STATE AID 2019 KNOW HOW

Economics in State Aid

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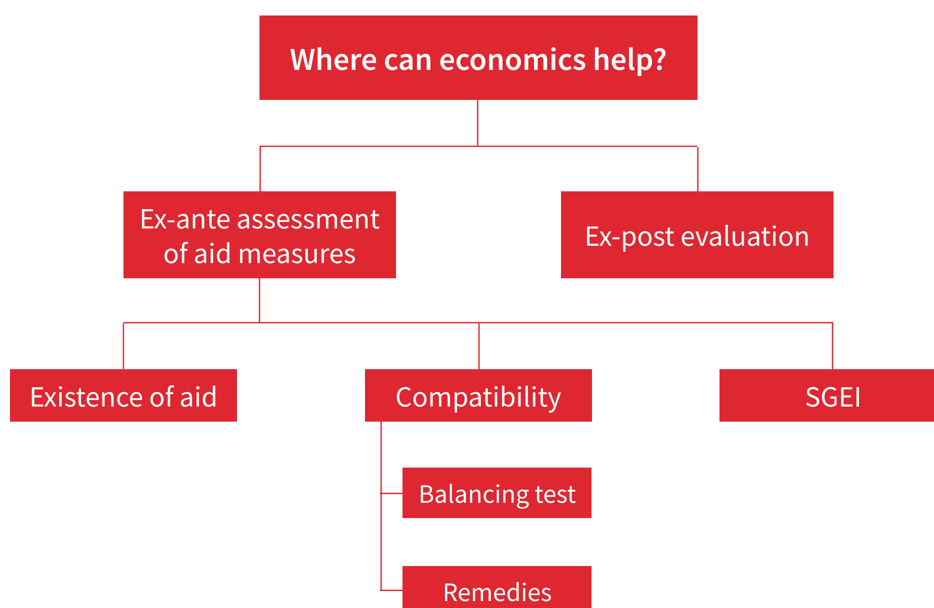
AUGUST 2019

GCR INSIGHT

Guide to the use of economics in state aid

Among all the areas of competition policy, state aid control is the branch that witnessed most changes in the past decade. In 2012, the European Commission acknowledged the need for reform by publishing a Communication on EU state aid modernisation.[1] The 2012 Communication proposed two main streams of action. On the one hand, it refers to focusing the enforcement on cases with the biggest impact on the internal market and on the other, to streamlining the rules.

With a focus on the use of economics in state aid, this article aims at addressing both issues identified in the Communication: the rules and the enforcement. The first part describes the applicable legal framework and explores how the increased use of economic arguments can contribute to enhancing the effectiveness of state aid control. The second part discusses enforcement priorities and recent developments in the field of state aid. We focus most part of the discussion on those issues where economics plays a role, by explaining the main principles as well as by means of case examples.



Part 1: General – the use of economics in state aid

State aid may pursue sound public policy objectives of the member states that could be driven by either efficiency or equity considerations. However, state aid may also have the potential to distort competition and trade. This dual facet of state aid can be clearly identified in the two parts of the article 107 of the Treaty on the Functioning of the European Union (TFEU) – the main provision in the Treaty dealing with state aid and providing the legal framework to the European Commission to exercise its control in this area.

This first paragraph of article 107, by acknowledging the possible negative effects of state aid, states a general prohibition:

> *"Any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be* ***incompatible*** *with the common market."*
>
> (emphasis added)

1 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0209&from=EN.

Hence, a measure is deemed to constitute state aid if it involves state resources, if it confers a selective economic advantage to certain companies and if it has the potential to affect competition and trade.

The second and third paragraphs of article 107, by recognising the potential positive effects of state aid, provide possible derogation from the general prohibition stated in 107(1).[2]

The assessment of state aid cases by the Commission follows the structure of article 107. First, the Commission addresses the issue of the **existence of aid**, as required in 107(1), by checking whether the conditions listed in this paragraph are simultaneously fulfilled. If they are, the public support is considered state aid and the Commission proceeds to verifying whether the aid can be declared **compatible** with the Treaty, as specified in 107(2) and 107(3).

