

European state aid control

November 2005

OFT821

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EXECUTIVE SUMMARY

Following its earlier work into the effects of state aid on competition, the Office of Fair Trading (OFT) has developed a set of proposals for refining how the European state aid rules assess whether a proposed aid is likely to distort competition. The proposals are based on an analytical model and tested on case studies and aim to strengthen the economic basis for approving state aid.

We propose that in assessing state aid that may be permitted under Article 87(3) EC:¹

- an effects based phase one assessment of the distortion to competition should be incorporated into the European Commission's (the Commission) guidelines for aid approval. Phase one will incorporate the critical factors that determine whether a state aid is likely to distort competition significantly. These include whether the aid addresses a market failure, eligibility for aid and market share of recipient, as well as limits on overall levels of aid
- for proposed aid that does not fall under the guidelines, the Commission should undertake a wider ranging phase two assessment based around transparent economic criteria. This assessment may lead to aid being approved if the distortion to competition caused by the aid is offset by benefits to the common interest
- national competition authorities (NCAs) could give formal advice concerning whether proposed aid met the economic conditions of the guidelines. The Commission could have regard to this advice in deciding whether to approve the aid, but would not be committed to following it.

¹ Unless otherwise stated, in this report references to the Treaty are to the Treaty establishing the European Community (which Treaty is referred to as 'EC') and references to 'Articles' are to those of that Treaty.

The OFT recognises that state aid is an important policy tool for achieving social and economic goals. The effect of these recommendations is to ensure that state aid is given in a way that minimises the risk that it will distort competition to a significant degree.

Introduction

In 2003, €37.4bn² or 0.4 percent of EU GDP was spent on state aid by the 15 countries that were Member States at this time. The UK spending was €3bn,³ which, although a lower proportion of national GDP, still accounted for 0.19 percent of public spending.

In 2004, the OFT undertook a first stage of work to test whether public subsidies including state aid could be distorting competition.⁴ Economic research highlighted the situations in which subsidies were most likely to cause distortions to competition. We then considered whether existing rules and guidance on subsidies minimised this risk. We found that although existing rules and guidance prevented a large number of subsidies that would distort competition, gaps remained.

We concluded that the European system for state aid control required reform to reduce the chance that the Commission approves subsidies that distort competition and prohibits those that do not distort competition. This report proposes a set of reforms to the system of state aid control to provide an effects based approach to the approval of state aid is taken.

In June 2005, the Commission announced a comprehensive reform of state aid policy and launched an Action Plan for consultation setting out high level reform proposals. The Action Plan is based on the aims of having 'less and better targeted state aid, a refined economic approach, more effective procedures and a shared responsibility between the Commission and Member States'. The OFT

² Figure from State Aid Scoreboard. Does not include transport, railways, agriculture or fisheries.

³ State Aid is a subset of all subsidies. In our Stage One work we attempted to quantify UK spending on all subsidies and estimated that this was around £6bn.

⁴ www.of.gov.uk/Business/Market+studies/subsidies.htm , referred to as the Stage One report.

supports the Commission's proposals. This report recommends how an economic approach could be applied to distortion to competition.

State aid control

State aid controls at the European level restrict the state aid that can be given by Member States through a process of prior notification and approval. The controls have an important role in promoting the common market through preventing many aids that would give some firms an unfair advantage over their competitors and would therefore distort trade and competition. The controls also prevent Member States using aid to entice businesses to locate in their country from getting involved with a bidding war using subsidies, a process that can lead to higher and higher subsidies.

State aid control is established by Articles 87 - 89 EC. Article 87(1) EC provides a general prohibition on state aid. However, the Treaty goes on to allow exceptions to the ban on state aid, in broad terms, where the proposed aid may have a beneficial impact. These are set out in Articles 87(2) EC and, of particular concern here, 87(3) EC. They refer to certain types of aid being 'compatible with the common market.' In order to assist the Commission and Member States with the assessment of whether a proposed aid is likely to be compatible with the common market (and permitted) under Article 87(3) EC, the Commission uses a system of controls made up of regulations, guidelines and procedures. It is this system of controls that the OFT believes could be improved to reduce the risk that aid that distorts competition significantly is approved, and aid that does not is prohibited.

Distortion to competition under existing rules

The provision of state aid may distort competition by:

- causing firms to set output and pricing levels inefficiently
- keeping inefficient firms in the market, discouraging entry by efficient companies or encouraging entry by inefficient firms, and
- distorting investment and research and development decisions.

In its first stage of work on public subsidies the OFT developed an economic framework to examine the impact of subsidies on competition. This showed that extent of distortion to competition depended the characteristics of the subsidy, such as its size and who it was available to, and the characteristics of the market(s) in which the recipients operate, such as the concentration of the market or barriers to entering the market.

As part of its second stage of work, the OFT used case studies to examine the effects of subsidies on competition in practice. The findings of the case studies were consistent with the economic framework developed in Stage One.

Therefore, in order to minimise the risk of granting subsidies that distort competition significantly, the state aid controls should be reformed to reflect more accurately the whether an aid is likely to have such an effect.

Proposed changes to state aid controls

An effects based approach should be applied when assessing whether a state aid may be permitted under Article 87(3).⁵ Proposed state aid would therefore be assessed on economic grounds and approved if the level of distortion to competition it gave rise to was justified by the benefits of the aid to the common interest.

We have considered how an effects-based assessment of the distortion to competition can be made. We support the Commission's view that aid that needs to address market failure in order to enhance productivity, hence we concern ourselves with whether aid to address a market failure is being granted in a way that will distort the market. Our proposals for changes to state aid controls are as follows:

⁵ We think that the existing approach to considering *whether a subsidy is a State Aid*, under Article 87(1) should not change. Retaining this approach ensures that aid with the potential to distort competition is identified and presumed to be prohibited unless approved.

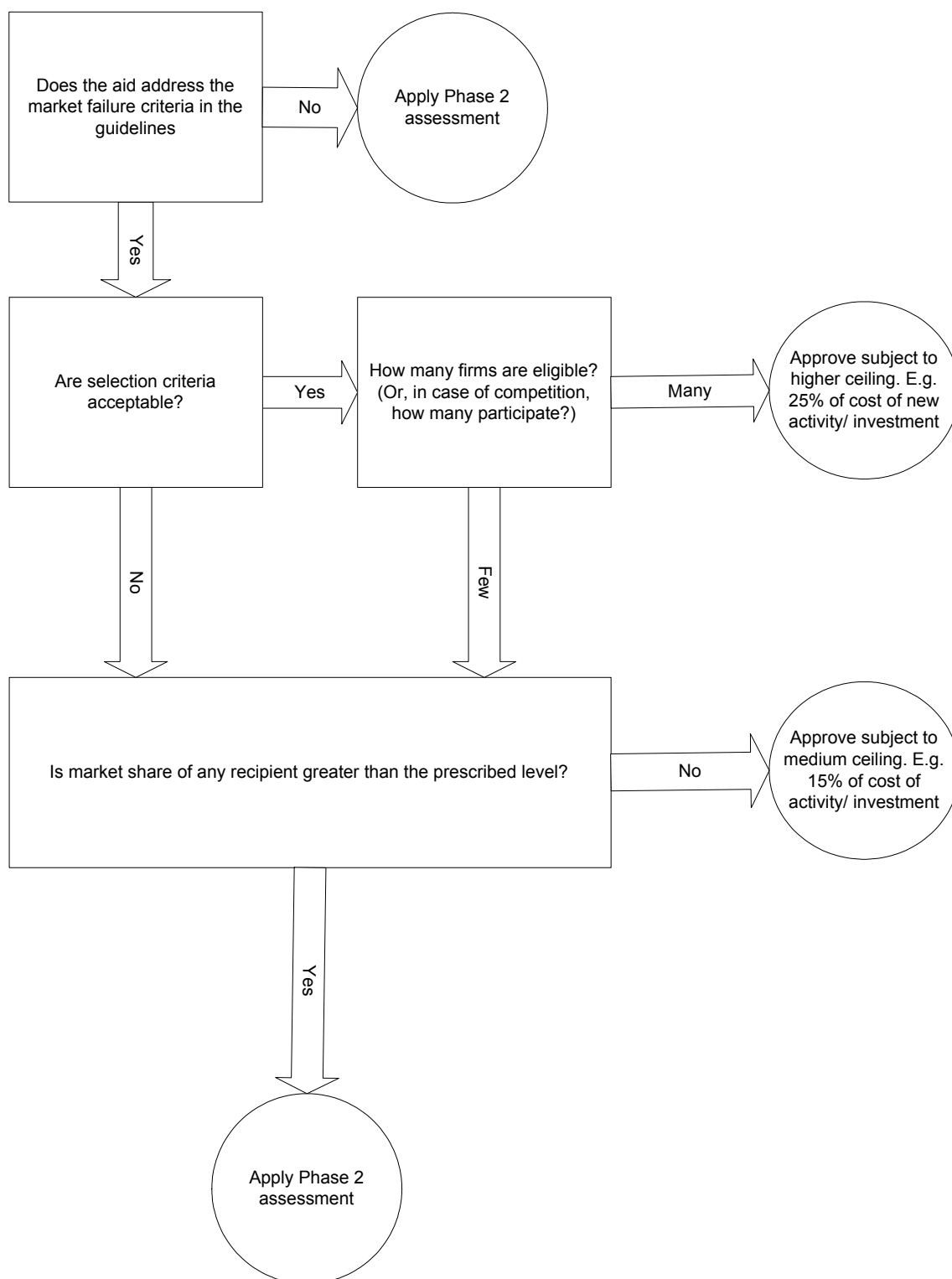
- block exemptions should continue to be used for those cases where competition effects are likely to be very small due to the small size and specific targeting of the aid
- a two phase approach is adopted for assessing the compatibility of aid under Article 87(3) EC
 - a phase one assessment of the likely significance of distortion to competition should be incorporated into the Commission's guidelines. Factors concerning whether the aid addresses a market failure, eligibility for aid and market share of recipient, should be included in combination with limits on overall levels of aid
 - for proposed aid that does not pass the phase one assessment the Commission should undertake an in depth phase two assessment based around transparent, economic criteria
- NCAs could give formal advice concerning whether proposed aid met the economic conditions of the guidelines. The Commission could have regard to this advice in deciding whether to approve the aid, but would not be committed to following it.

