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

Third monitoring report on steel restructuring in Bulgaria

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1. INTRODUCTION

In Protocol 2 to the Europe Agreement¹, the European Union agreed on transitional arrangements for restructuring aid to allow Bulgaria to complete the restructuring process in the steel industry. Bulgaria was allowed to grant State aid for restructuring purposes, provided that:

- it would lead to the viability of the benefiting firms under normal market conditions at the end of the restructuring period,
- the amount and intensity of such aid was strictly limited to what was absolutely necessary in order to restore such viability and was progressively reduced,
- the restructuring programme was linked to the rationalisation and reduction of overall production capacity in Bulgaria.

The original restructuring period was due to last until the end of 2006. However, Bulgaria indicated that it would not be able to meet the requirements of Protocol 2 under the existing National Restructuring Programme (NRP) and Individual Business Plan (IBP). Therefore, before its accession to the EU, Bulgaria submitted a modified restructuring programme and business plan and requested an extension to the restructuring period. The EU-Bulgaria Association Council Decision 3/2006 of 29 December 2006² amended Protocol 2 to extend the restructuring period until the end of 2008 and set out the monitoring and reporting obligations for the Commission. The only company covered by the extended NRP was Kremikovtzi AD.

The Commission has adopted its two monitoring reports for the years 2006³ and 2007⁴.

2. RESULTS OF MONITORING

This third and final monitoring report supplements the previous Commission reports and assesses the results achieved by the end of 2008, the last year of restructuring. Already in its previous reports, the Commission had noted non-compliance with the restructuring objectives listed in the Protocol concerning viability, technological and environmental investment, sales, cost reduction and productivity. Since then, the Bulgarian authorities have informed the Commission that the implementation of the IBP for Kremikovtzi AD ceased on 6 August 2008 following the announcement of insolvency and the opening of a bankruptcy procedure

¹ OJ L 358, 31.12.1994, pp. 3–222.

² UE-BG 1908/06 — <http://register.consilium.europa.eu/pdf/en/06/st01/st01908-re01.en06.pdf>.

³ COM/2008/511.

⁴ COM/2009/146.

by the Sofia City Court. The company's operations are currently being supervised by a receiver appointed by the Court.

2.1. Monitoring of the key restructuring benchmarks

State aid

Association Council Decision 3/2006 sets a ceiling on the amount of State aid that can be granted to Kremikovtzi AD and forbids the granting of public support to any other company in the steel sector. The maximum State aid amount allowed for Kremikovtzi AD was BGN 432.6 million. However, since the company did not use, and thus did not receive, part of the aid for employment restructuring, the amount of State aid effectively paid out was BGN 431.1 million.

No further State aid was granted in 2008, either to Kremikovtzi AD or to any other steel producer in Bulgaria.

Capacity reduction

In order to offset the competitive advantage of receiving State aid, Kremikovtzi AD was required to permanently close a rod mill with a capacity of 500 000 tonnes of finished products. Monitoring has established that the mill was closed in conformity with the relevant EU legislation⁵ by the end of the restructuring period.

Viability

At the end of the restructuring period in 2008, Kremikovtzi AD was expected to have reached long-term viability⁶. However, already by mid-2008, the company's situation had further deteriorated to such an extent that it was no longer able to service its debts, and bankruptcy proceedings had to be initiated. According to the Commission's State aid standards, an insolvent company is not viable.

The finding of non-viability is further substantiated by the company's financial results. The financial data submitted by the company cannot be considered an accurate depiction of the situation since a number of significant matters have not been clarified and the auditors have refused to give an opinion on the unconsolidated accounts of Kremikovtzi for 2006, 2007 and 2008. However, the unaudited financial statements show that performance in 2008 was negative, which constitutes non-compliance with the viability commitments adopted in the Individual Business Plan (IBP). The results — -33.1 % EBITDA/turnover (target: 13.5 %) and -107.1 % EBIT/turnover (target: 1.5 %) — were even worse than in 2007.

The main reason for this situation was a liquidity shortage due to the failure by the owners of the company to inject funds as an 'own contribution' as agreed in the IBP. One of the effects of the liquidity shortage was a negative impact on the credit conditions imposed by raw

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

⁶ OJ C 244, 1.10.2004, p. 2

Viability implies that a company's 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. % EBITDA (earnings before interest, tax, depreciation and amortisation) on turnover of at least 10 % for non-integrated steel companies and 13.5 % for integrated mills;
- a minimum return: i.e. % EBIT (earnings before interest and taxes) on turnover of at least 1.5 %.

material suppliers, hence increasing the prices the company had to pay for raw materials (on top of price increases in the global steel market).

Later in 2008, the company did not buy raw materials on the world market but engaged mainly in barter trade (as a result of continuing liquidity problems) through agreements to provide finished products in exchange for raw materials. In consequence, the increase in the prices of raw materials had a very limited influence on company viability since actual purchase prices were not subject to global market fluctuations but depended rather on the operational conditions of Kremikovtzi AD.

At the same time, viability was negatively influenced by the company's strategy of requesting pre-financing conditions (in advance payments) from customers in exchange for lower selling prices. Here, the company focused on traders rather than end-users, in spite of the lower margins. Due to the conditions of these commercial agreements the company obtained selling prices lower than the market average.

