

Reasons for the continued application of the Framework on State Aid to Shipbuilding

Point 3 of the introduction to the Framework on State Aid to Shipbuilding states that **“certain specific factors affecting the shipbuilding sector should be reflected in the Commission's policy of State aid control”**. These factors include:

- (a) over-capacity, depressed prices and trade distortions in the world shipbuilding market;
- (b) the nature of ships as very large capital goods, which raises the potential of State-supported credit facilities to distort competition;
- (c) the fact that World Trade Organisation ("WTO") unfair trade disciplines are difficult to apply in the shipbuilding sector;
- d) the existence of agreements within the Organisation for Economic Cooperation and Development ("OECD") in the shipbuilding sector, namely the 1998 OECD Arrangement on Guidelines for Officially Supported Export Credits with its Sector Understanding on Export Credits for Ships, which applies in the Community pursuant to Council Decision 2001/76/EC of 22 December 2000 replacing the Decision of 4 April 1978 on the application of certain guidelines in the field of officially supported export credits(2).

In what follows we shall briefly examine **whether those factors which once justified targeted aid to shipbuilding have changed or whether they have remained valid and in fact increased their adverse impact.**

Specific factors affecting shipbuilding

Developments in shipbuilding capacity

In the last few years, there has been a tremendous increase in the supply side of the shipbuilding market, with the appearance of new countries, particularly in East Asia, owing to considerable growth in China, Vietnam and the Philippines.

According to the latest analysis carried out by international shipbuilding associations, it is estimated that shipbuilding capacity in 2010 will exceed 44 million cgt and that it will reach 50 million cgt by 2012. **This expansion in capacity will be unevenly distributed in global terms: 86% growth is predicted for China, 37% for South Korea and 17% for Japan, whilst no significant growth in capacity is predicted for Europe.**

Similarly, as a result of the contracting boom of the last few years, **order books reached a historic high of nearly 180 million cgt on 31 December 2007 and a record output of 34 million cgt during 2007.** However, forecasts of output in the next few years vary between 25 and 30 million cgt, which means that **by 2012 the gap between capacity and production will amount to about 45% overcapacity.**

By 2012, estimated shipbuilding overcapacity (the gap between supply and demand) will be about 45%.

Unfair commercial practices in East Asia

Developments in the shipbuilding market over the last few year, **notably the spectacular emergence of China, have brought far-reaching changes which will affect the whole shipbuilding sector.** For instance, **to compensate for the loss of its market share in merchant vessels,** for which, given maritime transport needs, demand is highest (mainly for energy products, primary commodities and manufactured goods) - that is, tankers, bulk carriers and container ships - **South Korea will focus its full potential as a leading shipbuilding country on market segments in which it does not currently have any significant presence.**

These segments (ferries, cruise ships, offshore vessels, and so on) are currently the leading products of European shipyards and thus of the European equipment supply industry, which means that **when unfair competition occurs – something that has happened in the past, as established by the European Commission itself - it will hit not only shipyards but the European supply industry as a whole.** An example is the recent development of the Korean KC1 membrane for gas carriers, which was promoted jointly by the Korean Government and industry with the aim of “breaking the existing European monopoly”, and STX Korea's acquisition of 39% of AKER's capital as a strategic move to penetrate the market in ferries and cruise ships, a tactic which is currently under investigation by the Directorate-General for Competition.

On the other hand, **past experience has shown the difficulty of applying WTO disciplines to unfair commercial practices and, given that negotiations within the OECD on a new agreement** on normal competition conditions in the shipbuilding industry are at a standstill, and that a less favourable market situation will naturally do much to delay the reaching of a new agreement, it is reasonable to assume that unfair commercial practices will worsen further.

Worsening unfair commercial practices resulting from overcapacity in a shrinking market, in the absence of countervailing international disciplines

International agreements within the OECD

As acknowledged in the consultation document itself, the existence of OECD agreements in the shipbuilding sector, notably the 1998 OECD Arrangement on Guidelines for Officially Supported Export Credits, with its Sector Understanding on Export Credits for Ships, **does not give rise to any particular problems with the application of the Framework.**

However, the fact that the above-mentioned provisions are referred to in the Framework and its extension guarantees a certain level of legal certainty within the *acquis communautaire* and the national legal systems which transpose it, without there being any need for subsequent legislative amendments.