Phase one assessment

For the guidelines we propose a phase one assessment comprised of the following system of questions:⁶

⁶ It should be noted that the ceilings proposed for the phase one assessment are based roughly on our case study findings and that information from more cases should inform the actual ceilings used.

Questions for phase one:



These consider whether the eligibility for an aid is only limited in a way that is necessary to address the market failure in question, in which case the aid is

permitted subject to a ceiling or whether only a select group of firms are eligible, in which case the aid ceiling is lower. If very few firms are eligible for the aid, we propose that the aid is examined in greater depth through a phase two assessment if the market share of any of those recipients is greater than the prescribed level. Where the scale of the proposed aid is above the levels set in the phase one assessment, the aid would be subject to a phase two assessment unless it was aid for an activity that the private sector would not undertake commercially and the aid was tendered competitively.

Phase two assessment

In conducting a phase two assessment, the Commission would assess in detail the severity of distortion to competition against the benefit to the common interest of the aid. We propose a range of factors, based around the characteristics described in the first stage of work that should be taken into consideration when assessing the distortion to competition. We do not propose that a highly prescriptive approach is taken, as the potential risk to competition will depend on the exact circumstances of the aid. However, we do advocate that this approach should be consistent, transparent and based on sound economic principles.

Institutional changes

The Commission must retain its central position in state aid control, as it is best placed to ensure that all aid is assessed in a consistent manner across the EU.

NCA's could assist with the efficiency and ease of Commission decisions through giving an independent view of a proposed aid prior to it being notified to the Commission. Competition authorities could provide formal advice on whether proposed aid met the Commission's guidelines. The Commission would continue to be responsible for approving aid but could base this on the competition authority's advice. This would reduce the burden on the Commission of looking at proposed aid notified to it for approval. However, approval would remain the responsibility of the Commission which could re-examine the distortion to competition of aid about which it had concerns.

Finally, we would encourage the Commission to build a review into all of its reform plans for state aid, as it has proposed for the framework for Services of General Economic Interest.⁷ Any review should monitor the impacts of aid approved under the new regime to ensure that this aid that is not having unexpected effects on competition. This review would feed into further revisions of state aid control.

⁷ See Article 9 of the draft Decision on the application of Article 86(2) of the Treaty to State Aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, and Section 5 paragraph 23 of the Community Framework for State Aid in the form of public service compensation.

1 INTRODUCTION

- 1.1 In broad terms, any transfer of state resource that conveys an economic advantage on selected firms, and affects trade between EU Member States and distorts competition, or has the potential to do so, is considered to be state aid.⁸ In 2003, spending on state aid accounted for 0.4 per cent of European GDP, or €37.4bn. Although this reflects a decline in state aid from the peaks of the 1990s, it still accounts for 14.5 per cent of the combined budget deficits of Member States.
- 1.2 UK spending has been lower than most other Member States as a percentage of GDP, (€3bn or 0.19 per cent of GDP) but this figure has been rising since 1999. This is a significant sum of money and could have the potential to distort competition considerably.
- 1.3 In 2004 the OFT undertook a first stage of work to test whether subsidies could, in principle, distort competition.⁹ That study developed an economic framework for considering when the effects of subsidies on competition were likely to be significant.
- 1.4 The study found that the characteristics of the subsidy and the characteristics of the market were important in determining the magnitude of the effect on competition.^{10 11}

⁸ In this report we refer to 'state aid' when discussing subsidies controlled by the Commission. We define 'state aid' in the same terms as Article 87(1) EC. For the purposes of this report we have taken 'subsidies' to be any intervention by government that provides assistance to a firm or group of firms, this will include 'state aid'. It should be noted that our definition of 'subsidy' is different from the definition defined in *Steenkolenmijnen v High Authority* Case 30/59 [1961] ECR 1.

⁹ A copy of the OFT's first stage of work on Public Subsidies can be found at www.of.gov.uk

¹⁰ Characteristics of a subsidy found to be important included its size, whether repeated payments were made, selectivity of recipient and the direct effect on the recipient's costs.

¹¹ Characteristics of the market found to be important included the degree of concentration, product differentiation, entry barriers and relative size of firms.

- 1.5 In the first stage of our work, we also considered the extent to which existing state aid rules and guidelines reflected these characteristics and, therefore, prevented the subsidies that would have the most distortive effect on competition. We found that while the existing rules and guidelines prevented many potentially distortive subsidies, scope still remained to grant highly distorting subsidies. Therefore, the OFT proposed to undertake further work to indicate how state aid rules and UK guidance could be revised to reduce the risk of distorting subsidies being given.
- 1.6 In April 2005, we launched a second stage of work involving six case studies to test the economic framework identified in stage one, and determine whether these factors affected competition in practice. Information derived from the case studies, combined with our work in stage one, was used to develop our recommendations concerning how state aid rules and UK national guidance should be changed.
- 1.7 This report presents our proposals for changes to the way that state aid control is regulated. It sets out the rationale for moving to a more effects based approach to state aid control, describes the factors that are important for such an approach and sets out a practical way of revising the existing system to reduce the risk of significant competition distortions arising.
- 1.8 Our proposals for changes to UK national guidance will be published in a separate report and are not discussed further in this report.
- 1.9 Our study has proved timely. In June 2005, the Commission announced a comprehensive reform of state aid policy. At the time of the announcement the Commission launched an Action Plan for a consultation setting out high level reform proposals.¹²

¹² State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005 – 2009. http://europa.eu.int/comm/competition/state_aid/others/action_plan/

- 1.10 The Commission's aim is to present a comprehensive and consistent reform package based on the following elements: 'less and better targeted state aid, a refined economic approach, more effective procedures, better enforcement, higher predictability and enhanced transparency, and, a shared responsibility between the Commission and Member States.'
- 1.11 One intention underlying the Commission's proposals is the desire to reduce the caseload falling on DG Competition enabling them to focus more rigorously on the more complex distortive cases.¹³ The Commission's role involves approving or prohibiting proposed state aid notified to it, monitoring for state aid given unlawfully, pursuing cases of unlawful and misused state aid and ensuring enforcement decisions are followed. The Commission has struggled over the last few years with the workload generated by state aid control. As a result there are significant delays in reaching decisions concerning notified state aid. The enlargement of the EU in May 2004 has added to the pressure in the system.
- 1.12 The OFT has welcomed the Commission's initiative to undertake a comprehensive reform of state aid policy.¹⁴ The reforming of the guidelines, which the Commission uses for deciding on the compatibility of specific state aid, gives the Commission the opportunity to introduce a robust economic framework. An economic framework should ensure that state aid is permitted in areas beneficial to the common market where it addresses market failure in the most efficient manner without distorting competition significantly, and that state aid which does not benefit the common market is prohibited.

