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REPORT FROM THE COMMISSION TO THE COUNCIL
on Steel re-balancing action

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1. INTRODUCTION

Article 3 of Council Regulation (EC) No 1031/2002 of 13 June 2002 establishing additional customs duties on imports of certain products originating in the United States of America¹ requests the Commission to present a report on "the state of discussions with the USA, in particular on the issue of product exclusions and on trade compensation ...".

In the light of the delays in US decision making on the so called "exclusions" (of products from the safeguard measures) the Commission will only be in a position to present its recommendations on this important issue, including necessary proposal later this week.

As essential background, this report presents the impact of US steel safeguards on US and world markets (2) and a state of play on WTO dispute settlement, including envisaged timing (3). This report then assesses the current state of play on product exclusions (4) and on compensations (5).

2. THE IMPACT OF US STEEL SAFEGUARDS ON US AND WORLD MARKETS

When the US safeguards were announced on 5 March, President Bush said "The U.S. steel industry must use the temporary help today's action provides to restructure and ensure its long-term competitiveness." This section examines the impact of these measures on the US steel market, the likelihood of restructuring, and the consequences that will follow the withdrawal of these measures after the WTO ruling. **It concludes that the safeguards are producing very large artificial price increases, thereby encouraging the maintenance of uneconomic capacity and that withdrawal next year will cause further market disruption. Paradoxically, by any yardstick it is the US economy (in particular steel users) and the international and domestic reputation of US trade policy that have suffered from the adoption of these measures, whereas the economic impact outside the US and on the EU has been so far more limited.**

2.1. The impact of the US steel safeguard on the US market

2.1.1. *Impact of Safeguard on US steel prices*

The ITC recommendation in December and the Presidential announcement of steel safeguards on 5 March have had a dramatic impact on US steel prices. Hot rolled coil prices for delivery in the third quarter of this year are more than 20 per cent up on prices in the first quarter and over 40 per cent higher than those of the third quarter of 2001.

Such a substantial price increase is even more remarkable given that US steel prices were already significantly higher than those in the rest of the world (an average of around 9 per cent higher than EU prices over the period 1995 to 2001 and somewhat over 9 per cent in the

¹ OJ L157, 15.06.2002, p.8.

last quarter of 2001). Similarly, in October 2001, US prices were higher than Japanese prices by between 10 (quarto plate) and 50 (wire rod) per cent

2.1.2. Other factors tending to maintain uneconomic US production

The ability to maintain prices consistently in excess of world levels can be accounted for in part by the high level of protection already enjoyed by the US steel industry. It is estimated that there are in excess of 200 anti-dumping and anti-subsidy measures covering this sector, which both discourage competition from imports and put upward pressure on prices.

In addition, and contrary to the impression that is often given by the United States, US steel firms receive a wide range of federal, regional and local subsidies. According to a comprehensive study published in 1999², “the steel lobby has won at least \$16 billion (\$21.8 billion in constant 1999 dollars) in federal subsidies for domestic steel makers from US taxpayers with additional billions received from state and local governments.” These subsidies include pension bailouts, tax refunds and loopholes, environmental regulation exemption subsidies, “Buy America” requirements and emergency loan guarantee schemes.

A necessarily partial survey of publicly available information reveals at least six US steel firms receiving Federal and/or State assistance this year, including a \$250 million Federal loan guarantee, a grant of \$30 million from State governments and a variety of tax breaks as well as a State guarantee to a local utility company to ensure that it recovered the costs of providing the power supply for a proposed new electric furnace.

2.1.3. Impact of high prices on US production

Although more than 30 US steel companies are in one or other form of bankruptcy, most have continued producing steel. In addition, recent price increases have meant that a certain number of mothballed facilities (including parts of the former LTV group) have restarted or plan to do so in the near future. In addition, there are examples of firms planning to upgrade or expand their capacity. By the end of the year, we might expect to see a return to the market of LTV (4-6 million tons), Trico (1.5 million tons) and possibly other mills currently in bankruptcy.