Legal certainty concerning the application of the Framework in relation to the OECD Agreements

Continuity of the specific objectives of the existing Framework

As stated in paragraph 5, the aims of the current Framework were as follows:

- (a) encourage greater efficiency and competitiveness of Community yards, in particular through the promotion of innovation;
- (b) facilitate the reduction of economically non-viable capacity where necessary;
- (c) respect applicable international obligations in the field of export credits and development aid.

Over the last few years, following the Leadership 2015 document, European shipyards have achieved positive results with innovations and technological developments in products and processes which have enhanced their competitiveness.

Consequently, a strong correlation between competitiveness and technological innovation has developed, increasing the urgent need for European shipyards to successfully incorporate new technologies in products and processes and ensure their acceptance on the market so as not to forfeit competitiveness. In this context, it should be noted that **it is particularly difficult to protect intellectual property** in the

shipbuilding sector, given its particular characteristics, which means in practice that technological innovations are readily transferred to all other competing companies.

The above means that considerable technological risks will have to be accepted in order to retain the ability to maintain technological leadership.

Unique nature of the shipbuilding process

In Leadership 2015, the European Commission states: “Shipyards provide products of high complexity, requiring a multitude of skills, an outstanding degree of scientific knowledge and smart production technologies.

“Short production series, customisation as a general principle, and global competition force shipyards to permanently search for innovative solutions with regard to design and production technologies. Due to the complexity of the product, shipyards now depend on a large number of suppliers for components, sub-systems and knowledge-based services, including those provided by specialists in the financial sector. Today’s shipyards have to be seen as large scale integrators within a high technology industry whose key players are often highly specialised SMEs”.

“A fundamental obstacle to improved RDI investment results from the application of the current Community Regulation. The Community framework for state aid for research and development has been effective to ensure EU competition rules, but, due to certain specific characteristics of the sector, the shipbuilding industry has not been able to receive adequate RDI aid from Member States. Therefore new ways and means are needed in order to encourage RDI in the sector, while ensuring full compliance with the principles of the internal market.”

“Possible solutions could flow from the fact that in shipbuilding a significant part of the innovation activities is integrated in the design and production process itself, while in any other industries RDI activities are carried out before series production starts. Consequently, the largest part of the product development and of the innovation activities is carried out after the signature of the sales contract.”

In this context, it should be noted that the **risk involved in incorporating innovative designs and technologies which have not been tested in the process of design and construction is very high, and that in some cases considerable modifications to prototypes are required which call for additional resources, with associated additional costs and/or delays in construction time, which may even affect the process of building other vessels.**

Empirical experience shows that, on average, **the innovation processes described which take place in shipyards involve additional costs of between 5 and 10% and that in exceptional cases, where certain prototypes of vessels are concerned, they can exceed 50%.**

The risk involved in incorporating innovative designs/technologies is very high.

Point 7 of the introduction to the Framework states: “Certain features make shipbuilding unique and distinguish it from other industries such as short production series, the size, value and complexity of the units produced as well as the fact that prototypes are generally used commercially. **As a consequence, shipbuilding is the only sector eligible for innovation aid.**”

Horizontal measures to encourage research, development and innovation activities are aimed at industries involving mass production, in which the cost of prototypes far exceeds the unit cost of products and development costs are thus offset through mass production of a large number of units. (For example, the estimated cost of developing the Airbus A-380 model was €11 500 million and the price of a single aircraft is €220 million). In shipbuilding, however, the prototypes are sold, and although the cost of a prototype may exceed the price of the vessel, **the horizontal provisions regarding aid to RDI and the costs they consider eligible in relation to such activities are practically inapplicable to shipbuilding, as there is no mass production.**

Moreover, **the horizontal provisions relating to RDI aid** in relation to saleable prototypes contain a condition which **considerably reduces the possibility of their being applied to innovation in ships.**