¹³ DG Competition is the Competition Directorate General of the European Commission, which takes decisions on competition law cases (including infringements, mergers and State aid).

¹⁴ The former Chairman of the OFT welcomed the Commission's proposals in his July 2005 speech given at the DTI Presidency Event on State Aid, this can be downloaded at [www.oft.gov.uk/News/Speeches + and + articles/2005/index.htm](http://www.oft.gov.uk/News/Speeches+and+articles/2005/index.htm)
In addition, the OFT has published its response to the Commission's Action Plan on State Aid reform, this can be downloaded at [www.oft.gov.uk/Business/Market + studies/subsidies2.htm](http://www.oft.gov.uk/Business/Market+studies/subsidies2.htm)

1.13 This report, which is intended to contribute to the Commission's thinking on reform is structured as follows:

- Chapter 2 summarises the current rules controlling the provision of state aid and examines the potential effects of state aid on competition. It concludes that state aid can significantly distort competition and that the current rules on state aid do not always sufficiently address the risk of competition distortion
- Chapter 3 presents the need for an economic approach and explains how this could be incorporated within the existing Treaty framework for state aid control
- Chapter 4 presents our proposals for changes to the guidelines concerning which state aid should be approved
- Chapter 5 makes recommendations concerning how the Commission should assess state aid that does not fit within the guidelines, and
- Chapter 6 sets out the roles for different parties in state aid control.

2 ASSESSING THE CURRENT SYSTEM OF STATE AID CONTROL

Introduction

- 2.1 Chapter 2 examines the reasons for European state aid control, what the current rules are and how they work in practice. It assesses the current system of control to determine whether the current rules are able to detect all state aid that is likely to distort competition significantly, while allowing all aid that is not significantly distortive.
- 2.2 The chapter then looks at the characteristics identified in the first stage of our work and assesses these against the results of the case studies commissioned by the OFT in the second stage of our work and against case law to determine whether the economic principles are soundly based.
- 2.3 The chapter concludes that the current state aid rules:
- allow state aid that can significantly distort competition
 - subject insignificantly distortive state aid to too much scrutiny, causing an administratively unmanageable system, and
 - would be made more effective if an effects based approach to assessing state aid were introduced.

Reasons for European control of state aid

- 2.4 State aid is an important policy tool for achieving social and economic goals. However, depending on the way in which aid is given, it can lead to significant distortions to markets and detriment to consumers.

- 2.5 Competition is the process of rivalry between firms that ensures markets function effectively, by rewarding efficient firms that direct resources to the uses most valued by consumers. If firms are not rewarded for making such decisions, or are rewarded for making the wrong decisions, then resources will be used inefficiently, thus incurring a cost to the economy. State aid can interrupt this process by sending the wrong signals to firms about the desirability of certain goods to consumers, and allows less efficient firms to prosper against more efficient ones.
- 2.6 In the short term, consumers may benefit from lower prices as a consequence of state aid. However, in the longer term, as incentives for efficiency are dulled, prices are likely to rise above their original levels. Furthermore, the recipients may become more influenced by the aid than by their customers' desires.
- 2.7 State aid control is a way of limiting the risk that state aid distorts competition in the single European market. More specifically, state aid may distort competition by:
- causing firms to set output and pricing levels inefficiently
 - keeping inefficient firms in the market, discouraging entry by efficient companies or encouraging entry by inefficient firms, and
 - distorting investment and research and development decisions.

The first stage of our work discussed the costs arising from distortions to competition in more detail.

- 2.8 The risk to the common market posed by state aid was recognised at the inception of the European Community. Article 87(1) EC provides that:

'Save as otherwise provided in this Treaty, 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 firms or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.'

2.9 Article 87(2) and (3) EC, however, go on to recognise that state aid which fulfils certain Community objectives may have beneficial effects for the common market and may be permitted as compatible with it.

2.10 The OFT is of the view that the Commission, with its responsibility for protecting the common market, is in the best position to consider whether state aid is in the interest of that market, for three reasons:

- in providing state aid, the welfare benefit will often be experienced in the Member State providing the state aid, whereas the cost in terms of distortion to competition could often occur in other Member States, depending on the size of the market. Therefore, as the 2001 OECD report, *Competition policy in subsidies and state aids*,¹⁵ states, 'It is clear that the appropriate level of government [to control subsidies] is a jurisdiction with a geographic scope large enough to cover all of the effects of the subsidy.'
- where state aid is concerned, the possible distortion to competition arises from government intervention, rather than through actions by firms in the market. The Commission, which is independent from (national) government, can ensure that all state aid is assessed in a consistent and equal manner across the EU
- the Commission is also in the best position to prevent subsidy races between member states that may compete to attract companies by offering subsidies. The result of such races is that subsidies are bid up, which is expensive for taxpayers.¹⁶

¹⁵ *Competition Policy in subsidies and state aids* OECD 2001, p32, DAFPE/CLP(2001) 24.

¹⁶ *'The Effects and Policy Implications of state aids to Industry: an Economic Analysis'*, Economic Policy, 1998, T. Besley and P. Seabright, states, 'The source of the problem is the conjunction of externalities and non-cooperative behaviour. The latter could be remedied by private negotiations or repeated interactions. However, where these fall short of a full remedy (which they seem likely to in practice), there is need for some kind of central regulator.'