Cost reductions

A further impact of the lack of liquidity was the failure to implement the modernisation investment necessary to render the company competitive, in particular in the liquid phase of steel production, where state-of-the-art technical equipment is of particular importance. In some areas such as energy and materials consumption, the necessary cost reductions could only be achieved in the longer term through the modernisation investment agreed in the IBP. In the period 2006–2008, however, such investment represented 43 % of the IBP target. In 2008, the technological investment implemented amounted to only 1.7 % of the IBP target for the year.

A further reason for the failure to reduce costs in order to reach viability was low capacity utilisation in 2008 (steel production — 30 %, semi-finished and finished products — 20 %), with the result that Kremikovtzi AD did not manage to reduce its consumption of utilities and raw materials per unit produced.

In the period 2006–2008, environmental investment amounted to only 23 % of the IBP target.

Productivity and employment

During 2008, Kremikovtzi AD employed 5190 persons, which was 8 % below the IBP target for the year. Nevertheless, the productivity rate did not improve compared to 2007 because of low production volumes. Even in the first half of 2008, before the crisis, productivity reached 20 % of the IBP target. By the end of the restructuring period, productivity reached 26 % of IBP target (less than 20 % of the international standard) and only 13 % of the average productivity achieved by other Bulgarian steel companies. This had a negative impact on the efficiency and effectiveness of the company's business.

2.2. Environmental protection

Bulgaria had applied for a transitional period for the application of the IPPC directive⁷. By way of derogation, Kremikovtzi AD should have obtained a fully coordinated permit by 30 October 2007, containing a binding timetable for achieving full compliance by 31 December 2011. In April 2007 EMEPA presented its decision to not issue an integrated permit to

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

Kremikovtzi AD. The company resubmitted an application in May 2007. The procedure has not been completed, however, due to the declaration of insolvency.

3. CONCLUSIONS

By the end of the initial restructuring period in 2006, Kremikovtzi had already failed to achieve the restructuring goals. As a very exceptional occurrence, the company had its restructuring period extended by two years. However, the situation did not improve during this time and ultimately ended in the bankruptcy of the company.

The Commission considers a substantial effort by the company and its owners to be a key condition for the granting of restructuring aid. Accordingly, the company has to make an 'own financial contribution' to the financial support provided from public funds. The amount of own investment on which the IBP for Kremikovtzi was based has not been forthcoming. The lack of capital for modernisation investment and the lack of working capital were the main reasons why the company did not succeed in reaching viability.

The Commission highlights that these developments were not due to the economic crisis. Already in the first half of 2008 and in 2007, the company operated several facilities below the IBP capacity targets, mainly due to the lack of working capital. The same reason hindered the implementation of the investment programme. In the first half of 2008, operational performance was marked by a severe fall in sales volumes and amounts, combined with an increasing deterioration in operational conditions, causing losses. Both viability benchmarks EBIT and EBITDA were already negative. Consequently, the situation cannot be explained by the global crisis, since company conditions already began to deteriorate in 2007, when the steel market was experiencing exceptional growth. Also, the insolvency procedure was initiated in August 2008, before the financial crisis of September 2008.

In view of the findings, the Commission concludes that the provisions of Protocol 2 to the Europe Agreement⁸ and EU-Bulgaria Association Council Decision 3/2006 of 29 December 2006⁹ amending this Protocol were only respected in relation to the amount of restructuring aid granted and net capacity reduction. However, the Commission notes that the restructuring benchmarks (viability, productivity and cost reduction) were not achieved and were far below agreed targets.

The Commission concludes that the NRP and the IBP were not fully implemented and therefore are not in compliance with requirements of Protocol 2.

As a legal consequence of the beneficiary's failure to achieve the restructuring goals, Bulgaria has undertaken to claim reimbursement of the aid as agreed in the third paragraph of Article 3 as set out in Article 1 of the EU-Bulgaria Association Council Decision 3/2006 of 29 December 2006 amending Protocol 2 to the Europe Agreement:

'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 or that in the course of the restructuring period Bulgaria has granted additional State aid in favour of the steel industry, and to Kremikovtzi AD in particular, Bulgaria shall recover from the beneficiary any aid granted in breach of these conditions before or after its accession to the European Union.'

⁸ OJ L 358, 31.12.1994, pp. 3–222.

⁹ UE-BG 1909/06 — Adoption Decision 3/2006.

The recovery obligation resulting from this commitment has been acknowledged by the Bulgarian State aid authorities, who have initiated recovery proceedings. The recovery order has been challenged during the bankruptcy procedure. The Commission has explained in detail the practical and legal consequences ensuing for the Bulgarian authorities. This final report confirms the initial Commission assessment. In this respect, the Commission should be kept informed of developments in the insolvency procedure, in particular regarding the claim for the reimbursement of State aid.

In parallel, the Commission will issue a decision *sui generis* in accordance with the second paragraph of Article 3 as set out in Article 1 of EU-Bulgaria Association Council Decision 3/2006 of 29 December 2006 amending Protocol 2 to the Europe Agreement, according to which:

‘The Commission shall decide whether the restructuring programme and the plans are fully implemented and are in compliance with the requirements of Article 9(4) of Protocol 2 to the Europe Agreement.’