



Competition Competence Report 4/ 2005

STATE AID & THE MORE ECONOMICS BASED APPROACH

Recent comments by new Competition Commissioner Mrs. Neelie Kroes on reforming EC state aid have renewed discussions about this topic. Consequently, uncertainty in government circles has increased considerably as to whether support of enterprises by a government is permitted or not. Commissioner Kroes announced at the recent "OECD Global Forum on Competition" in Paris that the Commission intends to bring clarity to this topic and set out a road map on reform in a Communication to be published later this spring. It is likely that this Communication will also refer to an increased application of the "more economics based approach" in state aid too.

Economics & State Aid

Economics always has played an important role within the field of state aid. Prominent examples include the assessment of whether a government acts like a "private investor" in providing (financial) support to a selected enterprise or a group of enterprises as well as the exemption rule under Article 86 EC Treaty for the provision of services of general economic interest, the so-called "net additional cost test". In the following, these two aspects will be elaborated. Moreover, it is likely that the Commission will reevaluate the concept of "distortion of competition" in the light of the modernization of the EC antitrust rules. This aspect will be discussed as well.

Private Investor Test

Although the “private investor test” has already been applied in a number of cases (e.g. WestLB, judgement of 06.03.2003, T-228 & T-233/99 among others), guidance on a few issues is still required. If the “private investor test” is passed, funds are regarded as a regular market investment that a government happens to provide. In the following a few issues that deserve clarification are addressed.

One central issue in the private investor test is the appropriate rate of return (‘reasonable profit’) that serves as a benchmark for evaluating its classification. The related question is really whether an “average return on a market” is appropriate to apply since most private investors demand above-average returns.

Another expression that requires clarification is the term “rational private investor”. What makes an investor behave in a rational manner? Additionally, the term “comparable” is a key issue: there is not one unique private investor, but there is a whole range of different types of investors that may (or may not) be interested in an investment. Returning to the notion of “rational”, it must be noted that not all market investors necessarily act rationally in their decision-making.

Further complications may arise from the notion of the term “market”. What are these tests worth if there is not an ideal market, but, for example, a monopoly? Related issues, such as “what is the appropriate benchmark of a market return” arise anew. Hence, even if the private investor test appears to be quite encompassing, it cannot cover the whole range of support that is feasible.

Other factors demanding clarification are, for example, the treatment of, or preference for, risk and uncertainty, the scope of financial or intangible return, and the time horizon of relevance for the assessment. An additional feature lies in the degree of control that is expected or demanded in return for providing financial funds. These aspects are in fact related to the rate of return that is expected from a particular investment.

Another issue is that there may be investments of a size that a private investor finds unbearable. Similarly, the willingness to provide “follow-up investments” strongly depends on the size of funds already provided. The investor may be willing to provide additional funds if that improves the chances that the supplementary payments increase the profitability of the initial investment or, increases the likelihood of recovering the funds provided previously. A typical example is the level of the provision of restructuring aid that is eligible following the provision of rescue aid: The

rescue aid may well be lost if the enterprise at stake is not restructured after its rescue.

To conclude, each occasion demands a case-by-case analysis taking into account all aspects related to that specific occurrence. The Court of First Instance in the above mentioned WestLB judgement has already stated that the burden of proof in these cases is quite considerable, thereby making economic expertise indispensable.

Private Creditor Test

The so-called "private creditor test" is another test. This slightly different approach was, for example, applied in the Lenzing case (Lenzing, judgement of 21.10.2004, T-36/99). Regarding the repayment of investments already made the investor's priority lies less on the appropriate rate of return, but on the maximisation of the likelihood of re-obtaining the funds that has been provided already. Although the two concepts superficially do sound quite similar differences appear as implications are derived for a particular case at hand. The prospects of realizing a positive return on the restructuring aid may be neglected if its provision increases the probability that the previously provided rescue aid can in any way be recovered. The creditor may be willing in such circumstances to sacrifice a loss on the provision of restructuring aid provided, in exchange for a greater chance of recouping the rescue aid provided.

This means that the implementation of the private creditor test in practice requires a comprehensive economic analysis that is tailor-made for each case individually.

Net Additional Cost Test

State aid may be legal if it passes the requirements of Article 86 (2) EC Treaty – the so-called "net additional cost test". The Commission considers that such state aid may be declared compatible with the EC Treaty if the state aid is necessary to the operation of the Services of General Economic Interests (SGEIs). The Commission discusses this aspect in its 2004 proposal on a "Community Framework for State Aid in the Form of Public Service Compensation"

(http://europa.eu.int/comm/competition/state_aid/others/).

In this document, the Commission elaborates more explicitly on the so-called "net additional cost test". This draft does enhance the clarification of circumstances, although a few issues – as discussed above - have so

far remained unresolved. The main principle is that the amount of compensation may not exceed what is necessary to cover the costs incurred in discharging the public service obligations, taking into account the relevant receipts and reasonable profit for discharging those obligations. Such profit may include all or some of the productivity gains achieved by the undertakings concerned during an agreed limited period without affecting the quality level of the services laid down by the State. The costs to be taken into consideration are all the costs associated with the operation of the SGEI.

The Commission already applied this approach in its RAI decision (OJ (L) 119/1, 23.4.2004) that involved detailed calculations including multiple regression analyses. The Commission's conclusion was that measures do not constitute state aid if "[they] compensate RAI for the net additional cost of performing the general service task entrusted to it, [...]."

The difficulty lies in the identification of activities which contribute to the provision of public services and which do not. An enterprise as large as RAI obviously not only provides public services, but also runs some businesses that are comparable to the ones performed by private competitors. Calculations are especially complicated by the need to break down costs incurred and support received by the other activities. Various approaches of cost allocation may yield substantially different results (the adequate allocation of fixed costs may suffice here as an example). Therefore, any evaluation, allocation, and calculation according to the concept of the net additional cost test must be backed up by thorough and reasonable economic interpretations. So far, no benchmarks, universally valid definitions, concepts of estimation, etc. have been established, implying, there is no real practical guidance yet.

The Future of Economics in State Aid

The Commission is currently rethinking its approach towards state aid. As already mentioned a Communication on the road map for this reform will be published in late spring 2005.

One intention is to also apply the "more economics based approach" in EC state aid rules. This implies that even the term "distortion of competition" will be evaluated. Historically a broad definition of distortion of competition was applied. In the future, an evaluation of anti-competitive effects might already take place under Article 87 (1) EC Treaty compared to the kind of analysis applied under Article 81 (1) EC Treaty.

A position, discussed for example by the Commission's Chief Economist Prof. Röller, is that state aid may correct market failures and thereby restore competition again. Market failures may be caused by, for example, externalities, asymmetric information, and the provision of public goods. The effects of the market failures in combination with the provision of state aid ought to be assessed. Obviously, such a shift of emphasis would require a more thorough economic analysis than already included in Article 87 (1) EC Treaty. In such an assessment issues like intensity and type of state aid, degree of selectivity and market dominance would need a careful examination.

The implication of this modern concept is that economic expertise is required as early as possible, even before governments grant funds. EE&MC provides support in the economic assessment of funds in question at all stages of the evaluation process.



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