So far, US crude steel production this year has been broadly comparable to that of 2001. As additional plants start or increase production in response to the higher prices, there could well be a moderate decline (some \$40 – 60) in price levels over the coming months. And a more dramatic drop in prices - in other words, a rapid reversal of the “bubble” element of the current price levels - cannot be excluded. Such estimates are, of course, averages and price reductions will vary considerably from product to product and to some extent from producer to producer. In particular, as sheet prices have risen far more than those for plate or long products, they may be more vulnerable to a reversal.

Further downward pressure on prices may arise from the decision of US firms that use steel as an input to move production offshore in response to the higher prices and section 201 additional tariffs. The extent of this delocalisation will depend on the number of product exclusions that are granted for types of steel that are not available from US domestic producers. Demand factors will also be relevant. At present, automobile production appears to

² “Paying the Price for Big Steel” by William H Barringer and Kenneth J Pierce (American Institute for International Steel)

be holding up, but construction is in decline. Given uncertainty about developments in both the currency and equity markets, forecasts are more than usually hazardous.

2.1.4. Impact of the elimination of the US steel safeguards on the US market

We expect the WTO dispute settlement process to result in a definitive ruling against the US safeguard measures in the second half of next year, likely around August. Following this, either the measures will be withdrawn or Article 4 of Council Regulation (EC) No 1031/2002 of 13 June 2002 will automatically come into effect. This would mean additional duties on certain products imported from the United States with a value of \$2.2 billion. Faced with this alternative, it is to be expected that the US Administration will chose to conform to their WTO obligations and withdrawn the steel safeguards.

The withdrawal of these protectionist measures and a consequent increase in imports, at a time when US steel prices are already likely to be on a downward trend, could lead to anything from a further significant decline to a collapse in prices. Either would pose, in a very acute form, the question of whether US firms - particularly but not exclusively those that had added capacity during the period of high prices - could be viable at price levels close to or even below those experienced in EU or far eastern markets.

In summary, it can be seen that, although the US Administration promoted its policy as offering the industry short-term protection, enabling it to restructure and improve its competitiveness, the effect has been to reduce the incentive to take difficult decisions such as closing uneconomic plants. **Indeed one could say that the effects of the measures are almost precisely the reverse of the stated objectives.**

In the longer term, when the price bubble bursts, the situation will deteriorate further. Some time in the second half of next year we are likely to see yet another repetition of the “steel industry crisis” that has occurred every three to five years. No doubt, as in the past, such a crisis will lead to calls for yet more protectionism, including WTO illegal use of antidumping and countervailing duty measures. However, the cycle will only be broken if the US authorities and industry are willing to address the underlying issues, notably the problem of uneconomic capacity and market distortions.

2.1.5. US Competitiveness

Over the past twenty or thirty years integrated steel producers in high wage economies have faced increasing competition from, on the one side, mini mills exploiting technological advances to produce steel more cheaply and, on the other, firms located in developing or transitional economies whose labour costs are significantly lower. Successful integrated producers have responded by improving their own technology, focusing on higher quality products and being extremely responsive to their customers’ requirements. In many cases, this has involved mergers and rationalisation to create larger, international companies, which are better able to exploit economies of scale.

By contrast, the large, integrated U.S. steel producers have been in structural decline over this period in the face of intense competition from their domestic mini-mills, which, using much smaller scale plants with electric arc furnaces, have grown from 10 to more than 50 million tons of capacity. Thus, in considering the US steel industry’s competitiveness and the need for restructuring, it is essential to draw a clear distinction between what, in reality, are two very different industries.

Table 1

Estimated Pretax Cost of production for Sheet Products, 1998 and 2000 (\$ per Metric Tonne)

Producer	March 1998	April 2000
Japanese Integrated Firms	474	496
U.S. Integrated Firms	483	481
German Integrated Firms	467	440
Brazil	441	389
South Korea	336	378
U.S. Mini-mills	394	376
Former Soviet Republics	331	283

Source: World Steel Dynamics, *Steel Strategist* #24, June 1998 and *Steel Strategist* #26, July 2000.

Another way of expressing this point is looking at the hourly labour required to produce a net ton of steel. On this basis, US minimills need approximately one hour with Steel Dynamics Inc. currently claiming to need only 0.4 worker-hours to produce a ton of steel. By contrast US integrated producers need 3-4 worker-hours to produce a ton of steel. In 2001 US Steel used 3.1 worker-hours to produce a ton of steel.

