A new perspective for Spanish shipyards — reducing distortions in shipbuilding

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Introduction

On 12 May 2004 the European Commission took a negative decision concerning aid worth 500 million euro which the Spanish State holding company Sociedad Estatal de Participaciones Industriales (SEPI), granted in 1999 and 2000 to the publicly owned civilian shipyards, owned at the time by IZAR. The Commission concluded that this amount constituted state aid which could not be approved under the EU rules on aid to shipbuilding. As loans amounting to 192 million euro had been paid back to SEPI, the sum to be recovered from IZAR amounted to 308 million euro, plus interests.

On 20 October 2004, the European Commission took another decision (case C 38/03) with regard to the same company. The Commission in this decision established that SEPI during 2000 had granted an additional 556 million euro to the publicly owned civilian shipyards. This aid granted in favour of IZAR's civil activities was not in line with EC State aid rules and the Commission therefore concluded that also this amount had to be recovered from IZAR.

These two decisions followed after several years of complaints from competitors on the business behaviour of the Spanish public shipyards and forced the Spanish authorities to undertake a major restructuring of these shipyards.

Decision May 2004 (Case C 40/00)

The Commission decision taken in May 2004 covers a number of transactions that took place between 1999 and 2000 involving SEPI, its subsidiary Astilleros Españoles (AESA), the former holding company of the publicly owned civilian shipyards and AESA's producing subsidiaries. Since the Commission suspected that these transactions contained state aid, it opened a formal investigation (1) on 12 July 2000, which was extended (2) on 28 November 2001 and further extended (3) on 27 May 2003.

Based on the facts that were established during the formal investigation procedure the Commission concluded that the state holding company SEPI undertook the following transactions, which entailed state aid to the public Spanish shipyards:

- An excess purchase price paid by SEPI when AESA sold three shipyards to SEPI in 1999. According to the Commission's calculation the purchase price paid by SEPI contained an aid element of 56 million euro. The aid benefited the remaining civil shipyards still owned by AESA;
- Loans amounting to 192.1 million euro provided by SEPI to three of AESA's shipbuilding companies;
- A capital injection by SEPI of 252.4 million euro to AESA in 2000, benefiting three of AESA's civil shipyards.

October 2004 decision (case C 38/03)

The Commission decision of October 2004 concerns three capital injections, made in 2000, 2001 and 2002 by SEPI, to IZAR. When the Commission found out about these transactions it suspected that they contained state aid and therefore opened a formal investigation (4) on 27 May 2003.

The total amount of capital injected into IZAR was as follows: 1,322 million euro provided in July 2000, 105 million euro provided in 2001 and 50 million euro in 2002.

The Commission concluded that IZAR's civilian activities benefited from the capital injection in the year 2000, by receiving loss coverage of 364 million euro during the period 2000–2003. Furthermore, the Commission concluded that IZAR's repayment of a 192.1 million euro loan to

SEPI on behalf of three of the shipyards, as outlined above, constituted also a direct aid to these civil shipyards. The total aid amount for the civil shipyards was thus 556.1 million euro.

The additional capital injections in 2001 and 2002 from SEPI to IZAR were used to cover unexpected increased costs for pre-pensions in IZAR's former military shipyards and did not constitute aid.

Why is the aid incompatible?

The above mentioned aid measures, amounting to 500 million euro, respectively 556 million euro, were declared incompatible by Commission decisions of 12 May 2004 and 20 October 2004 for the following reasons.

Legal base

In 1997 pursuant to Council Regulation 1013/97, the Commission exceptionally approved a package of restructuring aids to the public Spanish shipyards amounting to 1.4 billion (1) euro subject to the condition that no further such aid could be provided. The total restructuring package amounted to 1.9 billion euro including aid approved in 1995. The restructuring period lasted from 1994 to 1998, after which the shipyards should have become profitable. In giving its agreement, the Council stressed the ‘one time, last time’ nature of the aid package.

Any further public measures that did not form part of the aid package approved in 1997 therefore needed to be assessed according to the general state aid rules, i.e. Article 87 of the EC Treaty. On 29 June 1998 the Council adopted the Shipbuilding Regulation, which was in force from 1 January 1999 to 31 December 2003 (2), i.e. the period when the concerned measures took place.

