



Competition Competence Report

## **COST CALCULATIONS OF SERVICES OF GENERAL ECONOMIC INTEREST ACCORDING TO THE EU STATE AID RULES**

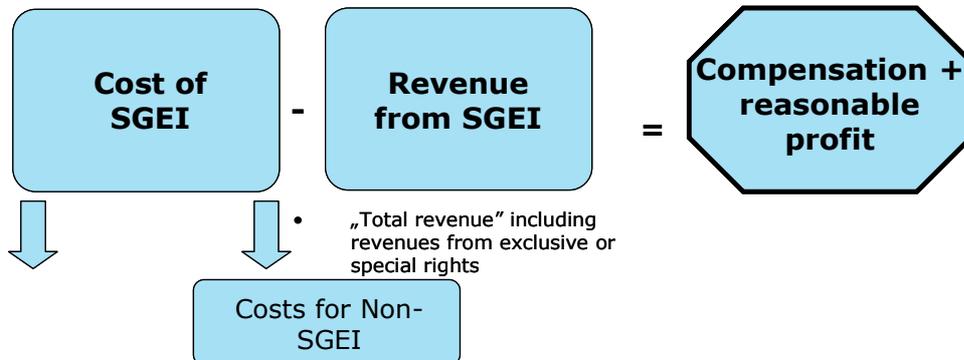
According to the Altmark judgement of the Court of Justice of the European Communities, public service compensation does not constitute State aid within the meaning of Article 107 (1) of the TFEU if it fulfils certain conditions. However, if public service compensation does not meet these conditions and if the general criteria for the applicability of Article 107(1) are satisfied, such compensation constitutes State aid. Under certain conditions such State aid can be found compatible with the common market pursuant to Article 106 (2) TFEU.

According to Article 106 (2) TFEU, compensation is exempted from the state aid prohibition if a company carries out public service tasks as defined and entrusted to them by public authorities, whilst ensuring that there is no over-compensation liable to distort competition. This means that the compensation needs to be proportionate. To evaluate proportionality, a cost analysis is necessary.<sup>1</sup> This analysis is called the "Net Additional Cost Test". The systematic of this test is illustrated in the following figure.

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<sup>1</sup> Commission Decision of 28 November 2005 on the application of Article 106(2) of the TFEU to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest

## Systematic of the Net Additional Cost Test



1. All variable Costs of SGEI
2. Appropriate contribution to fixed costs
3. Reasonable rate of return on capital assigned to the SGEI

Source: EE&MC

## DETERMINATION OF COSTS

In order to determine the appropriate costs it is necessary to take into account the scope of activities of the undertaking concerned. If the activities are confined to the service of general economic interest, all costs may be taken into consideration. This means that in case of a bus transportation company - for example - that exclusively performs a public service obligation all costs related to bus connections in a rural area could be taken into account. However, if the undertaking carries out activities in other sectors too, only those costs associated with the service of general economic interest may be taken into consideration.

To calculate the traceable costs it is necessary to determine the avoidable costs of the non-SGEI-activities. Those costs are not taken into consideration in the compensation calculation.<sup>2</sup> Since there is a lack of clarity regarding certain types of costs and since even the European Commission uses terms in her communications imprecisely, the different cost types are discussed in greater detail in the following.

<sup>2</sup> See Decision of the Commission in the RAI case of 15.10.2003, OJ 2004 No. L 119/1, para. 122.

## CONCEPT OF AVOIDABLE COSTS

Costs are considered to be avoidable, if they cease to exist in the hypothetical case that all Non-SGEI-activities are stopped. In accordance with the concept of *incremental costs*<sup>3</sup>, avoidable costs are also referred to as *decremental costs* in literature.<sup>4</sup> Avoidable cost comprise of all product or sector specific costs – including fix and variable costs - that would not occur in case of a stop of activities. The difference to incremental costs is that sunk costs that can not any more be avoided through a stop are taken into account for the calculation of incremental costs. However, the larger the period under review, the lower are the sunk costs. From this follows that avoidable costs are equal (if sunk costs are zero) or lower than incremental costs but never higher.

## VAGUE COMMISSION STATEMENTS

In the European Commission Decision on the application of Article 106 (2) TFEU, the European Commission states: „The costs allocated to the service of general economic interest may cover all the variable costs incurred in providing the service of general economic interest, a proportionate contribution to fixed costs common to both service of general economic interest and other activities and a reasonable profit.“ It is striking that the European Commission does not mention specific fixed costs but refers only to variable costs. The compensation of a service of general economic interest must in either case include the specific fixed costs that occur for the service obligation.

In addition to specific costs there are common costs. Common costs can not be attributed unambiguously to one sector. The European Commission refers to those fixed common costs for both, the service of general economic interest and other activities. The allocation of common costs to particular products or services is extremely difficult. Some commentators even call this arbitrary.<sup>5</sup>

However, in the context of the calculation of compensation, a cost allocation is necessary. It is unclear, to what extent common costs should be taken into account. In its Decision the European Commission refers to a *proportionate contribution*. In contrast, according to the RAI Decision,

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<sup>3</sup> See: Faulhaber, G, 1975, Cross-Subsidization: Pricing in Public Enterprises, The American Economic Review 65 (1975), p. 966-977,969.

<sup>4</sup> Baumol, W., 1996, Predation and the Logic of the Average Variable Cost Test, The Journal of Law and Economics 1996, p. 49-72, p. 58.

<sup>5</sup> Baumol, W., 1996, Predation and the Logic of the Average Variable Cost Test, The Journal of Law and Economics 1996, p. 49-72, p. 59.

only the *additional part* of common costs should be added to the avoidable costs for non-SGEI-activities. This indicates that a reasonable allocation of common costs between SGEI-activities and non-SGEI-activities is difficult to achieve.