The cost of production as described is not, however, the only element with an impact on US competitiveness. What makes the situation acutely difficult is the additional problem for many of the large integrated US producers which, to be profitable, are obliged to recover the costs not only of their existing workforce, but also the pension and health care costs of former employees (the so-called “legacy costs”). In effect, this means that these companies need to be more efficient (in terms of worker-hours per ton of steel) if they are to compete with firms that do not have such burdens of the past. In addition, these legacy costs have acted as a barrier to merger; as a result there is no US company amongst the world’s largest steel firms.

Finally, one might draw on the points explained in the preceding sections to note that a large proportion of US integrated steel firms are in financial difficulties despite the fact that they are benefiting from steel prices that are significantly higher than those on offer in the rest of the world. This might be seen as providing yet another reason to conclude that many such firms are high cost producers that would have great difficulty in withstanding the significant fall in prices that is likely to follow the WTO ruling.

2.2. Proliferation of safeguard measures in other markets

The taking of protectionist safeguard measures on a large spectrum of steel products by the USA has triggered chain reactions around the world, where the relevant authorities and steel industries fear to see the already severe impact of those measures on their business due to a decrease in their exports to the US market, increased by trade diversion to their own market.

Canada, China, Chile, the Czech Republic, Hungary, Mexico, Poland, Bulgaria and Romania have initiated or are in the process of initiating safeguards investigations. In addition, China and Hungary have imposed provisional safeguard measures.. It is again important to recall that all these investigations are, at least ostensibly, linked to the imposition of measures in the US.

2.3. The OECD process

The OECD high level steel dialogue, which held its first meeting in September 2001, aimed at finding an agreed multilateral approach to the underlying problems of the world steel market - the existence of uneconomic capacity encouraged by subsidies and other distorting policies. Although this process proved to be insufficient to resist the political pressure within the United States for unilateral protectionist action, the safeguard measures will do nothing to addressing the underlying problems and, to some extent, will actually add to them.

Whilst recognising the difficulties inherent in seeking an international steel agreement, the Commission intends to continue participating actively in the OECD discussions and any other forum that might address these issues. It believes that such an agreement would need to address subsidies from all levels of government, that a monitoring mechanism should be set up to enforce this, and that participants in the agreement should agree not take trade defence measures against each other's steel imports. To be successful this will require a willingness on behalf of all participating governments, including that of the US, to contribute by making politically difficult choices. The current exercise has been unsuccessful in doing so, largely because the US was seen as only paying lipservice to it.

3. STATE OF PLAY ON WTO DISPUTE SETTLEMENT, INCLUDING ENVISAGED TIMING

In response to the US steel safeguards, a coalition involving the EC, Japan, Korea, China, Switzerland, Norway, New-Zealand and Brazil has engaged WTO dispute settlement procedures against the US.

As a first step, joint consultations held on 11-12 April 2002 demonstrated that the US measures are really a matter of major concern for all the players on the global steel market. These joint consultations revealed that all the complainants raise highly similar claims against the US safeguard action³.

As a second step, because these consultations have failed to solve the dispute, a single Panel was established against the US steel safeguards pursuant to Article 9.1 of the DSU (with the same Panelists and timeframe), following the requests presented by the EC on 3 June 2002, Japan and Korea on 14 June 2002, China, Switzerland and Norway on 24 June 2002 and New Zealand on 8 July 2002. Brazil should join this Panel later in July.

³ These claims include a violation of the precondition of "unforeseen developments" laid down in Article XIX GATT; a lack of increased imports, as required by Article 2.1 SA; an incorrect definition of the domestic industries that produce like products, as required by Articles 2.1 and 4.2(a) in conjunction with Article 4.1(c) SA; a lack of serious injury or threat thereof serious injury, as required by Articles 2.1 and 4.2(a) SA; an absence of causal link between imports and serious injury or threat thereof, as required by Articles 2.1 and 4.2(b) SA; a breach of the proportionality principle set forth in Article 5.1 SA; a lack of parallelism between the scope of the safeguard investigation and the scope of the safeguard measures; inadequate setting forth of the findings of facts and law in the various documents underlying the US decision, as required by Article 3.1 SA.