A particular category of state aid is the aid given to those undertakings entrusted with the provision of certain universal public services, such as basic postal, communications or utility services. For the special nature stemming from the social character of this category of aid, the TFEU contains a separate provision to deal with it (ie, article 106). The second paragraph of 106 states the following:

> *"Undertakings entrusted with the operation of* ***services of general economic interest*** *or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union."*

As a general rule, state aid must be notified to and cleared by the Commission before it is granted. However, the **General Block Exemption Regulation (GBER)**[3] exempts aid measures from prior notification if certain conditions are respected. The GBER does not exclude the existence of aid but, owing to the size or its characteristics, aid is automatically considered compatible. As another milestone of its state aid modernisation initiative, the European Commission has considerably extended the scope of exemptions from prior notification of state aid. The revised GBER enables the Commission to concentrate its scrutiny on the aid measures that are most likely to distort competition in the Single Market, while also conducting improved ex post monitoring of measures benefitting from the exemption. In the context of state aid control that, so far, was based on a system of ex ante scrutiny and compatibility assessment, introducing **ex post evaluation** obligations will ensure a better understanding of the impact and effectiveness of state aid.

The following four subsections discuss in turn the use of economics with respect to, the existence of aid, compatibility of aid, the assessment of services of general economic interest and the ex post evaluation of aid schemes.

Existence of aid

Almost 50 years since the TFEU entered into force and has been implemented consistently in thousands of decisions, the European Commission has released a Communication to further clarify the key concepts relating to the notion of state aid as referred to in article 107(1). The Notice on the notion of state aid[4] is the last part of the Commission's state aid modernisation initiative launched in 2012. This document provides detailed guidance on when public spending falls within, and outside, the scope of EU state aid control. It does not concern the compatibility of state aid with the internal market pursuant to article 107(2) and (3). The Notice covers all aspects of the definition of state aid, by systematically summarising the case law of EU courts and the Commission's decision-making practice. Out of the four conditions required for the existence of aid (state resources, economic advantage, selectivity and effect on competition and trade), this section focuses on the economic advantage and briefly discusses the other three.

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2 The categories of aid potentially allowed by the Treaty include:

- aid having a social character, granted to individual consumers;
- aid to make good the damage caused by natural disasters or exceptional occurrences; aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a member state; aid to facilitate the development of certain economic activities or of certain economic areas; aid to promote culture and heritage conservation; other categories of aid as may be specified by decision of the Council on a proposal from the Commission.

3 http://ec.europa.eu/competition/state_aid/legislation/block.html.

4 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN.

The first condition for the existence of state aid is the involvement of **state resources**. Although it may seem uncontroversial, the public origin of a measure is not always straightforward to determine. This is especially the case when state involvement does not entail aid to a certain beneficiary but is rather limited to redistribution between private entities or obligations imposed on market participants.[5]

Second, to be declared aid, a state measure also needs to confer the beneficiary an **economic advantage**. The Commission's decision practice and the Union courts have developed a test to assess the presence of an economic advantage. This is the Market Economy Operator (MEO) Test and, in essence, states the following: economic transactions carried out by public bodies do not confer an advantage on its counterpart, and therefore do not constitute aid, if they are carried out in line with normal market conditions.[6] Among the four conditions of the paragraph 107(1), the MEO test requires thorough economic and financial analysis besides legal assessment. Hence, given the focus of this article, it will cover most of this section.

It is for the member state to conduct a MEO analysis before making its investment. If the test is fulfilled, the public measure does not need to be notified to the Commission. However, the legal risk remains with the member state. In case of a complaint or an investigation run by the Commission that concludes otherwise, the member state could be required to recover any illegal aid. Therefore, it may be interesting for a member state to notify the measure to the Commission, to obtain the legal certainty of a "no aid" decision.

The decisive element in establishing whether or not an economic transaction is in line with market conditions is whether the public body acted as a market economy operator would have done in a similar situation.[7] Usually, a prudent market economy operator, would carry out an ex ante assessment[8] of its strategy, normally by means of a business plan. There are, however, at least two particular cases when compliance with market conditions can be established directly, though transaction-specific market information. One case is when the transaction is carried out under the same terms and conditions (and therefore with the same level of risk and rewards) by public bodies and private operators who are in a comparable situation (a pari passu transaction).[9] Another case is the sale or purchase of assets, goods or services through competitive, transparent, non-discriminatory and unconditional tenders. The Notice on the notion of aid confirms that, if public authorities buy goods or services through tenders that respect EU rules on public procurement, this is in principle sufficient to ensure that the transaction is free of state aid. Both pari passu and tenders, by their very nature, are transactions that incorporate market forces that could constitute a reasonable guarantee that the public authority acts as a private operator.

In general, except for the two situations described above, the MEO test entails assessing the business plan and profitability of the proposed investment. There are two generally accepted methodologies to evaluate compliance with market conditions: profitability benchmarking and profitability analysis based on financial models.