The current rules

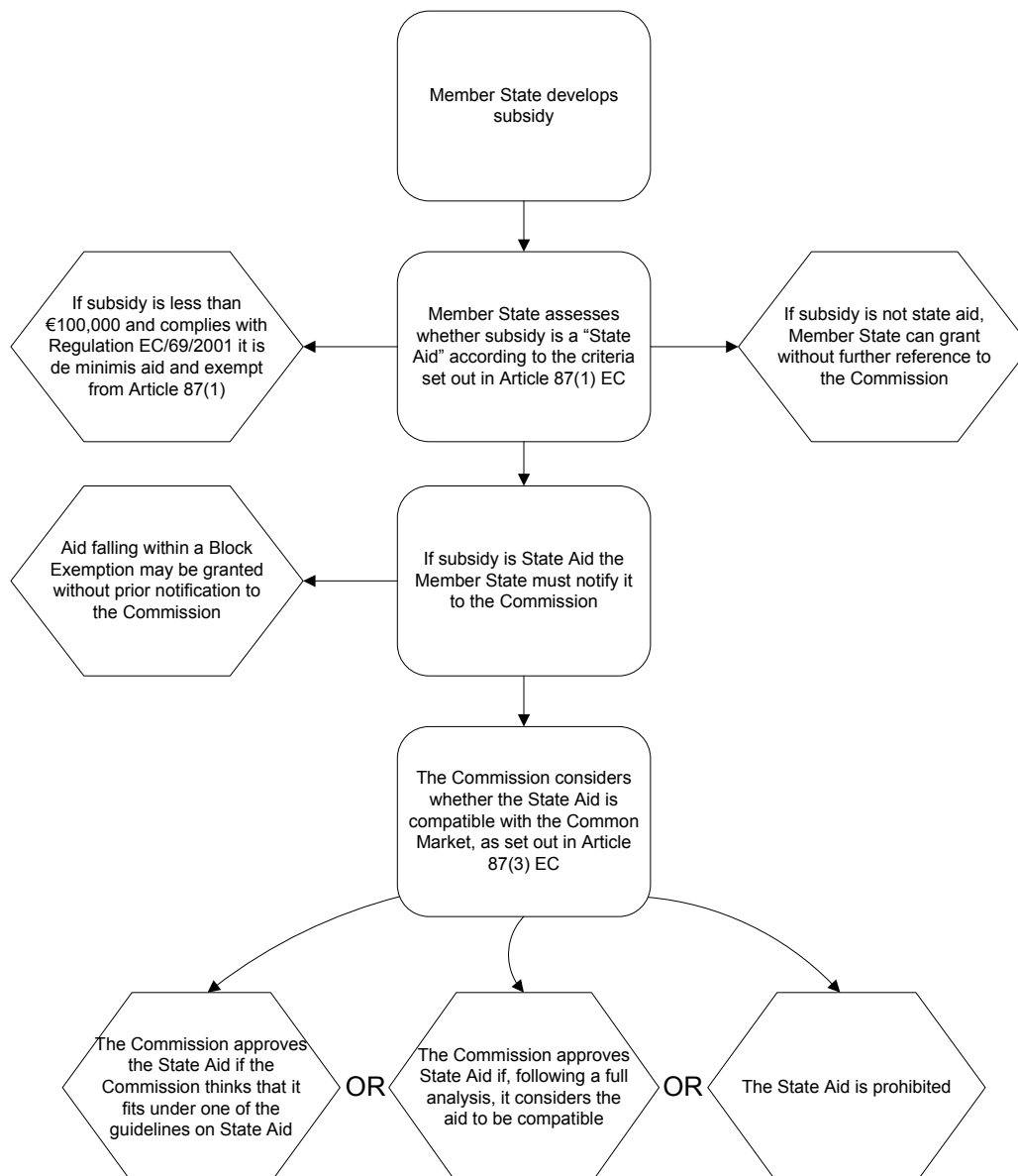
- 2.11 Articles 87-89 EC underpin the current state aid controls. As stated above, the Treaty starts from the position, in Article 87(1) EC, that all state aid should be prohibited. Articles 87(2) and 87(3) EC then provide for a number of derogations from this, where state aid is, or may be, permitted.
- 2.12 Under Article 87(2) EC aid to address certain specific issues, for example state aid to make good the damage caused by natural disasters, is permitted as compatible with the common market. Under Article 87(3) EC, aid falling within specified categories, which relate to Community objectives, may be permitted. Article 87(3) EC confers on the Commission discretion to permit as compatible with the common market, state aid that falls within those categories.¹⁷
- 2.13 Before it is granted proposed new state aid must be notified to the Commission for approval.¹⁸ The Commission has passed regulations and published procedural guidelines that describe in more detail the type and level of state aid that is likely to be considered acceptable under Article 87(3) EC, and the procedures they intend to follow when looking at proposed state aid.¹⁹
- 2.14 A Member State may also notify the Commission for approval of a state aid to which no procedural guidelines or regulations apply. In this situation the Commission must assess its compatibility with the common market directly on the basis of Article 87(3) EC, and may choose to permit the aid. Diagram 2.1 describes the approval route for state aid under the current rules.

¹⁷ Save in the case of aids falling within Article 87(3)(e) EC, where powers are given to the Council.

¹⁸ This is true for all state aid that does not meet the conditions of a block exemption regulation, see diagram below.

¹⁹ Further details on the current state aid regulations and the published procedural guidelines can be found in Annexe B.

Diagram 2.1: The approval route for state aid under the current system



How are the current rules applied?

2.15 Existing case law has developed a formalised approach to assessing distortions to competition under Article 87(1) EC. The Court has in effect, taken the approach that the starting point for the assessment of a proposed subsidy is a presumption that if one or a group of firms are favoured by the proposed subsidy then it will distort competition.

- 2.16 The OFT is of the view that the current approach to assessing the impact of state aid on competition is inadequate and that a more effects based approach is required. The current approach does not consistently apply economic criteria to assess competition distortions. The failure consistently to apply such criteria means the assessment of some state aid that does not fall within existing guidelines, especially minor state aid, requires an amount of work disproportionate to the significance of the state aid.
- 2.17 At present, the assessment need not analyse the effect on competition in the same way that is required when assessing agreements and practices for the purposes of Articles 81 and 82 EC.²⁰ Instead the Commission need only find that the proposed subsidy strengthens the position of the recipient(s) compared with other firms competing in intra-Community trade within the market.²¹
- 2.18 The result of the existing case law is that, in practice, it has created a broad view of what constitutes distortion to competition, in which subsidies that have only a very small effect on competition can fall within the definition of state aid in Article 87(1) EC and its prohibition.

²⁰ See *Philip Morris Holland BV v Commission* Case C-73/79 [1980] ECR 2671, where the court held that when state financial aid strengthens the position of an undertaking compared with others engaged in intra-Community trade, competition must be regarded as distorted.

²¹ This does not mean no assessment is necessary: in *Leeuwarder Papierwarenfabriek BV v Commission* Case C-296/82, 318/82 [1985] ECR 809 the court said that, in deciding an aid distorts competition, the Commission must set out the considerations that led it to that decision. So, some identification of the relevant market, the place of the recipient undertaking in it and the pattern of trade in the relevant products is necessary. But, in the absence of circumstances to rebut the starting presumption (see paragraph 2.11 above), aid is likely to be found to distort competition and to be a state aid within Article 87(1) EC (assuming the other criteria, such as effect on trade between Member States, are met).

- 2.19 As discussed in paragraphs 2.11 to 2.14, state aid may be permitted if it falls within a category that is deemed to be, or may be, compatible with the common market. The Commission has published guidelines outlining in more detail types of compatible state aid under Article 87(3) EC however, these guidelines do not apply economic criteria to assess the extent to which such state aid distorts competition.
- 2.20 The Commission's guidelines have been developed through experiences with notification and approval of specific forms of state aid, and in accordance with European policy. However this state aid when assessed itself, will not generally have been assessed on a rigorous economic basis. This means that current state aid permitted under the guidelines could still distort competition significantly.
- 2.21 A further result of the development of the guidelines to permit specific forms of state aid, is that the guidelines do not easily apply to new subsidy ideas.
- 2.22 Consequently, new subsidy ideas are often subjected to a direct assessment under Article 87(3) EC. The need for a direct assessment also means that some, especially minor, state aid is not assessed as efficiently as they could be.
- 2.23 This disproportionate amount of assessment for minor state aid has led to an administratively difficult system, in which proposed state aid even of a small scale is subject to a time-consuming direct assessment by the Commission under Article 87(3) EC. This view has been recognised recently by Commissioner Kroes in her speech as part of the UK Presidency event on state aid.²² An initial effects based assessment would identify state aid that is unlikely to significantly distort competition, and would therefore lead to the possibility of a more efficient approval process.

²²A copy of Commissioner Kroes speech can be found at:
<http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/440&format=HTML&aged=0&language=EN&guiLanguage=en>

The effect of state aid on competition

2.24 As outlined in Chapter 1, the first stage of our work into public subsidies concluded that almost all subsidies have some impact on competition.²³

The significance of this impact depends on two sets of factors: the characteristics of the subsidy and the characteristics of the market(s) in which the recipients operate.

2.25 The main characteristics of a subsidy that affect the size of any competition distortion are:

- the absolute size of the subsidy as well as its size relative to the costs of the activity being subsidised
- the level of selectivity of the subsidy, that is, whether it is provided to one, some or all firms in a market
- whether the subsidy affects the recipient's costs directly
- whether the subsidy is provided on a recurring basis.

2.26 In terms of market characteristics, distortions are most likely to be significant if:

- the market is concentrated, that is, if there are relatively few firms operating in the market affected by the subsidy
- there is a high level of product differentiation
- the firms in the market are of markedly different sizes
- there are barriers to entry
- the subsidy supports research and development and firms in the market compete on this basis.

²³ A copy of first stage of our report can be found on our website at www.oft.gov.uk

2.27 Our first stage of work found that these characteristics were not generally recognized in the Commission's guidelines. In principle, therefore, there was a risk that some state aid that is permitted under the guidelines can distort competition significantly.

The effectiveness of existing state aid rules in preventing distortion to competition

2.28 In stage two of our work we used six case studies to build on the theory developed in our first stage and to test our proposed recommendations.²⁴ This section examines the five case studies that concerned state aid and discusses our findings against the economic theory developed in stage one of work.

2.29 In case studies one and two we looked at grants which had been approved under the Commission's Regional Aid guidelines.

Case study one

In case study one, a state aid to support investment was provided on a selective basis to a manufacturing firm. Following a sharp unanticipated downturn in the relevant market the state aid has contributed towards retaining excess capacity in the industry. The terms of the state aid provide an incentive for the recipient to stay in the industry, despite incurring losses, while other firms are leaving the industry.²⁵

²⁴ Further details on our case studies will be published with our forthcoming report on UK National Guidance for subsidies.

