The Council approves the commission’s twin-track strategy against unfair Korean practices in the shipbuilding sector

Sean BRADLEY and Hans BERGMAN, Directorate-General Competition, unit H-1

In line with the 1998 Shipbuilding Regulation (1), decades of operating aid to Community shipyards came to an end in December 2000. The Community’s attempts to increase efficiency in this sector by reducing and re-orientating State aid have, however, been temporarily undermined by the need to counter unfair practices at South Korean shipyards. In June 2002, the Council gave the Commission the green light for its twin-track strategy against unfair Korean practices, by adopting the temporary defensive mechanism to shipbuilding (TDM) (2).

Accordingly, should further negotiations between the Community and Korea fail to lead to a satisfactory solution, the Commission will commence WTO action against Korea and, in response to the exceptional conditions in the shipbuilding industry, introduce a temporary and limited authorisation of operating aid to Community shipyards.

The History of operating aid

Since the early 1970s, state aid to the shipbuilding industry has been subject to a specific Community regime. In contrast to other sectors, the shipbuilding industry has systematically been the recipient of operating aid. Yet, operating aid is widely perceived as the most distortive and damaging form of State aid: it is granted simply as a contribution towards the normal running costs faced by businesses, without providing any incentive to invest, for example, in measures that would lead to greater efficiency or to improved environmental standards.

Indeed, handouts of operating aid from national authorities to inefficient yards erode the advantages gained by efficient and competitive yards that do not receive the same level of support. The distortive effects of operating aid were particularly aggravated by the exceptionally high maximum aid ceilings (over 30% of contract value) that were authorised for many years. For these reasons, a more restrictive approach was introduced in the 1987 Sixth directive on shipbuilding (3), the aim of which was to gradually phase out operating aid, through the progressive reduction of the maximum aid ceiling. Subsequently, the maximum aid ceiling for operating aid was gradually reduced from 28% of contract value in 1987 to 9% in 1992.

Although this progressive reduction encouraged moves towards greater competitiveness and structural change, the necessary impetus was not sustained, as the ceiling became static after 1992. In 1997 it was apparent that, despite the efforts made, many EU yards still lacked competitiveness, and were lagging behind their main Far Eastern competitors in terms of productivity. Against this background, the Commission put forward proposals for a new approach towards state aid for the sector: the abolition of operating aid; and a shift towards other forms of support, better geared towards helping industry achieve the necessary changes and overcome its weaknesses. The proposed new regime was adopted as the 1998 Shipbuilding Regulation, which extended the operating aid rules for two years, until end of 2000.

It should be noted that operating aid not only has damaging and distortive effects on the market, but comes at great cost to the European taxpayer. Since the beginning of the 1990s the average, annual amount of state aid awarded to shipbuilding has fluctuated between EUR 1.4 billion and EUR 1.7 billion. The largest share of the aid has been provided in the form of operating aid and restructuring aid. The amount of operating aid provided since 1990 has fluctuated between EUR 198 million and EUR 1.1 billion per year.

The 1998 Shipbuilding Regulation

In accordance with Article 3(1) of the 1998 Shipbuilding Regulation, operating aid was completely and permanently phased out at the end of 2000. Thus, a major part of the Commission’s state aid objectives in this sector was achieved. As a

counterpart to the phasing out of operating aid, the 1998 Shipbuilding Regulation provides Member States with the possibilities to grant other forms of aid, providing an incentive effect to encourage EU shipyards to improve their competitive performance or to ease the process of structural adjustment and mitigate the social repercussions when yards have to close or reorganise their activities. Member States may continue to grant the following types of aid to the shipbuilding industry:

— Aids for environmental protection in line with the general Community guidelines for such aids;

— Aids for research and development in line with the general Community framework for such aids;

— Aids for innovation (maximum aid intensity 10% gross), which are not allowed in any other industrial sectors except (until the end of 2003) the automobile sector;

— Regional investment aid for upgrading and modernising existing yards (but not involving the creation of new capacity), subject to certain caps below the normal regional aid ceilings;

— Aids for rescue and restructuring in line with the general Community guidelines for such aids subject to certain stricter provisions (as regards effective counterparts in terms of genuine and irreversible reductions in capacity, strict monitoring etc);

— Aids for partial and total closures (contingent on genuine and irreversible reductions of capacity).

Unfair Korean competition

Following complaints in 2000 and 2001 from the Community shipbuilding industry about unfair practices carried out in South Korea, the Commission carried out investigations into the behaviour of South Korean yards and the financial support that they had received, directly and indirectly, from the public authorities. These investigations concluded that subsidies and export support had been granted, in contravention of WTO rules, to the benefit of certain South Korean shipyards (1). The investigations concluded that the Community shipbuilding industry suffered adverse effects and serious prejudice as a result of these subsidies and export support. Specifically, it was found that Community industry had suffered material injury in relation to two shiptypes: container ships and product/chemical tankers. For one further shiptype (Liquefied natural gas carriers — LNGs), it was concluded that further examination was necessary before reaching a conclusion.