Article 5(1) of the Shipbuilding Regulation explicitly states that no rescue or restructuring aid may be granted to an undertaking that has been granted such aid pursuant to Regulation 1013/97 (i.e. within the 1997 shipbuilding aid package mentioned above). Consequently, rescue or restructuring aid to the public Spanish yards in excess of the aid, that was authorised by the initial Commission decision in 1997, would be considered incompatible with the common market.

The measures under investigation did not fall under any of the other derogations provided for by the Shipbuilding Regulation. Hence the crucial question in the investigation procedure was whether the measures granted by SEPI constituted aid, as the qualification of the measures as aid consequently would imply their incompatibility with the common market.

The role of SEPI

In the opening and extensions of the formal investigation procedure the Commission presumed that SEPI acted on behalf of the state, i.e. that its behaviour in the different transactions was imputable to the state. Spain contested this, and claimed that SEPI functions independently from the state and that therefore its actions are not imputable to the state. Furthermore, in Spain’s view, SEPI acted as a market investor and therefore the funds provided from SEPI in this case could not be considered as state aid.

The Commission, however, noted that SEPI is a public holding company which depends directly on the Ministry of Finance. As such it is considered a public undertaking in the sense of Commission Directive 80/723/CEE of 25 June 1980 (3) as amended by Commission Directive 2000/52/EC of 26 July 2000 (4), since, due to its ownership or its financial participation, the public authorities can directly or indirectly exercise a dominant influence on SEPI.

With reference to the jurisprudence of the Court (Case C-83/98 France v Ladbroke Racing and Commission (5); C-482/99, Stardust marine (6)) the Commission concluded that the funds provided by SEPI were to be considered state resources as they remained under public control. Furthermore, the actions of SEPI were considered imputable to the state, by the level of supervision exercised by government representatives over the company and the public nature of its activities.

The general principle that applies for financial transactions between the state and public companies is the so called market economy investor principle. Given that SEPI’s funds were considered state resources, it was essential that SEPI, in its economic transactions with its shipbuilding subsidiaries acted fully in line with the market rules.

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In order to be able to conclude that the funds provided were free of state aid, the market economy investor principle is explained in the Commission communication to the Member States on the Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector. The case law further establishes (e.g. in Case C 40/85 Boch) that the appropriate way of determining whether a measure constitutes state aid is to ask to what extent the undertaking would be able to obtain the sums in question on the private capital markets at the same conditions.

Therefore, the Commission had to apply the criteria of the market economy investor principle to each of the transactions undertaken by SEPI as it had to assess individually whether each transaction was free of aid.

**Aid via the purchase of assets by SEPI**

SEPI on 28 December 1999 bought the three companies Juliana, Cadiz, and Manises from AESA for 15 million euro which according to Spain corresponded to the book value of the companies at some point in 1999.

The Commission based its assessment on the information obtained within the investigation and concluded that SEPI on 28 December 1999 paid 15 million euro for three companies which had a book value of minus 41 million euro and which furthermore contained additional liabilities of substantial amounts. It therefore concluded that SEPI paid more than the market price for the companies (which on the basis of the available information was estimated at minus 41 million euro). The amount exceeding the market price, i.e. 56 million euro, consequently was to be considered as incompatible state aid to the seller, AESA.

**Aid via loans provided by SEPI to three shipyards in December 1999**

The three shipbuilding companies owned by AESA (Juliana, Cadiz and Manises) had accumulated a debt to AESA of 192 million euro. When SEPI took them over in 1999 it also provided them with 192.1 million euro ‘advance’ payment which was used to repay the loans to AESA. SEPI in turn took over the claim of 192.1 million euro from AESA. The assessment focused on SEPI’s loan of 192.1 million euro to the three companies Juliana, Cadiz and Manises.

The Commission again needed to assess whether an investor could, under normal market economy conditions, expect an acceptable rate of profitability on the capital invested and to what extent the undertaking would be able to obtain the sums in question on the private capital markets.