²⁵ We were unable to test whether the grant would have distorted competition, had the industry not experienced the sharp unanticipated downturn. We note that the grant would have assisted the recipient in accessing significant market share which, according to theory, would lead to adverse competition effects.

Case study two

State aid was given to a large manufacturing firm. The firm was considering moving production to the Far East. The objective of the state aid was to keep the firm in the UK, by providing support for investment. Projections however showed that the aid was expected to generate greater growth for the firm than it would have achieved in the Far East. Over the four years during which the state aid was provided the recipient has significantly increased its share of the market. Our research concluded that the subsidy characteristics are likely to have affected pricing and output decisions of the firm. In addition the market characteristics suggest that the state aid had an influence on the recipient's strategic decisions causing an impact on the market. Both these effects would therefore indicate that the state aid has distorted competition in the market, though there is no evidence to link the aid to any exit of competitors.

- 2.30 On initial examination the characteristics of the state aid in case studies one and two were highly suggestive that the aid could have a significant impact on competition. For example in one of the cases the subsidy was substantial in size, and was targeted at a market leader in a concentrated market. These characteristics were identified in the first stage of our work as characteristics that lead to state aid having a significant impact on competition. This appears to have been the case in practice.
- 2.31 The first two case studies support the conclusions of the first stage of our work that subsidies which can significantly distort competition can be given under the current state aid rules.

- 2.32 It may be the case that these subsidies generate significant benefits for the common market.²⁶ However, the current system of control does not ensure that, for subsidies that distort competition significantly, the comparison of costs and benefits is adequately undertaken.
- 2.33 In the third case study, we considered a case in which a research and development subsidy was approved to a firm involved with a new product design. On initial examination the subsidy characteristics were strongly suggestive that the subsidy could significantly distort competition. However, the characteristics of the market pointed the other way. On analysis, there was no evidence found of significant distortions to competition despite the near-to-market nature of the product. Indications from the research pointed to the fact that although the subsidy was large relative to the turnover of the recipient, the recipient was small relative to the market.

Case study three

State aid was provided to a firm involved with product design. The recipient received a total of four individual subsidies in order to help finance a feasibility study and the development of a prototype of the product to then be commercially exploited. This state aid was approved under the Research and Development guidelines, and was substantial in size relative to the size of the firm. Our research concluded that without the subsidy it would have been likely that the firm would have failed to develop some of the products. However it was found that competition distortions were highly unlikely to have arisen due to the relative size of the recipient in the market.

- 2.34 The results of the third case study seem to conflict with the position in the case of *Regione Autonoma Friuli-Venezia Giulia v Commission*.²⁷ In that case the state aid fell outside the Commission guidelines and was

²⁶ Assessment of the benefits of subsidy was not within the scope of this work.

²⁷ Case T-288/97 [2001] ECR II-1169.

assessed directly under Article 87(3). The court held that the state aid distorted competition despite it being argued that the state aid was very small, that the recipients had only a marginal share of the market and that the effect of the state aid on competition would be insignificant.

- 2.35 This contrast is indicative of the failure consistently to apply an effects based approach to assessing competition distortion. Our third case study would suggest that small market share should be one of the economic criterion used in assessing state aid under Article 87(3) EC.
- 2.36 Our remaining two case studies of state aid examined situations of competition for a state aid to create infrastructure and provision of a widely available aid to tackle market failure.²⁸ In these cases the framework suggested there would not be a significant impact on competition and this was supported in practice. In the former case no comparable private infrastructure was available, or was likely to become available for the duration of the subsidy. As a result, no significant effects on competition were observed. In the latter case, the aid was widely available with market principles determining the final recipients and hence was unlikely to create unfair competition between competitors.

Conclusions

- 2.37 In our view the European state aid rules should be improved to take better account of the potential for competition effects to arise, assessing those effects through a more rigorous economics based approach.
- 2.38 We have found evidence of approved state aid that can have a material impact on competition. An economics based approach would identify these potentially significantly distortive cases prior to approval.
- 2.39 It is therefore our aim to recommend changes to the state aid rules to ensure that distortion to competition is considered in a systematic, economic and proportionate manner.

²⁸ Our sixth case study concerned a subsidy that was not state aid.

- 2.40 In proposing changes, we recognise the need to ensure these are workable. In particular they need to have regard to time and resource constraints on the parties involved, information available and the incentives on the parties when assessing proposed state aid.
- 2.41 In balancing these aspects we have reached a set of recommendations we consider to be practical. We have tested our proposal for a two phase approach on the case studies and have found our approach to be both workable and practicable.

3 REFORMING THE APPROACH TO STATE AID CONTROL

Introduction

- 3.1 Chapter 3 discusses how the gaps identified in Chapter 2 regarding the current approach to state aid control can be addressed. It examines the economic and practical requirements which need to be taken into account in reform to state aid control, and proposes the introduction of a two phase process for assessing the potential impact of a proposed state aid on competition.
- 3.2 The chapter concludes by discussing how a two phase approach would fit into the state aid assessment system. It explains that, in our view, it would be most suitable to introduce an effects based approach when assessing the compatibility of state aids falling within the categories in Article 87(3) EC, rather than when assessing whether a subsidy is a state aid under Article 87(1) EC.

Requirements for reform of state aid control

- 3.3 As discussed in Chapter 2, the approach taken to assessing state aid is a strict formalised approach, in which subsidies that have only an insignificant effect on competition fall within the definition of state aid in Article 87(1) EC and its prohibition. Furthermore, some state aid that has the potential to distort competition significantly, can currently be approved under Article 87(3) EC without an economic assessment of its effects.
- 3.4 The Commission has recognised the need to adopt a more effects based approach in a system which allows the Commission to target the most distortive types of state aid. The challenge is therefore to ensure that any proposals for reform meet certain requirements:
- proposals must be compatible with the Treaty
 - the Treaty defines state aid in broad terms so many subsidies are captured. State aid controls need to be applicable to this wide range of subsidies

- finally, because so many subsidies are captured the control process needs to be administratively manageable.

- 3.5 In developing the framework, we therefore need to ensure that all state aid that may be compatible with the common market under Article 87(3) EC is subject to a certain level of assessment while at the same time allowing for a greater focus on ultimately more distortive state aid.
- 3.6 The OFT, therefore proposes that a two phase approach (not wholly dissimilar to that used in merger assessment) is used. This way, state aid that is unlikely to distort competition significantly is approved more easily, allowing more targeted assessment and control of state aid that is potentially more distortionary.
- 3.7 In developing this approach we have balanced what is ideal in economic terms with what is practical for the purposes of administration.²⁹ For this reason we propose that the system of block exemptions is retained. Block exemptions are a simple, efficient way of approving certain aid that meets objectives of common interest. Although the criteria for applying block exemptions are imperfect, because they do not take into account the benefit accruing to the recipient relative to its market position, the risks of distortion are low compared to the cost of applying economic criteria to such state aid.³⁰

²⁹ During the course of the study we have considered a range of alternative proposals before developing a present approach, these are detailed in Annexe C.

³⁰ It should be noted that our proposals are limited to ensuring that State Aid does not give rise to significant distortions to competition, taking into account, as appropriate, any benefit it might provide for the common good, rather than providing a full appraisal of proposed aid (for example, is it good value for money). It is our view that Member States, in developing State Aid proposals, will want to appraise the costs and benefits for themselves and the role of State Aid control is to address the situations in which the cost to the Member State giving the aid is not as great as the cost to the other Member States due to the aid's adverse effects on competition.