As regards the next steps, the Panel should be composed by the end of July 2002, the Panel report should be issued in April 2003 and the Appellate Body Report should be circulated in September 2003.

Once the dispute settlement proceedings have been concluded, as set forth in Article 4 of Regulation (EC) No. 1031/2002, five days after the adoption by the Dispute Settlement Body of the Report condemning the US measures, additional duties listed in Annex II to that Regulation will apply automatically.

Such automatic application of re-balancing measures is meant to ensure the immediate termination of the US measures after their condemnation in WTO and to avoid delayed withdrawal of US illegal safeguards which has systematically occurred in past cases. In this regard, the US safeguard measure on Line Pipe, found inconsistent with WTO rules in February 2002, is still in force. The EU and other trading partners are facing an increasingly unpredictable US trade policy. The Council's decision to apply rebalancing action automatically next year is therefore of great importance, not only in order to protect EU steel interests, but more widely to make such systematic, but still unpredictable, recourse to WTO illegal measures a costly proposition.

4. ASSESSMENT OF THE STATE OF PLAY ON PRODUCT EXCLUSIONS

As part of the ITC investigation, firms were able to request that certain products be excluded from any safeguard remedy. As a result, some product exclusions were included in the 5 March 2002 Presidential Proclamation and a further, very limited, number were announced on 5 April 2002. These exclusions are best regarded as part of the initial safeguard measures and should therefore be distinguished from the subsequent exclusion process, which reduces the impact of those measures.

Requests made during the investigation, or before the deadline of 23 April 2002 ("first round" requests) were allocated "X-numbers". Subsequent, "second round" requests, made by the deadline of 20 May, were allocated "N-numbers". 150 N numbers were published on 5 June, 134 on 14 June, 135 on 19 June, 131 on 27 June and a further 82 on 8 July. In total, over 1 200 requests are said to have been made.

The US authorities' stated intention was to grant only those exclusions "that do not undermine the objectives of the safeguard measure". They said that they would take into account factors such as whether the item is currently being produced in the United States; whether it is available in sufficient quantities from domestic sources; whether substitution of the product is possible; the level of inventories; and whether the requested product is under development by a U.S. producer who will imminently be able to produce it in marketable quantities.

During this assessment process, US producers have been given the opportunity to submit comments and objections. It would appear that such objections have been given considerable weight in reaching the final decision and that relatively few significant exemptions have been granted in the face of firm opposition from the domestic industry. In addition, certain European companies have complained that the US authorities have failed to register, or have ignored, without any explanation, some of their formal requests for exclusions.

Four exclusion lists, made up of a total of 247 product exclusions, have been announced, on 7, 17 and 24 June and on 11 July. About 150 of these exemptions have been granted either directly to European companies, or to US steel consumers purchasing their needs to European

companies. It is estimated that, up until 11 July, this exemption process has reduced the impact of the initial safeguard measures on EU steel producers by some \$230 million. By comparison, those measures originally hit European exports to the US worth around \$2.3 billion.

The total excluded quantities represent approximately 330 000 metric tonnes, whilst the total of the requests presented by EU companies exceeds 2.7 million tonnes (although it is possible that there is a certain element of double counting in these requests).

Total EU exports	First list 7 June 2002	Second list 17 June 2002	Third list 24 June 2002	Fourth list 11 July 2002	Total
Metric tonnes	150 000	60 000	80 000	40 000	330 000
(* millions US \$)	100	45	55	30	230

Whilst a number of small, specialist companies have had most or virtually all their requests accepted, the share of acceptance for the larger companies is typically in a range between 5 and 15 per cent. In some cases, however, lower acceptance rates reflects late filing of requests and so may not be a reliable indication of the final outcome.

Moreover, a number of caveats should be recognised:

- exemptions are for products, not for particular companies. It is therefore far from certain that a European firm will gain the full benefit from a particular exemption even if it has made the request. This is a particular problem when “first come first served” quotas limit the exemption;
- quota limits for some product exemptions will only be determined at a later stage. European companies might therefore only benefit on a fraction of the quantities requested;
- companies report that some exemptions have been granted in such limited quantities or for such a limited range of products that they will be unable to take advantage of them. In some cases the exemption is so restricted that it will not be attractive to the steel using company. For example, it makes little sense for an American company to take advantage of an exemption to buy one very specialist type of steel if it has to pay the full safeguard tariffs on other similar types of steel that it needs. In other cases, the fixed costs of producing a specialist product are such that it would not be economic only to manufacture the limited quantity benefiting from an exclusion;
- some requests have been tabled by US consumers and the identity of their main supplier is not always known. Moreover, the Commission services might not have been able to identify certain request originating from certain highly specialised European companies producing niche products.