The substance of this condition is as follows:

*"The development of commercially usable prototypes and pilot projects is also included where the prototype is necessarily the final commercial product and where it is too expensive to produce for it to be used only for demonstration and validation purposes. **In case of a subsequent commercial use of demonstration or pilot projects, any revenue generated from such use must be deducted from the eligible costs.**"*

In the case of ships, the prototype will always be the final commercial product, and it is not appropriate for the shipbuilder to deduct revenue obtained through its commercial exploitation from the eligible costs, **since this distorts the justification for the existence of aid to product innovation and therefore the existence of the prototype itself.**

Finally, although only five Member States have decided to provide the aid to innovation permitted under the Framework, **this limited experience allows certain conclusions to be drawn:**

1. Aid to innovation does more to encourage research, development and innovation activities in shipyards, as it allows innovatory solutions to be developed at the design and production stage which, if there were no such aid, would be avoided so as not to incur exposure to technological risks that are difficult to evaluate and quantify until tested.
2. Such aid encourages a culture of innovation in shipyards and their workforces, which are gratified that their RDI activities are receiving recognition and pleased to be achieving technological developments, which were not formerly valued as such, as there was no appropriate framework of instruments to promote such activities.
3. The rules set out in the horizontal provisions on RDI aid are, in practice, not applicable to product innovations in the shipbuilding sector, but only to process innovations.
4. Without product innovation, the competitiveness of European shipyards would be adversely affected.
5. Aid intensity has been estimated at 1.2% of the total turnover of European shipyards, which means that there is no distortion of the European shipbuilding market.
6. The choice of a constant €/cgt ratio, regardless of the type of vessel, to define the notification threshold penalises high value-added segments such as ferries, cruise ships and specialised small ships such as fishing vessels and other types of non-cargo ships such as tugs and supply vessels.

Proposal for new notification threshold

The reason for penalising high value-added segments is that the €/cgt ratio does not reflect the degree of innovation of a vessel, as more sophisticated vessels incorporate a higher proportion of equipment and systems, particularly in the case of smaller ships, than do more standard vessels.

If the average price of vessels grouped by CESA categories is taken as a reference, it will be seen that there is very considerable variation between vessels with high added value (category III) and standard vessels (category I). This means that selecting a constant €/cgt ratio, regardless of the type of vessel concerned, adversely affects smaller vessels and discourages innovatory projects by SMEs.

Average price in €/cgt by category

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Category I	Oil tankers, bulk carriers and combination carriers	€ 2178 /cgt
Category II	Products and ships carrying chemicals, general freight vessels, refrigerated vessels, container ships, ro-ro vessels, gas carriers	€ 2253 /cgt
Category III	Ferries, fishing vessels, cruise ships and other non-freight vessels	€ 4989 /cgt

In order to improve competitiveness through support for innovation as reflected in the aims of the Framework on State Aid to Shipbuilding, it would be a good idea to alter the notification threshold.

Proposal for new notification thresholds

Category I	150 Euros per cgt
Category II	200 Euros per cgt
Category III	350 Euros per cgt

Final conclusion

UNINAVE supports the European Commission's proposal to extend the Framework on State Aid to Shipbuilding, as the specific features of the sector which justified its continued existence have not disappeared; rather, they are still present and have even worsened, as in the case of shipbuilding overcapacity, or remained unchanged with no possibility of a rapid solution, as witness the difficulty of applying the unfair trade disciplines of the World Trade Organisation (WTO) and the standstill in negotiations within the OECD.

Secondly, given the special nature of the shipbuilding process and the strong correlation between the competitiveness of the European shipyards and technological innovation, there is a need to **do more to encourage research, development and innovation activities in the shipyards by pursuing aid to innovation, which, as has been shown by recent experience, does not distort the internal market and is an excellent mechanism for this reason.**

Finally, **in order to boost the competitiveness of SMEs that build small specialised vessels with a high added value**, which are adversely affected by the minimum threshold stipulated by the Framework, it would be a good idea to modify **the threshold as set out above.**

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