A two phase approach to state aid control

- 3.8 The aim of a two phase approach to state aid control is to improve the economic rigour of state aid regulation without requiring extensive analysis for the majority of state aid. The phase one assessment would facilitate a quick assessment of all subsidies that may be permitted under Article 87(3) but are outside the scope of the block exemptions. It would indicate whether they are unlikely to significantly distort competition, in which case they may be approved; while phase two would provide a more detailed assessment of the proposed state aid that failed phase one.
- 3.9 The OFT is of the view that the phase one assessment would be most effectively introduced through changing the guidelines on state aid.³¹³² Phase one will incorporate the critical factors that determine whether a state aid is likely to distort competition significantly. These include whether the aid addresses a market failure, eligibility for aid and market share of recipient as well as limits on overall levels of aid and are discussed in more detail in Chapter 4.
- 3.10 For proposed state aid which maybe compatible with the common market under Article 87(3) EC but fails the phase one assessment, the OFT proposes that the Commission undertake a detailed phase two assessment of the extent to which it distorts competition, based around transparent economic criteria.
- 3.11 The initial basis for the second phase assessment should be the characteristics set out in the framework, detailed in Chapter 2 and identified in the first stage of our work. However, these should form part of a wider economic analysis that includes all relevant factors.

³¹ Chapter 4 describes our approach to a phase one assessment in more detail.

³² Guidelines refers to the Commission guidelines on state aid that describe in more detail the type and level of state aid that is likely to be considered acceptable, and the procedures they intend to follow when looking at proposed state aid under Article 87(3).

3.12 Chapters 4 and 5 discuss our proposed changes in more detail. Annexe C contains detail on alternative recommendations that we considered and rejected.

How would a two phase approach fit into the state aid system?

3.13 A two phase effects based approach could potentially be applied to assess competition distortion in two areas:

- an effects based approach could be used to determine whether a subsidy is a state aid for the purposes of Article 87(1) EC
- alternatively, such an approach could be used to determine whether a state aid falling within the categories set out in Article 87(3) EC is compatible with the common market (and may therefore be permitted).

Article 87(1) EC

3.14 As previously noted, currently subsidies that result in only very small distortions to competition can amount to state aid for the purposes of Article 87(1) EC. An effects based approach under Article 87(1) EC, would subject each subsidy that met the other criteria of Article 87(1) EC to an assessment to see whether it had a significant (or appreciable) effect on competition based upon the proposed framework. This would mean that:

- subsidies that are identified as likely to have a significant impact on competition would be defined as state aid and either prohibited under Article 87(1) EC or permitted under derogations, like those in Article 87(3) EC, or
- subsidies that did not affect competition significantly, would not be considered to be state aid and would fall outside the state aid control, and thus would not need to be notified to the Commission.

- 3.15 The main benefit of introducing an assessment under Article 87(1) EC would be that it would allow for the identification of state aid that has the potential to impact significantly on competition. This would consequently reduce the number of state aid cases notified to the Commission, reducing the workload on the Commission and subsidy providers.
- 3.16 However, there are a number of risks with such an approach. By introducing a more rigorous approach under Article 87(1) EC, the definition of when a subsidy constitutes being defined as a state aid would effectively change. Arguably, this would require changes to the EC Treaty as discussed below.
- 3.17 As discussed in Chapter 2, existing case law has taken a formalised approach to determining what constitutes a distortion to competition. The result is that a large proportion of subsidies are caught within the state aid net.
- 3.18 Changing the approach to assessment under Article 87(1) EC would potentially raise the threshold as to what is deemed to be a distortion to competition. Raising the threshold at which a subsidy is deemed to distort competition would mean that less subsidies would fall within the definition of state aid.
- 3.19 Although there are benefits to this, it is to be recognised that currently only notified state aid to the Commission is systematically recorded across the EU. Reducing the amount of subsidies that are notified, has the potential to increase the risk of un-notified and unlawful state aid existing.
- 3.20 There would therefore appear merit in regarding subsidies as, generally distortive of competition and thus keeping a low threshold for the Article 87(1) EC prohibition. This would remove the risk of an increased amount of un-notified and unlawful state aid existing within the EU.

Article 87(3) EC

- 3.21 Applying an effects based approach in Article 87(3) EC rather than Article 87(1) EC would mean that the definition of what constitutes state aid would remain the same. An assessment of a proposed state aid would instead be applied to assess the extent of competition distortion of state aid falling within the categories in Article 87(3) EC.
- 3.22 Applying an effects based approach in this context would involve identifying whether distortions associated with a proposed state aid were likely to be large, or whether they were small relative to the benefit to the common market.
- 3.23 The benefits to applying an effects based analysis to be used in the assessment of state aid in the categories in Article 87(3) EC are that:
- assessment of these aids would enable the extent of their distortion to competition to be weighed up against other beneficial effects the state aid may have for the good of the common market
 - this would not involve challenging existing case law concerning what is defined as state aid under Article 87(1) EC, nor changes to the Treaty, and
 - it could, in the OFT's view, result in better designed subsidies. At present, subsidy providers may be inclined to design subsidies to 'fit' existing guidelines, to avoid the delay and uncertainty of a direct assessment under Article 87(3), regardless of whether the subsidy fully meets the desired policy objectives. If the Commission's assessment were based on clear, more certain, criteria, taking into account the economic effect of an aid and any benefits it may create for the common good, subsidy providers need not be so anxious simply to meet form based guidelines.

3.24 We recognise that this does not reduce the number of state aid cases and the Commission is potentially left in a position where it has an administratively unmanageable workload. However, this burden can be reduced by introducing the proposed two phase approach in which the phase one assessment deals efficiently with cases where competition would not be distorted significantly. Therefore the OFT believes it is more suitable to introduce an economics based approach in Article 87(3) EC as opposed to Article 87(1) EC.

4 PHASE ONE ASSESSMENT

Introduction

- 4.1 Chapter 3 discussed the principles of reform to the system of state aid control. This chapter sets out the phase one assessment that we propose should be incorporated into the Commission's guidelines.
- 4.2 This chapter proposes a phase one assessment that permits aid that is readily identifiable as being unlikely to distort competition significantly. This includes the following types of aid:
- aid that addresses a market failure objective and is available to all firms capable of meeting the objective
 - lower levels of aid that addresses a market failure but is available only to firms meeting criteria that are not essential to the market failure objective of the aid, and
 - aid for an activity that is non-commercial provided through an open and transparent competition.
- 4.3 Under a phase one assessment aid that had the potential to distort competition significantly would not be approved directly and would need to undergo an in-depth phase two assessment. This would include:
- aid that is given selectively to firms with high market share
 - aid that exceeds certain thresholds, and
 - aid not directed towards a recognised market failure.
- So too would any other aid which the Commission cannot conclude passes the phase one assessment.
- 4.4 This chapter discusses the selection of the characteristics that are included in the phase one assessment, sets out the structured questions for phase one assessment based on these characteristics and describes the treatment of aid that does not pass the phase one assessment. It

then explains how downstream effects and competition for subsidy should be considered in phase one before giving some detail concerning how to define the market for the purposes of conducting an economics based assessment.

Characteristics for inclusion in the phase one assessment

- 4.5 This section sets out the characteristics for inclusion in the phase one assessment and how these were selected.
- 4.6 The phase one assessment determines which aid can be approved without further analysis. Phase one must therefore include characteristics that can be used readily to screen out aid that is unlikely to distort competition significantly. These are characteristics that do not create a significant risk for competition if combined with other characteristics. For example, aid that is given to all firms in the market will not distort competition whether the firms in the market are similar sizes or not. Conversely, if firms in the market are the same size, competition may still be affected significantly depending on whether the aid is available to all firms or only a subset. Hence, selectivity would be a more appropriate characteristic for phase one than symmetry of firm size.
- 4.7 The characteristics in phase one (and the levels specified for these) need to be set to approve certain aid without further conditions. Aid that fails phase one may still be approved at phase two if it is found to be less damaging to competition when these characteristics are combined with others.
- 4.8 In addition, Chapter 2 concluded that there was a need for practical assessment that could be applied easily by subsidy providers. To be practical the characteristics in phase one should meet the following requirements:
- assessment of the characteristic does not require a significant amount of interpretation. This is required to minimise the risk that different subsidy providers might interpret similar information differently

- assessment of the characteristic is not unduly burdensome so subsidy providers are not faced with an onerous task, or
- the relationship between the characteristic and the distortion to competition is direct so it is easy to specify the level at which the subsidy becomes a significant risk to competition.

4.9 We considered all the characteristics identified in the framework established in the first stage of our work, and decided that questions based on the degree of selectivity of the aid, the relative size of the aid and, in some circumstances, the market share of the recipient were most appropriate for the phase one assessment. These questions enable subsidies that are unlikely to distort competition significantly to be approved quickly, and those which pose more of a risk to competition to be analysed in greater depth in a phase two assessment.