One way to establish whether a transaction is in compliance with market conditions is to benchmark it against similar investments carried out by comparable private operators that have taken place in comparable situations of risk and during the same period of time. The benchmarking exercise is often limited by the availability of data and appropriate comparators. In building a sample of comparable private operators, the following trade-off has to be taken into account: an increase in the number of companies included in the sample may increase the accuracy of results but not if this is done at the expense of considering companies that are not close comparators in terms of risk profile and other characteristics. Given the relative precision in comparability of two companies, the benchmarking exercise should provide ranges of plausible values rather than precise references. Furthermore, it can be appropriate to consider measures of central tendency such as the average or the median of the set of comparable transactions or companies.

5 See examples in paras. 61–65, Notice on the notion of state aid.

6 Para. 74, Notice on the notion of state aid.

7 Para. 76, Notice on the notion of state aid.

8 Normally ex post evidence entailing a retrospective finding that the investment made by the member state concerned was actually profitable are not enough to demonstrate the lack of an economic advantage, as it is considered that a private investor has an ex ante perspective when taking a decision to invest and it reasons in expected terms, with a positive probability of failure.

9 See, for example, Case C53/2006, Citynet Amsterdam where the European Commission approved the investment by the municipality of Amsterdam in a glass fibre telecommunications network because it participated in the project along with other private investors. The total equity investment in the project was €18 million. The Amsterdam municipality owned one-third of the shares, two private investors, ING Real Estate and Reggefiber together another third, while five housing corporations owned the remaining third. Following an in-depth investigation, the Commission concluded that the two private companies active in the sector, invested on equal terms with the municipality. In particular, all investing parties would have to support any losses in the event of an underperforming business. The structure of the new company ensures that the private investors have significant stakes in the project in a setup where no single shareholder can exert sole control over the company. Together with the detailed analysis of the business plan, these elements provided sufficient evidence for the Commission to conclude that the investment was conform to the market economy investor principle and therefore did not involve state aid.

Another methodology to evaluate the profitability of a transaction is the standard net present value (NPV) calculation. According to basic financial theory, in order to pursue an investment, private investors require that its NPV is positive or, in other words, that the present value of the future stream of cash flows (revenues minus costs) during the life time of the project is higher than the amount invested. In an NPV setting, the indicator measuring the expected profitability of in investments is called internal rate of return (IRR), defined as the discount rate for which the NPV equals zero.

Intuitively, when investors envisage a certain project, they look at its expected return, the IRR. In order to take the decision, they compare the IRR of that specific project with the alternatives in the market (ie, the opportunity cost) or the projects they will forgo in order to pursue the project in question. The profitability of those alternatives is measured by the cost of capital, that is, the price investors have to pay if they were to raise that capital in the market. One crucial element investors consider in this comparison is the level of risk, hence they compare the investment they are considering with alternatives of similar risk in the market. If the return they are promised by the IRR figure is higher than the opportunity cost of capital, then private investors undertake the investment. In this case, they would obtain a positive NPV.

This comparison is at the core of the MEO test. The estimation of the opportunity cost of capital is usually one of the most technically challenging elements in this exercise. The two main sources of capital are equity and debt. In assessing what is the cost of capital for an investment bearing a certain level of risk, an investor looks at the expected cost of equity, expected cost of debt and the financing structure of the investment (ie, the relative weights of equity and debt in the total capital). The weighted average cost of capital (WACC) is defined as follows:

$$WACC = K_e \frac{E}{C} + K_d \frac{(1-t)D}{C}$$

Where, K_e is the expected cost of equity, *E/C* – the equity share in total capital, K_d – the expected cost of debt, *D/C* – the share of debt capital and *(1–t)* is the tax advantage of debt financing.

Whereas the cost of debt (interest rate) is usually publicly available, the estimation of the cost of equity is more complex. A frequently used method to estimate the expected cost of equity is the Capital Asset Pricing Model (CAPM) developed in financial theory. According to CAPM, the expected cost of equity is:

$$K_e + R_f + M_p * ß$$

Where, R_f is the risk-free rate, M_p – the market risk premium (ie, the difference between the return on a given portfolio or security and the risk-free rate) and *ß* is a measure of the volatility or systematic risk of a security or a portfolio in comparison to the market as a whole.

Finding accurate estimates for the parameters presented in these formulae represents the core of the analysis required in an MEO test. This has to be done on a case-by-case basis. Given the forward-looking nature of the WACC in a world of uncertainty as well as the difficulty to quantify a precise level of risk, the values estimated by the member state and the Commission are not absolute. Strength of results can be reinforced by robustness checks and sensitivity analysis.

The third condition of article 107(1) for the existence of state aid, **selectivity**, requires that the advantage must favour "certain undertakings or the production of certain **goods**" (emphasis added). Hence, not all measures that favour economic operators fall under the notion of aid, but only those which grant an advantage in a selective way to certain undertakings or categories of undertakings or to certain economic sectors.[10] Notwithstanding that fact that selectivity has been highly debated and addressed in various court judgments, clear guidance and legal certainty is still lacking. In the second part of this article we will discuss some of the latest developments on the interpretation of selectivity in recent tax cases.

