Regional investment aid to the shipbuilding industry:
How to deal with capacity increases? — Experience with
the Volkswerft Stralsund and Rolandwerft cases (1)

Sabine CROME and Charlotte DUPUIS,
Directorate-General for Competition, unit G-2

1. Introduction

In November and December 2006, the Commission adopted final decisions in the cases Volkswerft Stralsund (2) and Rolandwerft (3). Volkswerft Stralsund and Rolandwerft are two German shipyards located in assisted areas where State aid can be authorised to promote regional development. Germany had notified regional investment aid to these two yards.

Regional aid measures aim at increasing the economic strength of a certain region whose living standard is below average. Among others, this can be achieved through investments involving the setting up of new companies or increasing the production capacity of a company which is already present. Both types of investment are seen to create jobs and to contribute to the economic development of the region.

However, these general rules on regional aid do no apply to the shipbuilding sector. The shipbuilding sector is a cyclical market which regularly faced periods of over-capacity and depressed prices in the past, and also for the future over-capacity issues can be expected. Because of the sector’s high sensitivity, State aid to shipbuilding is governed by a special set of rules, the Framework on State aid to Shipbuilding (“Framework”) (4). This Framework is more restrictive than the general rules on regional investment aid as it allows aid for investments only into upgrading and modernisation and only to improve the productivity of existing installations.

But the Framework does not provide a straightforward answer to the question whether aid for investments which will lead to a capacity increase is under all circumstances prohibited or whether there is a certain degree of flexibility. The previous few cases on regional aid to shipbuilding (5) involved only single investments for which it was apparent that they would have no impact on the capacity of the yard. The Commission could therefore approve the aid without further assessing this point in depth. Volkswerft Stralsund and Rolandwerft were the first cases which involved a higher number of different kinds of investments and for which the impact of the investments on the yards’ capacities and, ultimately, on the outcome of the Commission’s assessment, was not clear.

This article has the purpose to describe the line of assessment which was developed in the context of the two cases. First, the question was analysed whether the Framework prohibits regional aid for investments entailing any form and degree of capacity increases. It was concluded that this was not the case but that a certain degree of flexibility was given.

Second, as concerns the application of this flexibility in practice, the Commission had to define a coherent pattern of analysis which would respect the purpose of the Framework and the realities of the shipbuilding sector. It was decided to structure the assessment into three steps. In a first step, it has to be ascertained that the measure constitutes a modernisation or upgrading aiming at increasing the productivity of the existing installations, as prescribed by the wording of the Framework. In a second step, the effects of the investment on the capacities of the yard have to be evaluated. Finally, in the last step, any detected increase of capacities has to be balanced against the increase of productivity and should be found not to be disproportionate.

The article will end with a brief description of how the developed line of assessment was applied on the two cases Volkswerft Stralsund and Rolandwerft.

(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information provided and the views expressed lies entirely with the authors.
2. No strict prohibition of capacity increases

The central provision for the assessment of regional aid to shipbuilding is Point 26 of the Framework which stipulates that "Regional aid to shipbuilding, ship repair or ship conversion may be deemed to be compatible with the common market only if it fulfils the following conditions: (a) the aid must be granted for investment in upgrading or modernising existing yards, not linked to a financial restructuring of the yard(s) concerned, with the objective of improving the productivity of existing installations [...]".

How is that provision to be read against the background of point 3 of the Framework, following which "[...] the Commission recognises that certain specific factors affecting the shipbuilding sector should be reflected in the Commission's policy of State aid control: (a) over-capacity, depressed prices [...]"? Does this imply that no aid can be authorised for investments that lead to a capacity increase?

Point 3(a) is systematically located in Section 1 of the Framework entitled "Introduction". Point 26 is part of Section 3.3, which contains the specific provisions applying to the shipbuilding industry, i.e. the provisions which deviate from the normal rules. The chapter on the specific provisions is introduced by point 13, which explains that "The general principle outlined in Section 3.2 is subject to the following exceptions, which are justified by the specific factors presented in Section 1."