In light of these practices by the South Korean government and industry, the Commission actively sought a mutually acceptable solution with the South Korean authorities. On 22 June 2000, negotiations between South Korea and the Community led to the signing of the ‘Agreed Minutes’, including the following commitments by the Korean side:

— not to provide bail-outs or public support for yards in difficulty;

— greater transparency in their yards’ accounting systems;

— prices that reflect all factors of costs and include a margin of profit; and

— a consultative mechanism to settle disputes.

Since the signing of the Agreed Minutes, however, progress on their implementation by the Korean side has been wholly inadequate. Further negotiations have failed to lead to improvements, obliging the Community to take a more robust approach. This has resulted in the adoption of the Commission’s twin-track strategy against unfair South Korean practices.

The Community’s Twin-track strategy against South Korean practices

On 27 June 2002 the Council the approved the twin-track strategy proposed by the European Commission to counter unfair Korean practices in the shipbuilding sector. The Council requested the Commission to continue negotiations with South Korea, in a final attempt to find a mutually satisfactory solution to this longstanding issue. Should no solution be found by the end of September 2002, the Commission will immediately launch its twin-track strategy, namely:

— the establishment of a WTO Panel and dispute settlement procedures against the South Korean authorities in relation to the subsidies granted; and

— the activation of the temporary defensive mechanism.

(1) The public versions of the Commission’s investigations are available at the following address: http://europa.eu.int/comm/trade/policy/traderegul/kor_ship.htm
WTO action against South Korea

If no solution is reached with Korea by 30 September 2002, the Commission will inform the Council accordingly and will initiate dispute settlement proceedings against South Korea, by requesting consultations in accordance with the WTO’s Understanding on the Rules and Procedures for the Settlement of Disputes. As fully detailed in the two investigations (see above), the Commission will complain that the subsidies and export support provided to the South Korean industry contravenes the WTO’s Agreement on Subsidies and Countervailing Measures.

It is anticipated that the dispute settlement proceedings will take approximately 18 months to conclude. If the Community’s complaint is successful, South Korea will be obliged to restore normal trading practices in the shipbuilding industry. Failure to observe the WTO ruling would ultimately entitle the Community to take retaliatory measures against South Korea, in the form of countervailing duties against goods imported from South Korea.

The temporary defensive mechanism

The TDM, adopted by the Council on 27 June 2002, entered into force on 3 July 2002. However, in accordance with Article 4, no aid may be authorised under the TDM until the Commission gives notice in the Official Journal that it has initiated dispute settlement proceedings with South Korea. This is because the TDM is designed, primarily, as a tool to encourage South Korea to reach and adequately implement an agreement with the Community to restore normal trading conditions; and to support the WTO action.

This role of the TDM as a support mechanism to WTO action is clearly reflected in its substance:

— Operating aid up to a maximum of 6% of contract value may be authorised only for the two ship types in which Community industry is suffering material injury as a result of unfair Korean practices, namely container ships and product/chemical tankers (Article 2(1));

— LNGs will also be eligible for aid, should the Commission’s further investigations conclude that Community industry is also suffering material injury in this segment

— Aid may only be authorised in relation to contracts for which there has been competition from a Korean shipyard offering a lower price than that offered by the Community yard (Article 2(1));

— The TDM will expire on 31 March 2004, to coincide with the approximate conclusion of the WTO proceedings. Should the WTO proceedings be resolved or suspended before that date, no further aid will be authorised.

As for procedural questions, any aid that a Member State proposes to grant under the TDM must receive Commission approval, either in the form of a scheme, or as ad hoc aid. The State aid procedural regulation (1) will apply in the normal way.

It is clear, therefore, that the TDM is strictly limited in time and scope. It is designed to cover only those ship types most seriously injured by unfair Korean practices and to accompany the Commission’s action in the WTO against Korea. It does not represent the re-introduction of general operating aid and does not undermine the recent progress made in reforming the state aid regime in this industry.

Long-term prospects for the Community industry

In order to improve competitiveness and fair competition in this sector, the Commission, with the support of all the Member States, is taking an active role in negotiations for a new OECD agreement on the respect of normal competitive conditions in the shipbuilding industry. A mandate to create a Special Negotiating Group to bring about normal competitive conditions in the world commercial shipbuilding and repair industry is expected to be approved shortly by the OECD Council. The new agreement shall review and address market distorting factors, in particular government support measures, pricing and other practices which distort normal competitive conditions in the world shipbuilding industry, as well as mechanisms to deal with these.

Furthermore, the Community shipbuilding industry must help itself to become more competitive. It is clear that the long-term strategy for the Community shipbuilding industry should be to continue to improve efficiency and competitiveness, by focussing on, for example, research and development and training. It is now absolutely clear that shipyards can no longer rely on handouts of operating aid from public authorities for their survival.