10 Para 117, Notice on the notion of state aid.

The Ciudad de la Luz Decision (2012) and Paks II Nuclear Power Plant (2017)

Among the vast MEO-relate case law, a good template for the analysis can be found in the ***Ciudad de la Luz Decision*** (2012). The case was about a public capital injection in favour of a cinema studio in Spain. The Commission carried out an in-depth economic and financial assessment that highlighted the importance and the difficulty of establishing a proper benchmark. It also provided valuable guidance for estimating the cost of capital and for applying the NPV methodology. The General Court endorsed the Commission Decision, which found that the MEO test was not met, implying that the capital injection was considered to constitute state aid.

Subsequently, the Commission's analysis in *Paks II* case developed significantly the MEO test on the grounds laid by *Ciudad de la Luz*. In the 2017 decision regarding the construction of a nuclear power plant in Hungary, the Commission assessed the MEO test in-depth, using different methodologies to benchmark both the cost of capital (WACC) as well as in the internal rate of return. A refined and robust analysis led to the conclusion that the public financing of the power plant constituted state aid.

For more information about the case, see:

- SA.22668 Ciudad de la Luz studios http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C8_2008.
- T-319/12 – *Spain v Commission*: http://curia.europa.eu/juris/liste.jsf?num=T-319/12&language=en.
- Claici, A et al (2016), "The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case", *Journal of Competition Law and Economics*, 12(1).
- SA.38454 Possible aid to the Paks nuclear power station http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38454.

Finally, the two last elements required for the existence of state aid are the **effect on trade** of the measure and its potential to distort competition. EU state aid control focuses on public investments that have effect cross-border. Funding provided to local infrastructures or local services that are unlikely to attract customers from other member states, and which only has a marginal effect on cross-border investment, does not fall under EU state aid rules. As regards **distortions of competition** within the meaning of article 107(1) of the Treaty, it is generally found to exist when the state grants an economic advantage to an undertaking in a liberalised sector where there is, or could be, competition.

Compatibility of aid

Once a public measure is proven to constitute state aid, the Commission balances the positive effects of the aid with the negative ones to establish whether the aid may be declared compatible as stipulated in article 107(2) or (3) of the TFEU. In order to interpret the general provisions in the Treaty, the Commission has published numerous guidelines, both horizontal and sector specific (eg, rescue and restructuring aid, regional aid, R&D&I, environmental and energy aid, risk finance, broadband, aviation, etc).

One proposal and follow-up on the state aid modernisation process includes the identification of common principles for assessing the compatibility of aid with the internal market, across various guidelines and frameworks. In that context, the Commission has published a paper on **Common Principles for an Economic Assessment of the Compatibility of State Aid** under article 107(3).[11] The aim of that paper was to provide more details and clarification on the methodology used by the Commission in balancing the positive and negative effects of state aid. The general analytical principles are also reflected, with adaptations in the light of the specific policy context, in a number of guidelines for specific aid categories.

The balancing test consists in the following three steps. First, it requires that the aid measures are aimed at a well-defined objective of common interest (positive effect). Member states have to prove that aid is necessary to pursue the identified objective, which can be an efficiency objective or an equity objective. The second issue in the balancing is the design of the aid (positive effects). The main points of assessment in the aid design are: establishing the incentive effect of the aid (ie, whether the aid changed the behaviour of the recipient in the direction of the stated objective) and evaluating whether the aid measure is proportionate (ie, whether the aid is limited to the minimum necessary or the same objective could have been achieved with less aid). The third

11 http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

step in the balancing test is the assessment of distortions in competition and effect on trade (potential negative effects of the aid). In addition, practice has established that even in the cases where the Commission has evidence that negative effects of state aid outweigh the positive ones, member states may propose remedies to correct the measure such that it becomes compatible. Economic tools may be useful to assess all three steps in the compatibility analysis *as well* as to shape the measure in order to remedy the potential negative effects. For the rest of this subsection, we will explain each of these elements in turn.