In the hypothetical example of a bus transportation company, beside a public service obligation a purely commercial section may exist as well, for instance coach tours. In such a case, the avoidable costs of the coach tours section must be determined and excluded from the compensation. Avoidable costs include the specific variable costs such as fuel costs for coach tours, but also the specific fixed costs such as the purchase of coaches that are exclusively used for commercial activities. In addition, a reasonable share of common costs needs to be added. This might be e.g. the share of the costs for a bus garage in which both types of buses park. The allocation of costs could be carried out on the basis of the respective number of buses. If the garage exists anyway, the purchase of coaches would cause no additional common costs in connection with the garage. In this respect, the costs are non-avoidable.

Furthermore, for the cost calculation an adequate return on capital needs to be taken into account, which will be discussed in detail below. In addition, costs linked with investment, notably concerning infrastructure, might possibly be taken into consideration as far as these are necessary for the operation of a service of general economical interest too. In case of a swimming pool, for example, necessary modernisation measures might be imputed.

## **REVENUES AND PROFITS**

With respect to revenues, all direct and indirect revenues as well as advantages from the provision of a service of general interest have to be taken into consideration. In order to remain with the example of the transport enterprise, the passenger fees collected by performing the public service obligations are incorporated into the calculation of the amount of compensation. Among the direct revenues, the corresponding financial counter-value of all granted advantages must be assessed. This might include for instance reputation effects or advantages from the maintenance of a dense branch network.

If a firm was granted particular or exclusive rights connected to another SGEI and if this area achieves gains above a reasonable profit, these gains have to be incorporated into the calculation of revenues as well. The same applies if other allowances were granted to the firm by the State. Member states can further determine that also the gains from activities with no

public service obligation have to be incorporated into the calculation of revenues.

When calculating the reasonable profit, the incurred risk has to be taken into account. It should thereby be considered to what extent the state intervention has reduced the risk. This rule is based on knowledge of investment theory according to which investors are risk averse so a higher risk must be compensated by a higher profit in order to be attractive. Especially if a firm has been granted particular or exclusive rights, then a reduction or an absence of the risk is assumed which must result in a reduction of the reasonable profit.

As a measure of comparison, average rates of profit achieved in the previous years in the relevant sector should be applied, which can not be exceeded. However, this can imply that it is unattractive for companies to accept SGEIs because they operate very efficiently and therefore with an above average profitability. SGEIs on the other hand enable activities only at an average rate of profit. It might be worth to debate whether above-average profits should not at least temporarily be allowed as long as they are a result of cost savings/efficiency. Such proceedings would probably be compatible with the requirements of the European Commission since according to the Community framework for State aid also criteria that refer to productivity gains may be used for the calculation of profits.<sup>6</sup>

## **EXAMPLE INFRASTRUCTURE MEASURES**

The public financing of infrastructure can under certain circumstances fall within the concept of State aid. In the context an evaluation of infrastructure measures, the selectivity of the measure needs to be assessed, whether this is a general measure or it is tailored to a certain undertaking. If for example a sea port is built near an undertaking, which enables especially this undertaking to ship its products more easily, a selective aid can be assumed. This should be differentiated from general infrastructure measures such as the construction of a generally available port or a road that can be used by a large group of companies. General public would benefit from such a measure, which typically causes no competition distortion or impact on trade.

Infrastructure measures should be allocated by public procurement procedures. This ensures that competition takes place and the undertak-

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<sup>6</sup> European Commission, Community Framework for state aid in the form of public service compensation, OJ 2005 Nr. C297/4, No. 18.

ing with the lowest costs is entrusted with the task. If no such procedure takes place, the compensation must take the real costs of the operation of the service into consideration. If no public procurement is carried out, the requirements of Article 106 (2) TFEU need to be applied coherently, i.e. only the real costs necessary to operate the service are taken into consideration.

## **REDUCTION OF COMPENSATIONS PAYMENTS FOR OPERATING COSTS OVER TIME**

Sometimes it is discussed to what extent a reduction of compensation for operating costs over time is reasonable. Over a forecast period of 3-5 years, a reduction of annual compensations might occur by means of estimated saving effects in order to prevent overcompensation. However, such procedure should be evaluated critically. Basically, saving potential is thinkable over time, e.g. by excess revenues, technological progress or effects of scale. These effects must be incorporated into the calculation to prevent overcompensation and to ensure an effective application of state funds. However, a fixed amount that is necessarily based on future oriented estimates should be rejected since such predictions are always associated with uncertainty. An exact forecast of the savings is not possible; the target of state aid might not be fully achieved in this manner.

Rather than a fixed reduction, an examination over time should take place. This requires a coherent application of the presented calculation methods. Such an examination enables a control on the basis of real development thus reducing potential uncertainty of financing and enabling a more effective achievement of objectives.

## **EE&MC APPROACH**

EE&MC disposes of the necessary know-how and the experience to carry out the "Net Additional Cost Test " as well as the other complex cost analyses in connection with the European State aid rules. EE&MC has already utilised the concept of the Net Additional Cost Test in a number of cases. Those expertises have been submitted to the European Commission in the proceedings. From a client perspective these costs analyses increase the objectiveness of the case. Compensation payments as well as all calculations are for all parties traceable and increase therefore transparency. EE&MC guarantees that from a competition economist perspective all cost analyses are precise and according to the legal requirements. The realisation of such analyses by EE&MC guarantees the client a reliable

and definitive assessment of the problem. If necessary, EE&MC provides advice how to comply with the rules. In this way, compatibility of compensation payments with the EC State aid rules can be achieved and potential harmful repayment claims by the European Commission are avoided.