It can thus be concluded that the fact that the sector, according to Section 1, suffers from over-capacities, finds its expression in the specific rules, among others point 26. Point 26 thus contains all conditions for the granting of regional investment aid to this specific industry. Point 3(a) does not contain an additional condition but merely justifies the restricted rules in point 26 and serves as an interpretation guideline.

This interpretation is further supported by the wording of point 3 which stipulates that it is the Commission’s “policy” which reflects the listed specific factors, in the sense of “policy” as opposed to “the Commission’s case by case decision practice”. Also no express strict prohibition to increase capacities is laid down in point 26. In addition, a strict prohibition to increase capacities would probably not well serve the actual aim of the Framework, namely to strengthen the European yards in the fierce worldwide competition by encouraging productivity increases without encouraging capacity increases.

Finally, a number of investments into productivity automatically lead to an increase of capacity. Where investments aim at producing faster, it is obvious that they may give the yard the opportunity to produce more. However, the Commission should not hinder Community yards from becoming more efficient. On the contrary, point 5(a) of the Framework explicitly mentions as one of the objectives of the Framework to encourage greater efficiency and competitiveness of Community yards.

While the prohibition of any form of capacity increase did not seem justified, it was on the other hand also clear that capacity increases could not be disregarded altogether. It emanates from the wording of point 26 that investment aid should be restricted to measures which improve what already exists. As stated above, point 3 (a) serves as an interpretation guideline for point 26. Point 3 thus provides a justification for the limitation in point 26 by referring inter alia to overcapacities.

The Commission therefore concluded that the Framework does not exclude capacity increases as such. Nevertheless, as required by the wording of point 26, the Commission must ascertain that the investments are for the modernisation and upgrading of an existing yard with the objective of improving the productivity of existing installations. Investments which have as sole objective to increase the capacity of the yard are therefore excluded. For all other investments, the Commission concluded that, where investments led to a capacity increase, it would be necessary to balance this capacity increase against the productivity increase.

3. Eligibility of measures leading to a capacity increase

After having concluded that the Framework did not strictly prohibit the subsidising of measures also leading to capacity increases, but that a balanced approach was the most appropriate way to proceed, the next question was how this balancing would be carried out in practice. To this end, the first crucial step is to make sure that the purpose and the effect of the investment is to strengthen the competitiveness of the yard by improving its productivity. In the second step, the effect of the investment on the capacity of the yard has to be evaluated. And, quite logically, in the third step, both have to be weighed against each other.

a) Improving the productivity of existing installations

Point 26 prescribes that only "investment [...] with the objective of improving the productivity of exist-
"installations" can be eligible. The background to this criterion is the sensitivity of the world market for shipbuilding where competition, in particular from Asia, is fierce and recurrent overcapacities regularly lead to a sharp drop in prices. Until today, the strength of the European shipbuilding industry lies in its high degree of quality and specialisation. To maintain its competitiveness the European shipbuilding industry should further build up on quality (instead of quantity). Therefore only investments into further modernisation and upgrading which improve the productivity of the yards should be encouraged through State support and not the mere setting-up of additional capacity. As a first assessment step, the Commission must therefore ascertain that each investment notified fulfils this condition.

To be able to analyse whether this precondition is fulfilled, it was first necessary to clarify the notion of “installation”, or more precisely, to define at which level “installations” should be considered. At a level of greater detail, an installation would be for instance some machine in a production line, a crane or a rail track. At a broader level, an installation could be a panel production line or a fitting quay etc. It was concluded that a narrow approach would not be justified. Adopting a narrow approach could result in excluding from eligibility investments that increase the productivity of the production process as such but are no investments in the single installations already existing on the yard. An example would be the purchase of an automatic welding machine to replace manual welding which would have no impact on the productivity of the other machines. Such limitation would put an unjustified obstacle to these investments even if they had the effect to render the yard concerned more competitive. However, considering installations at an even broader level than explained above would not make sense because it would practically mean to equal “existing installations” with “existing yards”, whereas the Framework clearly makes a difference between the two. It was thus concluded that the most appropriate level would be the aggregate intermediate level of an installation as serving a specific production step.