The balancing test

1. On the positive side, first step of the balancing step entails establishing the common interest **objective of the aid** (ie, whether it responds to efficiency or equity considerations). Aid is usually deemed to cover an **efficiency objective** if it has the potential to correct a market failure. Examples of market failures are positive externalities in the case of R&D&I or asymmetries of information in the case of start-up firms that find it difficult to raise financing in the financial markets. The fact that a project has positive effects that are not fully appropriated by the aid beneficiary or it may suffer from coordination or imperfect information problems, does not automatically validate the existence of a market failure. Member states have to demonstrate that the market would not undertake such a project (ie, that the project is not profitable without aid). This can be done through quantitative or qualitative evidence such as econometric analysis, benchmarks, surveys, studies or internal documents. Establishing a counterfactual (ie, what would happen without the aid) and demonstrating a genuine market failure is often a complex exercise, requiring economic intuition and a good understanding of market conditions. **Equity objectives** (such as cohesion between European regions or employment considerations) are usually set by the EU or the member states. Governments may consider that inequalities stemming from a free market game are unacceptable and may choose to intervene in the redistribution of wealth. Equity considerations may be demonstrated, for example, by statistical indicators illustrating social or regional disparities.

High-speed train test centre in Andalusia (2016) and Paks II Nuclear Power Plant (2017)

An interesting case where the Commission has concluded that an aid does not meet a genuine objective of common interest (efficiency objective) is the construction of a high-speed train test centre in Andalusia.

The CEATF is a railway circuit where trains can run at very high speeds (up to 520km/h) with additional installations for testing, approval and tuning of mobile rail equipment, infrastructure and superstructure elements. The Commission's investigation concluded there does not appear to be any interest in the market to develop products that run at such high speeds, because they would not be commercially viable. In the absence of demand for such specific services, the use of the CEATF facility would in practice have been limited to testing trains and equipment up to the commercially viable speeds of 320–350km/h, for which testing centres already exist in the EU. Usually, investigations under the R&D framework reveal significant positive externalities that make this type of aid generally compatible. This decision is unique in this category owing to its lack of a positive objective.

For more information about the case, see:

- SA.37185 Aid to ADIF http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_37185.

2. The second step in the balancing exercise covers the **design of the aid**. Member states need to prove that aid would change their behaviour in the direction of achieving the objective and it is not a simple lump-sum transfer from the state without any real effect (this is called the **incentive effect**). They are also expected to show that aid is **proportional** (ie, is not higher than necessary to achieve the stated objective). Financial evidence, such as profitability calculations for a given project with and without the aid or project finance analysis, including scenario forecasts may constitute relevant pieces of evidence to endorse an appropriate design.

Aid to BMW Leipzig (2014, 2017)

This case is about regional aid to attract major investment projects. BMW targeted the production of two models of electric passenger cars and applied for an aid amount of €45 million in Germany. Several locations were considered for the new plant. The least costly was at its headquarters in Munich. The next best location was in Leipzig. But production in Leipzig would require an extra €17 million resulting from additional expenses in investment, planning and start-up costs, production costs, supply costs, logistics costs and shipment costs. The project would contribute to regional development primarily through the creation of 800 jobs.

The Commission has found that only part of the planned aid was necessary to carry out the project and has therefore authorised €17 million out of the €45 million planned by Germany. BMW contested the decision by the General Court has dismissed the appeal.

- http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_32009
- http://curia.europa.eu/juris/document/document.jsf;jsessionid=0D8BFC756208A08857C15BA2F4DCC8AF?text=&docid=194321&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=2038471

http://stateaidhub.eu/blogs/stateaiduncovered/post/9012

3. The third step in the balancing exercise regards the negative side of the aid, namely the **potential to distort competition and trade**. One can distinguish at least three kinds of distortions of competition induced by state aid. First, state aid, by interfering with the allocation of rents through markets, may have long-term dynamic effects on the incentive to invest and compete. Second, at a more specific level, state aids may affect competition in the product market and trigger different responses by competitors depending on the circumstances. Third, state aid may affect competition in the input markets and in particular the location of investment.[12] A thorough analysis of competition distortion would include delineating the market where the beneficiary of the aid is present and establishing the potential harm stemming from the aid. While assessing the effect of an aid on competition the Commission may take into account, among others, the following indicators: aid characteristics (eg, aid amount; beneficiary selection process, duration and repetition of the aid; effect on the beneficiary's costs); structure of affected markets (eg, market concentration, number and size of firms, existence of market power, product differentiation, barriers to entry and exit, dimension of the product and geographic market concerned); industry/market characteristics (eg, markets with overcapacity, inefficiencies at the level of the beneficiary (productivity), importance of innovation, feasibility of moving production facilities).[13]

Airport cases (2014)

In 2014 the Commission took two negative decisions in the aviation sector, regarding Gdynia-Kosakowo airport in Poland and Zweibrücken airport in Germany. The main reason triggering these decisions was the finding of significant distortions in competition vis-à-vis neighbouring airports.