It was clear from the annual reports that the three companies receiving the loans were in difficulties. There were no signs that the difficult financial situation of the companies would improve. For these reasons, it was obvious that the three companies would not have been able to obtain the loans on the private capital markets and that SEPI, consequently, could not have expected a reasonable rate of return. Thus, the Commission considered the loans from SEPI to the shipbuilding companies amounting to 192.1 million euro as state aid, which was incompatible with the common market.

These loans were repaid with interest to SEPI on 12 September 2000 by IZAR which at that time had taken over and dissolved the companies Juliana, Cadiz and Manises. The Commission therefore declared that the aid had been recovered. However, this information was used in the second decision on IZAR (see further below).

**Aid via a capital injection from SEPI to AESA**

AESA on 20 July 2000 sold to Bazán (later renamed IZAR) its remaining three shipyard companies, Puerto Real, Sestao and Sevilla for one Peseta each. On 18 July 2000, two days before, SEPI decided to provide AESA with a 252 million euro capital injection. This capital was then paid out in September 2000. Spain claimed that since this capital was only provided in September 2000, when AESA already had sold its shipyards, it could not distort competition for shipbuilding.

The Commission in this respect concluded first, that the capital injection, in view of the financial situation of AESA, could not be expected to generate a reasonable rate of return and consequently constituted incompatible aid that needed to be recovered.

Secondly, the Commission noted that AESA cancelled debts to its shipyards for 309 million euro before the yards were transferred to Bazán for a symbolic price. This improved their financial conditions.

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(2) [1986] ECR 2321.
situation by the same amount. It was also concluded that since AESA's debt cancellation did not involve any cash payment, already SEPI's decision on 18 July 2000 to inject 252 million euro to AESA enabled AESA to cancel the concerned debts without having to declare immediate bankruptcy, although the money was only provided in September 2000.

From a state aid perspective the aid was therefore granted by SEPI's decision on 18 July 2000 to provide the capital injection, since this decision was the precondition to enable AESA to relieve the shipyards of its debts. The ultimate beneficiaries of this aid were the shipyards, since the effect of the operation was that the shipyards were relieved of their debts to AESA.

AESA's debt cancellation improved the financial situation of the concerned shipyards by 309 million euro. However, the Commission only assessed the provision of funds from SEPI, which in this transaction amounted to 252 million euro. This state aid was not compatible with the common market, since it could not be authorised under the rules for restructuring aid or any other type of aid.

Aid through the capital injection to IZAR

The Commission established that out of the 1322 million euro injected by SEPI into IZAR (at the time called Bazán) in July 2000, 364 million euro had benefited the civilian activities of the shipyards since it was used to cover losses of these companies for the years 2000 to 2003.

From the information provided by Spain it is clear that the civilian companies bought by Bazán in July 2000 were in economic difficulties. There were furthermore no signs that the difficult financial situation for their activities would improve. It can therefore be excluded that the civilian activities, under the ownership of Bazán/IZAR would generate an acceptable rate of return.

For these reasons, it can be established that IZAR would not have been able to obtain loans or capital on the private capital markets to cover the losses of its civilian activities. Therefore, the provision of capital to these activities did not comply with the market economy investor test. For the same reasons SEPI could not have expected a return on this capital. Therefore the provision of these resources from SEPI to IZAR did not comply with the market economy investor principle. Therefore the capital injected for the use by the civilian activities constitutes state aid to IZAR. This state aid was illegal, since it had not been notified to the Commission.

It can furthermore be concluded that this aid was not compatible with the Common market as it could not be authorised as restructuring aid. The aid could neither be approved under any other provision of the shipbuilding Regulation or under any other of the derogations laid down in Article 87(2) and (3) of the EC Treaty.

Loans repaid by IZAR on behalf of three activities

As noted above, in the state aid decision on case C 40/00, IZAR had repaid loans amounting to 192.1 million euro with interest to SEPI. The funds had been provided in 1999 to the companies Juliana, Cadiz and Manises, which subsequently were taken over by IZAR in July 2000.

According to information received from Spain, the reported losses for the civilian activities for the year 2000 did not include the repayment of the above mentioned loans.

It is evident that funds provided by SEPI in 1999 benefited the civilian companies Juliana, Cadiz and Manises. However, since the repayment of these loans was made from the general accounts of IZAR, the effect is that the three companies, later dissolved into business units, benefited from not having to repay the concerned loans. It is thus clear that it was IZAR, which through the payment from its own resources, alleviated Juliana, Cadiz and Manises from the financial burden to repay the loans.