Second, it should be noted that the regional aid provision of the Framework does not explicitly require that, in order to be eligible, investments have to concern directly existing installations. Instead the requirement is that the investments have to be into existing yards and the objective of the investments has to be an increase of the productivity of existing installations. One could imagine a situation where investments into new installations do increase the productivity of other, existing installations. This can happen in case of installations with idle capacities because of other bottlenecks in previous production steps. An example would be a panel construction line with a capacity of x, with a subsequent section construction line of a capacity of 2x. The section construction line would only work at half capacity. The construction of a second panel construction line would be considered a new installation (at an existing yard). It would however enable the yard to use its section construction line at full capacity and thus increase the productivity of this existing installation.

Where an investment in a new installation has no positive impact on the productivity of the existing installations, the situation is clear: a regional investment aid would not be covered by the Framework.

b) Assessment of capacity increases

If the condition of the improvement of productivity is fulfilled, the Commission will look more closely at the effect of the measure on the yard’s capacity. However, assessment experience shows that capacity measurements in figures are no straightforward exercise. It should therefore be clarified in which cases an in depth assessment of capacity changes is really required.

A first conclusion which was drawn in this respect concerned capacity increases which are the direct result of productivity increases. As already explained above, investments which enable specific installations to produce faster may have as direct consequence that the yard can produce more (6). However, since the main aim of the Framework is to increase the productivity of the yard, such type of directly linked and “unavoidable” capacity increases do seem acceptable. Therefore, this type of capacity increases is not normally further evaluated and balanced against the productivity increase (unless there would be indications hinting at a disproportionality of the capacity increase).

Second, the assessment of the single investments in the two cases Volkswerft Stralsund and Rolandswerf showed that a distinction can normally be made between investments into existing installations and investments into new installations.

An investment into an existing installation, which has the aim to increase the productivity of this installation, is normally less likely to increase the yard’s capacity (apart from capacity increases which are a direct result of the productivity

(6) This requires that there are no other bottlenecks in the yard which would hinder an overall speeding up of the production.
increase). The production facility already exists and it is merely "modernised" or "upgraded". This is precisely what the Framework aims at. It thus appears that no in depth balancing test would normally be necessary for investments into existing installations either, unless there are doubts on the proportionality of the capacity increase.

The case is different for an investment into new installations. Even if such an investment increases the productivity of existing installations, it consists in setting up new facilities and is more likely to enable the yard to (significantly) increase its production. In how far these new facilities will additionally increase the capacity of the yard in general can only be assessed on a case by case basis. As experience in the Rolandwerft case shows (see below), the assessment here can go quite into the details of the yard's technical possibilities to increase its activities.

c) Balancing of capacity increase against productivity increase

It should always be excluded that the capacity increase of the yard would be disproportionate in relation to the productivity increase. In practice, as a consequence of the explanations above, no in depth balancing will normally be necessary where the capacity increase is the direct result of the productivity increase or where the investment is done in an existing installation.

A substantial balancing should normally be carried out where the investment sets up new installations on the yard. However, in the existing decision practice, the Commission so far did not need to fully apply such a proportionality test. For the most controversial investment in the Rolandwerft case — the construction of an additional fitting quay — an increase of capacity could be excluded, such that proportionality did not have to be assessed anymore. In the Volkswerft Stralsund case no capacity increase measured in annual output of ships (taking into account the size of the ships) was found. Only the steel processing capacity of the yard increased slightly. No experience is thus so far available concerning the precise determination of "disproportionate".

4. What does this approach mean in practice: the Volkswerft Stralsund and Rolandwerft cases

Volkswerft Stralsund

The investment project of Volkswerft Stralsund concerned the modernisation and rationalisation of the yard to allow the yard to efficiently build a larger type of vessels, the so-called "panamax vessels". It comprised investments into existing installations (prolongation of the existing ship lift to be able to lift larger ships, enlargement of two of the four already existing cells of the conservation facilities) as well as investments into new installations (construction of a new production line for panels and for section parts and construction of four additional sites for section construction).