For more information about the case, see:

- SA.35388 Setting up the Gdynia-Kosakowo Airport http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_35388.
- SA.27339 State aid to Zweibrücken Airport: http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_27339.

Remedies

If, following the balancing test, the Commission identifies significant negative elements, such as, for example, distortions in competition or excessive amount of aid, it is possible for member states to propose remedies that might change the measure in order to comply with compatibility criteria. The remedies negotiations between the Commission and member states span over multiple areas and economic analysis can support the achievement of

12 Para. 44, Common Principles.

13 Para. 56, Common Principles.

efficient outcomes, where the potential negative impact of the aid is minimised, without undermining the extent to which the measure can contribute to the stated objective.

Construction of nuclear power plants

In numerous recent cases, after the Commission opened an in-depth investigation signalling concerns, member states offered remedies that enabled the approval of the respective measures. Take, for example, two cases concerning the construction of nuclear power plants (one in the UK and one in Hungary). In the UK, the Commission found the aid to be excessive (ie, the proportionality principle was not met). The UK proposed and the Commission accepted remedies to correct the amount of the aid (including a gain sharing arrangement that would return part of the potential benefits from the measure to taxpayers). In the case of Hungary, the Commission had concerns that the aid would confer excessive market power to the beneficiary the vertically integrated electricity incumbent. A commitment to sell at least 30 per cent of its total electricity output on the open power exchange was considered acceptable by the Commission to remedy these concerns.

For more information about the case, see:

- SA.34847 Support to Hinkley Point C Nuclear Power Station http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_34947.
- SSA.38454 Possible aid to the Paks nuclear power station http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38454.

Services of general economic interest (SGEI)

In strategic sectors such as postal services, transport, broadband, social services, among others, member states can decide on the necessity of universal service availability for its citizens that may not always be delivered profitably by markets. Where markets fail to deliver the socially desirable level of goods or services, public authorities have the choice to subsidise a certain level of universal service. Whereas the definition of the of the universal public service is in general at the discretion of member states, the Commission has to ensure that the compensation received by the universal service provider is not excessive, with a potential negative impact on competition or taxpayers.

In specific circumstances, the compensation for costs incurred to provide a service of general economic interest may not constitute state aid. As explained in Part 1, for a state measure to be state aid, it is necessary that a set of simultaneous conditions are fulfilled. One of those conditions was the existence of an economic advantage. In the case of SGEI, the court made clear in the Altmark judgment that, if four conditions[14] are met, than the existence of an economic advantage is excluded and hence the SGEI does not constitute state aid, pursuant to article 107(1).

However, if not all Altmark criteria are fulfilled, universal service compensation is considered state aid and is subject to compatibility assessment. To this end, the Commission published a framework for assessing the compatibility of public service compensation[15] with state aid rules. A core element in the compatibility exercise is the assessment of the amount of compensation, which "must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit".[16]

The main methodology proposed by the SGEI framework to calculate the amount of compensation if the Net avoided cost methodology. This is the cost that could have been avoided should the provider not have the obligation to provide the public service, hence requires the construction of a counterfactual. The amount of

14 First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined. Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner. Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit. Fourth, where the undertaking that is to discharge public service obligations is not chosen following a public procurement procedure to select a tenderer capable of providing these services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs that a typical undertaking, well run and adequately provided with means to meet the public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

15 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012XC0111(03)&from=EN.

16 Para. 21, SGEI Framework.

compensation is then "the difference between the net cost for the provider of operating with the public service obligation and the net cost or profit for the same provider of operating without that obligation".[17]

Although the Commission regards the net avoided cost methodology as the most accurate method for determining the cost of a public service obligation, there may be cases where the use of that methodology is not feasible or appropriate. In such cases, where duly justified, the Commission can accept alternative methods for calculating the net cost necessary to discharge the public service obligations, such as the methodology based on cost allocation. Under this methodology, the net cost is calculated as the difference between the costs and the revenues for a designated provider to fulfil the public service obligation.[18] On top of the right to compensate the net losses, the public service provider should be allowed to obtain a "reasonable profit". Ideally, the reasonable profit should be equal to an ex ante measure of the expected profitability that a market operator would require in order to provide that service, taking into account the level of risk (IRR). Where duly justified, profit level indicators other than the rate of return on capital can be used to determine what the reasonable profit should be, such as the average return on equity over the entrustment period, the return on capital employed, the return on assets or the return on sales.[19]

BPost (2012)

Benchmarking this "reasonable" profit requires knowledge of finance in general and of specific sectors in particular. Among the numerous SGEI cases run by the Commission it is worth mentioning the BPost Decision (2012), where not less than three economic consulting firms provided estimates and benchmark ranges for the reasonable profit. Following an in-depth assessment, the Commission found that the substantial profits made by BPost in activities where it still enjoyed exclusive rights until 2010 led to an overcompensation of the postal incumbent and therefore ordered Belgium to recover €417 million of incompatible aid.