4.10 In developing this approach to permitting subsidies that do not have a significant impact on competition we have assumed that the Commission will follow the intention set out in the State Aid Action Plan, to revise the guidelines so that aid is considered according to whether it meets a recognised market failure. This is discussed in greater detail in paragraphs 4.18 and 4.21.

4.11 These characteristics are discussed in turn. Detail on the characteristics not selected is provided at Annexe C.

Selectivity

4.12 The degree of selectivity of the aid is important because the provision of a subsidy to a subset of participants in the market will advantage these participants relative to others, thus distorting competition. In some circumstances subsidies can be designed so that all competitors are eligible.³³ However, in other cases the objective of addressing the market failure may require a greater degree of selection. For example, there may be a market failure in the provision of venture capital only for small firms

³³ This is more likely to be the case for local markets.

due to the transaction costs of investing in such firms. In this case a venture capital subsidy might need to be targeted towards small firms rather than all firms in the industry.

Market share

- 4.13 Firms with large market share are more likely to have market power and therefore their behaviour is more likely to affect competitors.³⁴ Hence a subsidy that changes the behaviour of a firm with large market share is more likely to force other firms in the market to respond by changing output or price or to consider whether they wish to stay in the market.
- 4.14 In addition there is the possibility for aid to increase the recipient's market share to an extent that it achieves a position of market power. Although a firm in a dominant position in a market will not necessarily abuse its market power, there is greater likelihood that an opportunity has been created for this to happen. Hence it is important to ensure that the risk to competition is fully assessed when aid is proposed that may create market power.

Size

- 4.15 The size of the subsidy is a major factor in determining the subsidy's impact, both in terms of the desired impact and the undesired impact. We propose that the size of the subsidy relative to the size of the new investment or activity is considered in the phase one assessment (as in existing guidelines).

³⁴ In this report we consider the market that is made up of competitors, regardless of where the competitors are located. Hence, for some recipients the relevant market will be the local one while for others it will be a European or even global market. This is discussed in greater depth in the paragraph on market definition.

- 4.16 This ratio is not a perfect measure of the likely competition distortion because substantial public support for an investment may not distort the market if the total investment is small relative to the size of the market. However, it is used here as a safeguard to ensure that aid that gives a high degree of assistance in changing the recipient's behaviour, can be looked at in depth by the Commission.
- 4.17 Ideally we would want to limit the size of the subsidy to the minimum size required to address the market failure being targeted. However, in practice this would be difficult for the Commission to assess when considering an aid notified to it. Hence the size of the subsidy relative to the new investment is proposed here.

Market failure

- 4.18 In its State Aid Action Plan the Commission states, 'A market failure is a situation where the market does not lead to an economically efficient outcome. When markets do not achieve economic efficiency, Member States or the Union may intervene in order to correct market failures.'
- 4.19 Consideration of market failure is also important when examining distortion to competition, as a well designed subsidy, targeted at a market failure, should improve the functioning of the market. To understand why this is the case, consider the example of training. It is often argued that the market undersupplies training relative to the socially optimum level because an employer does not obtain the full benefits of training because the trained employee may leave the employer. As a result, too little training is invested in from the perspective of the economy as a whole. A subsidy could be used to increase the amount of training provided to the socially optimum level.
- 4.20 Subsidy that addresses a market failure must be given in a way that minimises the distortion to competition otherwise the improvement in efficiency being created may be undermined by other distortions. In the Action Plan the Commission recognises this concern and also highlights that there may be alternative policies to subsidies that may tackle the market failure without distorting competition as much.

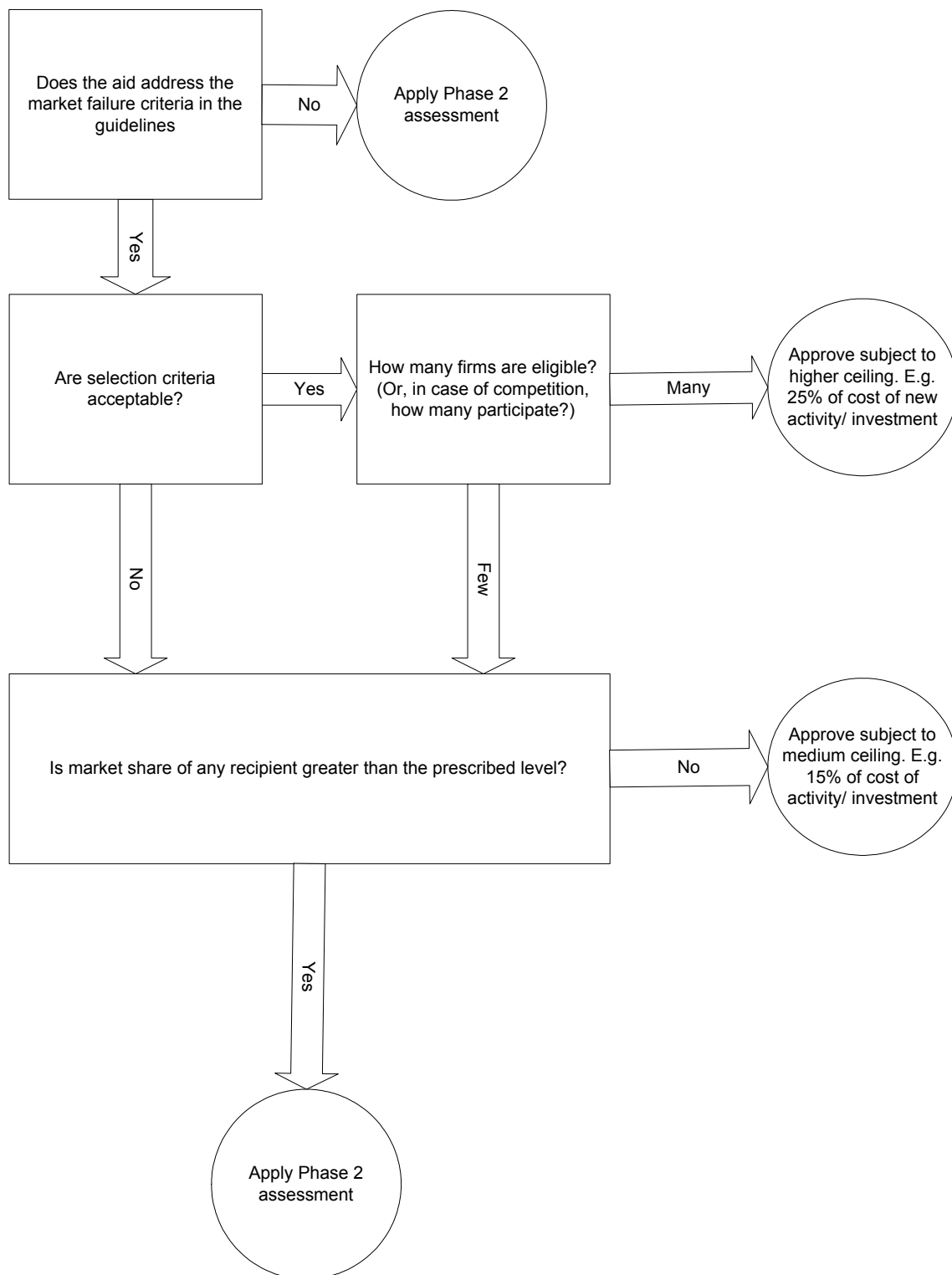
4.21 We therefore also include whether the subsidy addresses a market failure as one of the characteristics in the phase one assessment. As this is an area that the Commission has undertaken work on and as it is primarily linked with whether a subsidy is effective in promoting growth, we have not sought to specify the eligible market failures in this work.

Details of phase one

4.22 This section explains in more detail how the phase one characteristics would be assessed.

4.23 Diagram 4.2 presents the questions that would be considered in phase one. The approach we propose to applying the selected characteristics reflects their complementary nature.

Diagram 4.2: Questions that would be considered in phase one



4.24 This assessment would apply to any aid that was being notified under the revised guidelines. It would be applied to individual aid or to aid schemes.

4.25 The figures in this diagram indicate possible levels for passing each question.³⁵ In practice these would be set based on the views of the effects of existing aid, concerns businesses have expressed about aid that has been notified in the past and the possible risks of moving to a new system. These might also vary with the type of market failure the aid was addressing.