The Commission concluded that the project would improve the productivity of the yard and its existing installations as it would enable the yard to assemble panamax vessels from larger sections than before, thus increasing efficiency and competitiveness of the yard.

Nevertheless, as the investment project also comprised investments into new installations, in a second step it was necessary to assess the impact of the investments on the capacity of the yard and to balance any potential capacity increase against the productivity increase. It was found that the capacity of the yard measured in annual output of ships (taking into account the larger size of the ships) would not increase. The capacity of the yard measured in tons of steel processed per working hour would increase. However, the Commission concluded that this increase in steel processing capacity was a side effect of the productivity improvements and that it would not be disproportionate to the achieved productivity increases.

Rolandwerft

In the case Rolandwerft, most of the investments concerned existing installations, they increased the productivity of the installations and any potential capacity increase would have been the direct result of the productivity increase. The measures could therefore be approved without any deeper assessment.

A much more detailed analysis was required for an investment into the construction of a new equipping quay. Before the implementation of the investment project, Rolandwerft had equipped two ships in parallel on the same fitting quay. The first ship was berthed directly at the quay side and equipped by using the quay equipment. The second ship, which was berthed alongside the first ship, was equipped from the water side by using rented swimming cranes and from the quay side by crossing the first ship. The notified investment foresaw the construction of a new equipping quay so that it would not be necessary anymore to equip two ships berthed in parallel on the first fitting quay.

The Commission concluded that the second quay would increase the productivity of the first quay
and that the condition of improving the productivity of an existing installation would be fulfilled (7).

As regards the question whether the investment concerned an existing installation, Germany brought forward the argument that the second berth should be qualified as an existing second equipping quay which would merely be relocated. However, as there were hardly any existing physical installations for this second “quay”, the Commission concluded that it could not be considered as an existing installation. A second argument brought forward was that the investment into the installations for equipping a second ship on this quay merely constituted a prolongation of the existing quay. In the end, it was not necessary to determine whether the investment should be regarded as an investment into an existing installation or into a new installation as it was concluded that the investment in any event would not result in a capacity increase.

As regards the analysis of the effects of the investment on the capacities of the yard, the Commission carried out a separate analysis for each type of shipbuilding activity of Rolandwerft, i.e. new-building, ship repair/conversion and equipping of prefabricated hulls. The question was assessed against the specific history of the yard, which has always equipped two ships at the same time. Originally, two smaller ships were equipped at the quay, but when the yard began to build bigger ships, the quay became too short and the second ship was shifted on the “parallel” berth. The Commission therefore concluded that the equipping of a second ship was not only an occasional activity, and that the capacities of the yard before the investments also include the equipping of a second ship. On this basis, it could be excluded, for each of the shipbuilding activities, that the yard would be able to use the second quay to increase its capacity: the construction installations in preceding stages were already used at full capacity and therefore represented a bottleneck for an increase of the activities on the quays. Outsourcing with the aim to equip prefabricated hulls was not possible for technical reasons either. It was also verified that the yard would not be able, through a simple further investment, to remove the bottleneck. The aid could therefore be approved without having to carry out a balancing exercise.

5. Conclusion

The cases Volkswerft Stralsund and Rolandwerft obliged the Commission to reflect upon its assessment line when dealing with cases where investments increase the yard’s capacities. An essential conclusion was that it is, as a general principle, necessary to see any capacity increase in relation to the productivity increase achieved through the investment and to assess whether a capacity increase would be disproportionate in relation to the productivity increase. The aid would then not be allowed. In practice however such detailed analysis seems only necessary in a limited number of cases. For investments in existing installations it is normally possible to assume that they will not lead to a disproportionate capacity increase as no new facilities will be set up. But, as Rolandwerft showed, as soon as there are doubts as to the qualification of an installation as existing or new, a more detailed assessment of the impact of the investments on the yard’s capacity cannot be avoided.

(7) One crane system for both ships was set up, the new crane would facilitate the lifting of charges also on the first quay and works on the first ship would not be impeded anymore by having to cross it for works on the second ship.