For more information about the case, see:

- SA.14588 Mesures en faveur de La Poste belge, http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_14588.

Ex post evaluation

In line with the goals of the state aid modernisation process, ex post evaluation aims at promoting the self-assessment of state aid and therefore, the focus on more efficient, cheaper and less distortive aid. This initiative constitutes a shift in Commission's ex ante perspective of approving aid schemes based on expected costs and benefits to an ex post evaluation perspective, with member states having to assess the effect of their own schemes in a rigorous way.

In principle, ex post evaluation covers aid schemes only, and not aid to individual beneficiaries. The categories of aid schemes under an ex post evaluation obligation include: large aid schemes in specific aid categories mentioned in the GBER and also notified aid schemes, as long as they are large, novel or foreseen in specific guidelines.

To assist member states to conduct evaluations, the Commission issued a guidance paper that illustrates the different quantitative methods to which member states could resort to do a proper ex post assessment of aid measures.[20]

The overall objective of state aid evaluation is to verify the balance between the positive and negative effects of aid. Evaluation should aim in particular at providing evidence useful in answering questions such as whether the aid changed the behaviour of the beneficiaries, whether the effects differed significantly across beneficiaries, whether the scheme led to spillover effects on the activity of other firms or whether the scheme contributed to the desired policy objective. In general, evaluations are greatly facilitated when they are properly anticipated and prepared, in particular as this allows suitable data collection.[21]

17 Para. 25, SGEI Framework.

18 Paras 27–28, SGEI Framework.

19 Para. 34, SGEI Framework.

20 http://ec.europa.eu/competition/state_aid/modernisation/state_aid_evaluation_methodology_en.pdf.

21 Competition Policy Brief (2014), Issue 7 at http://ec.europa.eu/competition/publications/cpb/2014/007_en.pdf.

The methodological guidance paper describes the most relevant methods for counterfactual impact evaluations. To ensure objective and rigorous evaluation, according to best practice, evaluators should be independent from the granting authority and should be experts with adequate experience in econometric analysis.

A comprehensive list of cases that have been assessed by the Commission can be found at: http://ec.europa.eu/competition/state_aid/overview/transparency_and_evaluation.html.

Evaluation plan of UK scheme (2015)

For example, the Commission accepted an evaluation plan of a UK scheme with an annual average budget of €3,600 million, aimed at stimulating economic growth through the support of innovative businesses, in particular SMEs, across all sectors of the economy as well as research organisations.

The evaluation will allow examining any differences in impact across beneficiaries (eg, by company size, sector, location). For the assessment of the aid scheme's direct impact the selected control group will consist of unsuccessful applicants to the scheme and the envisaged method to estimate the impact is regression discontinuity design. The evaluation will make use of the following three main sources of data: administrative data, survey data from the treatment and control group and secondary government-owned data sets. With regard to the proportionality, the evaluation will investigate whether the same impacts could have been realised with less aid. To this end, a comparative analysis of situations where different amounts of aid have been granted will be undertaken in order to assess whether the outcomes differ across aid amounts. An independent evaluation body will be selected via an open and competitive tendering process.

For more information about the case, see:

- SA.40761 innovate uk 2014 – evaluation plan http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_40761.

Part 2: Recent developments in the field of state aid

Following the adoption of the State Aid Modernisation initiative (SAM), there has been a decrease in the number of notifications of state aid given that more measures are being covered by the General Block Exemption Regulation (GBER) and, therefore, they do not require ex ante approval by the Commission.

In 2018, the decreasing trend in the number of state aid cases continued. The Commission took 278 decisions compared to the 323 decisions of the previous year. In 29 cases, the Commission decided that the measure did not constitute state aid. These decisions were taken mostly on the grounds that: (i) the beneficiary does not perform an economic activity and cannot therefore be characterised as an undertaking within the meaning of article 107(1) TFEU; (ii) the measure does not confer an economic advantage to the beneficiary as the state acted as a prudent market operator would have; or (iii) the measure is awarded in such a way that ensures that no selective advantage was granted.

In the majority of cases (85 per cent) the notified measure was found to be compatible with the internal market, that is, no objection was raised by the Commission. In six cases, after a first assessment of the measure, the Commission raised some doubts on the compatibility of the aid with the internal market and it decided to initiate a formal investigation. Overall, only in six cases did the Commission take a negative decision.

