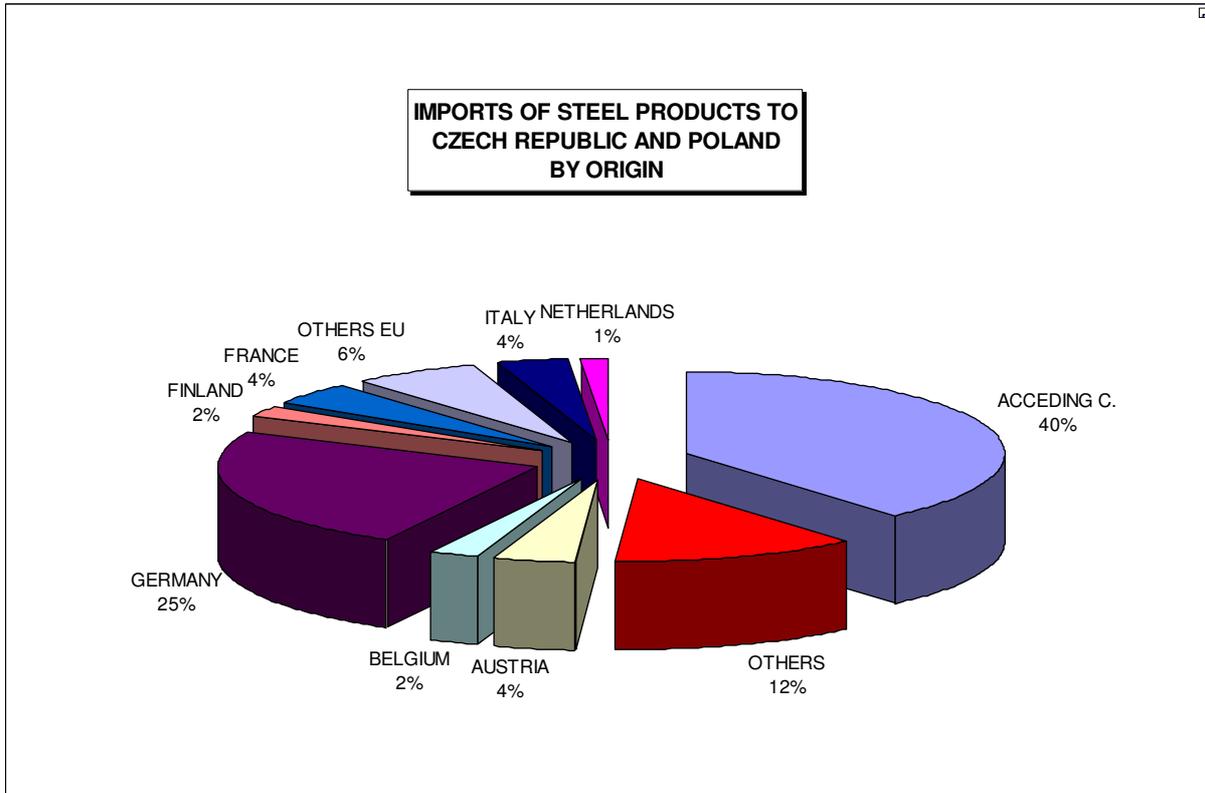


Table I. Imports of Steel Products into the Czech Republic (by origin)

Million tonnes

	1999	2000	2001	2002	2003
EU 15	0,8	1,0	1,2	1,3	1,4
Acceding C.	1,3	1,4	1,5	1,4	1,4
Others	0,2	0,2	0,2	0,3	0,2
Total	2,3	2,6	2,9	3	3

Table II. Exports of Steel Products from the Czech Republic (by destination)

Million tonnes

	1999	2000	2001	2002	2003
EU 15	2,0	2,1	2,1	2,1	2,1
Acceding C.	1,2	1,3	1,6	1,4	1,5
Others	0,6	0,7	0,7	0,9	1,0
Total	3,8	4,1	4,4	4,4	4,6

Table III. Imports of Steel Products into Poland (by origin)

Million tonnes

	1999	2000	2001	2002	2003
EU 15	0,8	1,1	1,4	1,4	1,6
Acceding C.	0,8	0,8	1,0	0,9	1,0
Others	0,4	0,3	0,5	0,4	0,5
Total	2	2,2	2,9	2,7	3,1

Table IV. Exports of Steel Products from Poland (by destination)

Million tonnes

	1999	2000	2001	2002	2003
EU 15	1,6	2,1	2,0	1,6	1,8
Acceding C.	0,5	0,6	0,8	0,8	0,7
Others	0,9	1,0	0,8	1,0	1,1
Total	3	3,7	3,6	3,4	3,5