FRESHFIELDS BRUCKHAUS DERINGER

Autumn 2004

Automotive update

Contents

EU

Proposed removal of design protection for car spare parts

The European Commission is proposing to amend the Designs Directive (98/71) to remove member states' option to maintain registered design protection for visible, 'must-match' replacement parts for cars. The aim is to harmonise the design protection regime and complete the internal market, increase legal certainty, increase competition, widen choice and reduce prices. Only nine member states (including the UK) do not allow design protection for spare parts. France and Germany are among those who do allow it, and they have been trying to prevent the proposal being adopted.

Article 14 of the Directive provides that existing laws covering the use of a component part for repair of a complex product to restore its original appearance may only be changed to liberalise the market for such parts (the 'freeze plus' provision). Article 18 requires the Commission to have submitted an analysis of the consequences of the Directive by October 2004 and, by October 2005, to propose any changes needed, including those 'to complete the internal market in respect of component parts of complex products'. The Commission is proposing the revision relatively early (but after full consultation). It says it believes this is the right time because it has proved impossible to reach a voluntary agreement within the industry. Also, it is a logical consequence of the changes to the competition rules (block exemption regulation) for car dealerships.

The removal of design protection for car spare parts will have strong effects on a market that is believed to be worth more than €40bn. Supporters of the liberalisation say that the removal will affect at least 25 per cent of this market, whereas car producers believe that the affected part of the market will be much smaller (around 5 per cent). The Commission is hoping to foster price cuts in many EU countries for the most affected parts such as body panels, auto glazing and lighting. For bumpers, doors, wings, lamps, lids and bonnets, prices were reportedly between 6.4 per cent and 10.3 per cent higher in member states where design protection for these parts still exists. The Commission also believes that the liberalisation will help to create new jobs in the spare parts industry as parts manufacturers would not only be able to produce parts for supplying important home/export markets in the EU but would also gain access to the market of imported cars (which makes up 15 per cent of the EU car market).

The proposal is part of the Commission's initiative to increase competition in the automotive after market. In its Block Exemption Regulation for Car Dealerships 2002, suppliers of original spare parts were granted the right to market such parts parallel to the supply chain with the car manufacturers. Trade patterns in the automotive parts distribution have already changed because of the Commission's initiative. This development would certainly be reinforced for replacement parts if the Commission's proposal to amend the Design Directive is to be implemented.

For further information contact Matthias Koch T +49 221 20 50 71 36.

CHINA

Automotive Industry Development Policy

A new Automotive Industry Development Policy (the new auto policy) was recently issued by China's State Development and Reform Commission, replacing the previous automotive policy promulgated in 1994. The main goals of the new policy are to satisfy domestic demand; encourage industry consolidation; increase the technology levels in the industry; promote environmentally friendly vehicles; and eventually make China's automotive industry globally competitive. The main points of the new auto policy include the following:

- The new auto policy encourages industry consolidation in vehicle manufacturing in order to take advantage of economies of scale. The goal is to create a small number of large automotive groups that can compete globally. The new policy defines large automotive groups as those having a 15 per cent domestic market share either in terms of sales or volume.
- Foreign ownership of vehicle joint ventures continues to be capped at 50 per cent under the new auto policy. Exceptions exist for export-oriented vehicle joint ventures established in free trade zones.
- Foreign investors are still limited to establishing a maximum of two vehicle joint ventures in each category (passenger, commercial and motorcycle). Furthermore, the limitation extends to foreign investors that are under the same control. For example, Ford and Jaguar would not be permitted to each establish two vehicle joint ventures. However, the new auto policy allows each joint venture to establish an unlimited number of subsidiaries. The purpose of this is to encourage these joint ventures to acquire the numerous smaller automotive manufacturers in the Chinese market.
- The new auto policy raises the entry barriers for vehicle manufacturers, setting higher minimum investment amounts for new vehicle manufacturers, and requiring them to have research and development centres.
- In an effort to prevent a proliferation of poorly planned investments, the new auto policy bans non-automotive makers, non-motorcycle makers and private investors from acquiring troubled vehicle manufacturers. The intent is to compel troubled vehicle manufacturers to sell out to one of the large automotive groups.
- The previous 1994 policy encouraged automotive manufacturers to purchase certain percentages of domestically manufactured parts. The new policy has eliminated these local content requirements.
- Earlier drafts of the new auto policy had set an export target of 40 per cent for domestically produced automotive parts by 2010. This target has been deleted from the new auto policy.
- The new policy prohibits the import of used products and parts, and places restrictions on the importation of knockdown kits.
- By 2005 automobile, motorcycle, engine and parts manufacturers are required to place their registered trade marks prominently on their products. This measure is intended to help improve the quality of the products on the market by prohibiting knock-off non-branded products.
- There was a controversial provision in earlier drafts of the new policy, which stated that by 2010, 50 per cent of the vehicles sold in China must consist of vehicles whose technology is fully Chinese-owned, rather than technology that is licensed from foreign manufacturers. This provision was deleted from the new auto policy. On the surface, the provision had the laudatory purpose of encouraging domestic manufacturers to uplift their technology. However, foreign manufacturers objected to the provision because they felt that if Chinese domestic manufacturers were still not capable of selling sufficient quantities of fully domestic technology vehicles by 2010, the government might attempt to force foreign manufacturers to turn over their technology to the domestic manufacturers as a condition to staying in the Chinese market.
- Automobile, motorcycle, engine and parts and components manufacturers are encouraged to develop R&D centres. Tax incentives will be offered under the new auto policy for R&D activities that comply with China's technology policy, which includes both developing independent technology and combining imported technology with independently developed technology.
- The new auto policy requires dealers to obtain sales licences from the manufacturer. The goal is to formalise distribution channels and discourage the

currently fragmented grey market.
- The new policy encourages environmental protection, requiring that the average fuel consumption of newly assembled passenger vehicles be reduced by at least 15 per cent on 2003 levels by 2010. Hybrid-powered automobiles will be encouraged. Furthermore, it has been recently reported that the State Environmental Protection Administration will forbid the manufacture, sale and export of vehicles that do not meet Euro II standards after July 2005 and is considering requiring compliance with Euro III standards nationwide by 2008.

