Competition Competence Report

STATE AID & THE MORE ECONOMICS BASED APPROACH

Economics always has played an important role within the field of state aid. Prominent examples include the assessment whether a government act 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, the concept of "distortion of competition" will be discussed.

Private Investor Test

Although the "private investor test" was already applied in quite a number of cases (e.g. WestLB, judgement of 06.03.2003, T-228 & T-233/99 among others), guidance on quite 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 which 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 whether really an "average return on a market" is appropriate to apply since most private investors demand above-average returns.

Another expression that requires clarification is for example the term of the "rational private investor". What makes an investor to 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.

Coming back to the notion of "rational", it must also be noted that not necessarily all market investors 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 no such ideal market, but e.g. 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 (preference) of risk and uncertainty, the scope of return (financial or intangible), and the time horizon of relevance for the assessment. An additional feature lies in the degree of control that is expected/ 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 still investments of a size that is not bearable for any private investor. Similarly, the willingness to provide "follow-up investments" depends strongly on the size of funds already provided: the investor may be willing to provide additional funds if he thinks that the funds improve the chances that his supplementary payments increase the profitability of the formerly provided investment packages (or, even increasing the likelihood of recovering the funds he provided at all…). A typical example relates to the provision of restructuring aid that is eligible to follow 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 case demands a case-by-case analysis taking into account all aspects related to that specific case. The Court of First Instance in the above mentioned WestLB judgement was already stating that the burden of proof in those cases is quite considerable making economic expertise indispensable.

Private Creditor Test

Another test is the so-called "private creditor 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 he has 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

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the already provided rescue aid can be recovered at all. The creditor may be willing in such circumstances to sacrifice a loss on the provision of restructuring aid he provides in exchange for a greater chance of re-obtaining 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 Interest (SGEIs). The Commission discusses this aspect in its proposal on a "Community framework for State aid in the form of Public Service Compensation" (http://europa.eu.int/comm/competition/state_aid/others/) from 2004.

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. 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 grains 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 operation of the SGEI.

The Commission already applied this approach in its RAI Decision (OJ (L) 119/1, 23.4.2004) which 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

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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.

Perspective for Economics in State Aid

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

One intention is to apply the "more economics based approach" also 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 pro- and anticompetitive 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 restoring competition again. Reasons for market failures are for example externalities, asymmetric information, and the provision of public goods. The effects of the market failures in combination with the provided state aid should be assessed. Obviously, such a shift of emphasis would require a more thorough economic analysis already 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 some funds are granted by the government. EE&MC provides support in the economic assessment of funds in question at any stage of the evaluation process.

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