In theory, all the X-number requests should have been dealt with by 3 July although, in practice, this deadline proved to be non-binding whilst certain N-number requests were moved up the queue. On 3 July, a Presidential Proclamation set a new deadline on 31 August 2002 to consider pending exclusion requests.

5. STATE OF PLAY OF DISCUSSIONS WITH THE US ON COMPENSATION

The issue of compensation under Article 8 SA does not only arise in the specific case of the US steel safeguards but is really of systemic nature. The requirement to maintain a substantially equivalent level of concessions between Members applying safeguard measures and exporting Members affected by these measures is the cornerstone of the Safeguards agreement.

Members applying safeguard measures have to provide adequate trade compensation for the adverse effect of their measures, otherwise exporting Members affected by these measures are entitled to suspend substantially equivalent concessions vis-à-vis the Members concerned. Suspension of concessions can apply as soon as violations of WTO rules have been found through Panel and/or Appellate Body procedures and without delay against safeguard actions which have not been based on an absolute increase in imports.

In the ongoing discussion with the US, the EC has indicated its expectations in terms of trade compensation to the US that tariff reductions should be agreed for products where the EC is principal or substantial supplier, for a total amount of duty reduction equivalent to the amount of duty collected through the application of tariff increases imposed by the US on average EC steel exports in 1999-2001.

In addition to methodological questions, discussions with the US have allowed clarification of the US domestic process to present a compensation offer. Thus, the US President has the authority to decide trade compensation under Section 123 and 131 of the 1974 Trade Act in the form of tariff reductions limited to 30% and after consultation of the ITC, which has 90 days to deliver its recommendation.

The US has not accepted so far the principle that it should offer compensation in the form of tariff reductions in other products than steel. In part, this is due to differences on the interpretation of the provisions of Article 8 SA. It should be noted, however, that any interpretation of Article 8 SA, which would allow WTO Members to implement safeguard measures without facing any consequence before the Appellate Body has ruled on their safeguard actions even if there has been no absolute increase in imports, would inevitably lead to systemic abuse of safeguard action.

Therefore, the Commission considers that even the US should have a long term interest in avoiding an interpretation of Article 8 SA that leads to a proliferation of safeguard actions.

6. CONCLUSIONS

As a conclusion of this report, the Commission wishes to highlight the following:

- WTO dispute settlement is expected to result in a ruling on the illegality of the US safeguard action at around September of 2003. The automatic application of the long list of rebalancing measures upon a negative WTO ruling - as provided in Article 4 of Council Regulation 1031/2002 - is the best guarantee that the illegal safeguard measures should be terminated immediately upon a WTO ruling.
- The US steel safeguard is having a significant negative impact on the US economy (in particular for steel users), whereas the impact outside the US and in the EU has been so far more limited. Upon termination of the steel safeguard, it can be expected that the absence of US restructuring, together with a potential collapse in prices, would result in a new

crisis affecting the US steel industry. Therefore, a broad international initiative should be envisaged to tackle the difficulties faced by the world steel industry.

- The product exclusions granted so far by the US have been manifestly insufficient. Many pending requests would allow steel users to have access to products, which are either purchased in small quantities, at low quality or high cost from US steel makers, thereby limiting the negative impact of the steel safeguards on the US economy and on EU exports.
- The issue of compensation remains of great systemic importance to avoid abuse of safeguard action. Discussions with the US on compensation are ongoing, although so far the US has not accepted the principle that it should offer compensation in the form of tariff reductions in other products than steel. The Commission considers that even the US should have a long term interest on avoiding an interpretation of Article 8 of the Safeguard agreement that leads to a proliferation of safeguard actions.

In the light of the elements above, the Commission will present recommendations, including any necessary proposal.