The Commission has assessed whether the loans repaid by IZAR could have been financed with funds received through a new loan taken by IZAR under market conditions. Concerning this aspect the Commission considers that without the capital injection in the year 2000, which — as has been shown above — has been used to support the civilian activities of IZAR, the latter's financial situation would have been much worse than it was. For this reason it can be excluded that IZAR could have received a loan on market conditions if it had not received the illegal and incompatible aid in the form of 364 million of the capital injection.

The repayment of 192.1 million euro by IZAR to SEPI should therefore be considered as a further use of the capital injection under investigation to the benefit of IZAR's civilian activities. For the same reasons as outlined above for the loss coverage, this use of funds for the civilian activities did not comply with the market economy
investor principle and the corresponding amount used from the capital injected to IZAR constitutes incompatible state aid to IZAR.

**Aid recovery following change of ownership**

The shipyard companies that ultimately benefited from the illegal aid established in the first decision were, at the time of the decision, owned by IZAR. The Commission decision therefore found that this illegal aid should be recovered from IZAR. The Commission took the view that after the change of ownership of the yards, from AESA or SEPI to IZAR, the recovery of the aid should not remain with the previous owner of the concerned companies as they were not transferred to IZAR on market terms in open and transparent tendering procedures, but in the form of a reorganisation within the SEPI group, with the use of symbolic prices. Therefore all incompatible aid is to be recovered from the owner of the ultimate beneficiaries of the aid, i.e. IZAR.

**Future**

Following the Commission decisions, Spain has taken several steps in order to reorganise its public shipbuilding sector. The reason is that IZAR had to declare bankruptcy once the recovery claim for the illegal and incompatible aid would be introduced in the balance sheet of the company. This was done in January 2005.

One aim of the reorganisation has been to avoid that IZAR’s military production would be harmed, which is a legitimate objective in accordance with Article 296 of the EC Treaty. This goal is reached by transferring the military production to a new public company (‘Navantia’). Since the new company, for viability reasons, will need to have certain civilian activities, safeguards have to be put in place in agreement with the Commission.

Another aim has been to, if possible, rescue employment in the civil shipyards, while still respecting Community legislation. The objective is to privatise the civil shipyards, through open and transparent market operations. In this way, the Commission may accept that the recovery claim on IZAR does not follow to the privatised shipyards.

A third aim has been to alleviate the social problems, by granting pre-pensions to all IZAR employees at the age of 52 or above. In this way it is hoped that direct lay-offs can be avoided.

**Conclusion**

The Commission, when it took the decisions, was aware that the consequences of the decisions may be serious for the Spanish public shipyards and their employees. However, the Commission also had received numerous complaints from shipyards in other EU Member States, and even from Spanish competitors. It therefore had to act to ensure that competition in the EU shipbuilding market was not distorted.

The state aid history of the Spanish shipyards may be seen as an illustration of how repeated state aid in order to cover losses creates problems not only for competitors, but in the end also is harmful for the employees. Competitors suffer, since a company that runs with permanent deficits supported by state aid tends to undercut prices and thus create serious distortions in the market. Employees also suffer, at least in the long run, since such companies feel less pressure to innovate and improve productivity, which is necessary in order to ensure long-term job security.

The effects of the recent restructuring will be on the one hand a viable military shipbuilding company, with a limited civilian activity which is strictly obliged to respect EC Competition rules. On the other hand, the civilian yards, significantly downsized, may find new buyers.

The Commission has also underlined the European Community's coherent policy in support of EU shipyards, facing unfair competition from Korean shipyards, which consists of three main elements:

- A WTO panel against Korea, challenging restructuring aid and export aid and the price depression these measures have caused. This procedure was terminated by adoption of the final report by the Dispute Settlement Body on 11 April 2005.
- The temporary defensive mechanism (1), which allows for the granting of state aid to EU-yards constructing ship-types particularly harmed by unfair competition.
- ‘LeaderSHIP (2) 2015’. A Commission initiative aiming at strengthening the competitiveness of EC shipyards.

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