The new auto policy is not strictly speaking a 'law' but only a statement of national policy issued by the State Development and Reform Commission (SDRC), China's macro-economic policy-making body. The SDRC will be dependent on other government entities to come up with and put into effect the concrete steps necessary to implement the goals of the new policy. However, this process has begun, as China's ministries and lower level government authorities have already begun issuing some of the regulations and rules necessary to bring into effect various aspects of the new policy, and this process is expected to continue.

For further information contact Carl Cheng T +8621 5049 1118.

SLOVAKIA

Magnet for automotive sector companies

Automotive suppliers keen to be near to large customers have recently been flocking to Slovakia, which has been successful in attracting large automotive manufacturers such as Volkswagen, PSA Peugeot and Kia Motors. The most recent example is the announcement by US supplier Johnson Controls to invest up to $26m to build a new technical centre in Slovakia in the next few years.

Despite being a small and relatively less developed European country (having a population of only 5.3m), Slovakia's success continues unabated. One of the most important, if not the key reason, is the abundance of cheap but qualified labour. Historically, Slovakia's economy and education systems have focused on the heavy machinery industry. Labour strife is uncommon. Labour unions, though present in most companies, traditionally have not played any sort of antagonistic role and strikes are quite rare.

Slovakia also benefits from being located in the geographical heart of Europe, with direct access to western Europe, other central European countries and the region further east including the Ukraine. This allows for short transportation routes in serving neighbouring markets.

Another magnet for automotive companies is governmental policy aimed at establishing a competitive, free-market business environment. Taxation is extremely low. There has been a flat income and corporate tax rate of 19 per cent as well as a VAT rate of 19 per cent since the beginning of 2004; there is no dividend tax; and there is a very low land transfer tax. The legislative framework also allows for a flexible labour market. Furthermore, the importance of Slovakia's accession to the EU and NATO also cannot be underestimated. Compared to other countries in the region, such as the Ukraine, that have been mentioned as potential 'tigers of the east', Slovakia is now embedded in acknowledged political and economical frameworks.

Of enormous practical importance is the enthusiasm that the government continues to show in supporting foreign investment by offering subsidies for job creation, employee education and state aid for construction of the necessary facilities. On top of this, all of Slovakia is a tier 1 area for receiving subsidies.

One of the lessons to be learned – and which other investors are still learning – is the importance of carefully selecting the site for future activities. As Kia Motors has been painfully experiencing recently, the purchase of land that is dispersed among hundreds of landowners can sometimes be a risky business since land speculators may purchase property with the intent of holding out in negotiations with the incoming investor. Although legislation exists in Slovakia allowing for the expropriation of land for major private investments, land speculators might still attempt to slow down the expropriation by various procedural motions. This can force the investor to contemplate what costs more – the delay of the start of production or the increased price for the land. Ideally, property will be sought out that is either in the ownership of only a few persons or where the future purchase of land from the owners is guaranteed not only by the promises of the national or municipal politicians, but also by legal documents. By way of example, contracts on future purchase agreements between the municipality and the land owners were entered into that facilitated the smooth arrival of PSA Peugeot to the Trnava region.

Although there are certainly potential pitfalls, the future continues to look bright. As a result of foreign investment in the automotive sector in Slovakia, the automotive industry is by far the fastest developing sector of the Slovak economy. Automotive production represents 20 per cent of Slovak industrial production and contributes 17 per cent to the overall GDP of Slovakia, while automotive products form 25 per cent of total Slovak exports.

With the arrival of the most recent investors, approximately 800,000 cars will be produced annually in Slovakia, which amounts to 1.5 cars per inhabitant and the highest per capita ranking worldwide. Given the strong base already existing in Slovakia in the automotive sector, it generally is anticipated that the influx of foreign automotive suppliers will continue at an impressive rate.

For further information contact Paul Luiki and Stanislav Kovar on T +421 2 5413 1121.

Our automotive team

Our automotive team is at the forefront of developments in the sector, sharing the knowledge and experience gained from many years advising automotive clients or clients with interests in the sector. The team brings together specialists from across our international offices and network and from a wide range of practice areas.

Recent work includes advising major car and component manufacturers on automotive risk management including product liability and safety issues, multijurisdictional recalls, the Transportation Recall Enhancement, Accountability and Documentation (TREAD) Act matters and responsibilities along the supply chain; design protection; financial services products and financing including the securitisation of automotive receivables; European distribution laws; outsourcing; creating new sources of revenue from downstream activities, including the development of telematics services; and the extension of brands into other non-auto sectors. We have also advised on many of the major automotive mergers and acquisitions that have taken place as the industry consolidates.

For further information please contact

Ralph Kästner
T +49 69 27 30 80
E ralph.kaestner@freshfields.com

Yves Huyghé de Mahenge
T +33 1 44 56 44 40
E yhm@freshfields.com