Direct grants continued to be by far the most used instrument for state aid and their prevalence increased from 55 per cent in 2017 to 67 per cent of all state aid cases in 2018. Tax allowances and other fiscal measures were granted in 13 per cent of cases. The remaining state aid was granted through other instruments, including guarantees, interest subsidies, loans or repayable advances. As per the type of state aid measure, schemes represented the majority of state aid cases (76 per cent). The remaining cases concerned ad hoc cases (14 per cent), individual applications (9 per cent) and other measures (2 per cent).

The main objectives of state aid granted in 2017 were energy savings and environmental protection aid (19 per cent), aid to agriculture and forestry sectors (17 per cent), aid to export, regional and sectoral development (14 per cent), aid to transport sector and airport infrastructure (6 per cent). Rescue and restructuring aid concerned nine cases (3 per cent).

In 2018, important areas of activity remained tax rulings and capacity mechanisms among others. An interesting new area was represented by a category of aid for important projects of common European interest (IPCEI), reflecting the role of the European industries in the global arena.

A few relevant decisions in these three fields that were published in 2018 are briefly described in the boxes below:

Luxemburg's tax advantage to Amazon (2017)

In 2018, the Commission decided on a state aid case involving tax advantages granted by Luxembourg to two companies of the Engie group from 2008 and 2010. Following an in-depth investigation started in 2016, the Commission concluded that Luxembourg's tax treatment of the profits made by the two companies granted them a selective economic advantage by allowing them to pay less tax than other companies subject to the same national tax rules. The investigation concerned two tax rulings adopted by Luxembourg, which endorsed a complex intra-group triangular financing structure of the two companies operating in Luxembourg. The triangular financing structure enabled the treatment of the financing funds both as debt and as an investment in return on sales. As a result, only 1 per cent and 0.3 per cent of profits of the two companies in Luxembourg were taxed.

For more information, see Commission Decision:

- SA.44888 – Aid to Engie
  http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_44888

Capacity mechanisms (2018)

Capacity mechanisms are measures taken by member states to support investments to fill the expected energy capacity gaps and ensure security of supply at the national level. They involve financial rewards granted to providers of capacity when they commit to maintaining capacity or investing in increasing capacity to the level needed to ensure security of supply of electricity. These measures have an impact on competition in the national or regional electricity markets. They are then assessed by the Commission under the "Guidelines on State aid for environmental protection and energy (EEAG) 2014–2020" adopted in 2014.

In 2018, the number of capacity mechanisms notified to the Commission was the highest since the adoption of the EEAG Guidelines: in 2018, the Commission approved seven cases, compared to three in 2017, five in 2016 and one in 2014. Member states notifying capacity mechanisms to the Commission in 2018 were: Greece (to cases), Belgium, France, Germany, Italy and Poland. The Commission approved all capacity mechanisms notified. The Commission opened a formal investigation only on the capacity mechanism notified by Germany, which reduced renewable energy surcharges for electricity users that produce their own electricity using highly efficient co-generation plants. The Commission concluded that the mechanism is designed to prevent overcompensation to users producing their own electricity and its impact on competition is minimised.

For more information, see:

- Commission page dedicated to capacity mechanisms http://ec.europa.eu/competition/sectors/energy/state_aid_to_secure_electricity_supply_en.html
- SA.49522 – Germany – Reduced surcharges for cogeneration under EEG http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_49522

Important projects of common European interest (2018)

In 2014, the Commission set the criteria under which member states can support Important Projects of Common European Interest (IPCEI) in line with state aid provisions. The Commission's communication encouraged member states to support large projects that contribute to economic growth, jobs and Europe's competitiveness. Aid to IPCEI is not limited to any sector and member states are allowed to cover up to 100 per cent of the funding gap (based on a set of eligible costs).

In 2018, the Commission has approved plans by France, Germany, Italy and the UK to support a joint research and innovation project in microelectronics. The project involves 29 participants and concerns 40 sub-projects. The project focuses on five areas: energy efficient chips, power semiconductors, smart sensors, advanced optical equipment and compound materials. The role of IPCEI is expected to grow. For instance, the European Battery Alliance will notify a large cross-border project engaging a consortium of operators in 10 member states (Sweden, Finland, Portugal, Belgium, Poland, Germany, France, Italy, Spain, Slovakia) and covering the whole batteries value chain.

For more information, see:

- Commission press release on adoption of rules in support of IPCEI http://europa.eu/rapid/press-release_IP-14-673_en.htm
- Commission press release on approval of IPCEI plans by France, Germany, Italy and the UK http://europa.eu/rapid/press-release_IP-18-6862_en.htm
- Commission statement on a meeting under the European Battery Alliance http://europa.eu/rapid/press-release_STATEMENT-19-2337_en.htm

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