4.26 Breaking down the questions set out above:

Does the aid address the market failure criteria in the guidelines?

4.27 As discussed above, this condition would be specified by the Commission.

Are the selection criteria acceptable?

4.28 This question considers whether aid is available to all firms in the market, in which case their relative positions are unchanged or whether, if the aid is not available to all firms in the market, its selectivity criteria are necessary in order to achieve the market failure objective of the aid or in order to prevent fraud.

Yes If all firms in market are able to apply,³⁶ for example, the UK's Energy Efficiency Best Practice Programme.

³⁵ Based loosely on our case study findings.

³⁶ It is also required here that aid of comparable magnitude is available to each firm, in line with the objective of the subsidy. That is, if the aid is business advice to each firm, the same value of business advice should be available to all. If the aid is to improve the firms' inputs (training for staff, less environmentally damaging inputs) then it should be proportionate to the firms' outputs. (If it was proportional to the inputs it would advantage firms with certain production methods more than others).

- Yes If transparent, open tender for one or more firms to undertake a non-commercial project, for example, the UK's broadband infrastructure projects.
- Yes If the only criteria are those required to meet the market failure objective of the aid and aid guideline and those necessary to prevent fraud concerning the subsidy. For example, under the High Tech Venture Capital Fund aid is available to all firms if they have good business plan and invest in high tech sector. Another example is the Highlands and Islands Enterprise: initial investment and job creation scheme under which aid is available to all starting business in the assisted area.
- No If the criteria are not necessary for the market failure objective, only a subset of firms in the market get the subsidy. For example, collaborative research is only available to a subset of those conducting similar research.

How many firms are eligible?

- 4.29 The purpose of this question is to detect when an aid that is seemingly widely available can only actually be obtained by a small number of firms in practice. This is a safeguard that prevents the subsidy provider setting criteria that it knows only certain firms can meet in order to give a selective subsidy by a backdoor route. The budget made available for the aid should indicate the expected number of recipients.
- Many Competitors genuinely have the same access to the aid. Only those who do not meet subsidy objectives are excluded, for example, all firms have the opportunity to participate in the UK emissions trading scheme and only those that do not reduce their emissions are not eligible for aid.
 - Few Despite achieving market failure objectives with only necessary criteria, aid gives support to few firms putting them at an advantage to their competitors.

Is the market share of any recipient greater than the specified amount?

4.30 This question asks whether the recipient is a significant player in the market and may have a direct effect on the behaviour of others in the market.

No Some unfair advantage is being conferred on the recipients but ceilings prevent this from being too large and none of the recipients are being assisted in or towards a position of market dominance. Hence there is a risk of distortion but this is small and the aid is addressing a market failure as required by the guideline.

Yes A firm that may have market power is gaining an advantage relative to its competitors. This may be necessary to achieve a particular market failure objective but still warrants thorough review of the costs and benefits to the common interest in a phase two assessment by the Commission.

4.31 We have not set out the market share that should be specified here as we have limited information from our case studies to guide us. Tentatively we propose a market share of five to ten percent. This apparently low threshold reflects the fact that aid is a government intervention to a market, rather than an optimizing response to market signals. Our case studies found no significant distortion associated with a selective aid to a recipient with 0.1 percent market share but significant effects from aid to a recipient with 55 percent market share and potentially significant effects from aid to a recipient with just under five percent market share.

Aid that does not pass phase one

4.32 This section describes the treatment of aid that does not pass the phase one assessment.

4.33 Aid will fail to be approved through the phase one assessment under the following circumstances:

- if it is granted, with an undue element of selectivity, to firms with market share over 10 per cent
- if the amount of the aid exceeds the ceilings, or
- if the aid is not targeted at a specified market failure.

Such aid, will be subject to a phase two assessment by the Commission, as described in the next chapter. It will be prohibited under Article 87(1) EC unless the Commission finds it compatible with the common market under Article 87(3) EC after such an assessment.

4.34 In addition, where it is not possible to conclude that the phase one assessment criteria are met, an aid would be subject to a phase two assessment. This would apply where, for example, a definition of the market is required but is very difficult, because aid is being offered to a firm that engages in many markets. This would be subject to a phase two assessment to examine the common interest benefit of the aid as well as its effects on competition.

Downstream effects and intermediaries

4.35 This section describes how the assessment should be applied to examine the effects downstream and on intermediaries.

4.36 In some situations the aid provider gives aid to an intermediary that will distribute the aid amongst the intended recipients.³⁷ In other situations the aid will be targeted at certain upstream recipients and market forces may cause some of the aid to be passed on to downstream business through reductions in the selling price by the upstream recipient.

4.37 In the event that aid is being given to an intermediary that will distribute the aid amongst its intended recipients, the phase one assessment would be applied to both the intermediary and the end recipient.

³⁷ An intermediary could be a separate government agency, a non-government organisation or a private business.

- 4.38 To understand how this would work, consider the example of aid being given to a venture capitalist to increase the investment available for small and medium sized enterprises (SMEs). First, the phase one assessment is applied to the venture capitalist. If we assume that the Commission has recognised that there are market failures in venture capital provision to SMEs then the aid meets this criterion in the phase one assessment. Next the method of selecting the venture capitalist is considered. If it is selected through an open and effective competition, and if the aid can only be applied to investments that are currently non-commercial, there should be no major competition concerns at the upstream level.³⁸ If, however, there are criteria for those who can compete for the aid which are not essential to address the market failure then the aid may distort competition significantly. In this case the market share of the recipients needs to be considered and the amount of aid permitted for the aid to pass phase one is reduced.
- 4.39 If the support to the venture capitalist is permitted, the phase one assessment should then be applied to the beneficiaries of the funds from the venture capitalist. First the rules of the fund/ scheme are considered to test whether aid is available to all small firms that apply and demonstrate they can be commercially viable given similar support. If this condition is met it is then verified that the aid is being provided to a significant number of firms. If it is only being given to a small number of firms, then the subsidy provider would need to check that the market share of the recipients was small. If, on the other hand, it is being given to a large number of firms the aid should be approved.
- 4.40 The alternative situation in which downstream markets may be affected is when some benefit is passed to downstream firms through purchasing goods from the subsidy recipient, for example, the subsidy recipient may be able to reduce prices. We do not think this situation will lead to significant distortions to competition. This is because all downstream

³⁸ By 'non-commercial' we mean activities that the private sector will not undertake because the private return is too low (and see footnote no. 42 below). As we have already indicated, the grant should be targeted at market failure. The implication is that the social return on the activity is high enough for it to be worth the investment.

firms using the same inputs could purchase the lower priced goods from the subsidy recipient.³⁹ Alternatively, competitors in the upstream market might lower their prices in order to compete, thus lowering the price to all downstream customers.⁴⁰

Competition for subsidy

- 4.41 The phase one assessment is adapted slightly when there is competition for a subsidy. This section discusses how the assessment would work in this circumstance.
- 4.42 The venture capital case above is an example where there is competition for the aid. Competition for an aid is unlikely to raise significant competition concerns if the aid is for an activity that cannot be provided commercially at the current time,^{41,42} for example, aid to develop a particular area of land that the private sector is not interested in

³⁹ If the recipient is not in a position to meet all demand at the reduced price, the downstream firms are likely to bid up the price to the market level that all downstream competitors pay.

⁴⁰ This is a simplification. If the recipient has a single customer but this customer competes with other firms that make the same product but use different inputs, the customer may gain a competitive advantage from the upstream aid.

⁴¹ That is, it is a missing market that the private sector will not create because it is not profitable.

⁴² In the case that the desired non commercial activity is a Service of General Economic Interest the payment by the State may not amount to aid at all. In *Altmark Trans GmbH and Regierungspräsidium Magdeburg v. Nahverkehrsgesellschaft Altmark GmbH*, Judgement of 24 July 2003 C-280/00 ECR I-7747, the Court laid down the conditions under which public service compensation does not constitute state aid. Where the payment is state aid it may be permitted under 86(2) EC Treaty. The Commission has issued a new Decision and Framework setting out the conditions under which this will be so. The position is explained in more detail in the legal annex to this report. The OFT does not propose any changes to that position. The phase one assessment therefore applies to state aid that do not fall within the Commission Decision or Framework and which fall to be assessed by the Commission under its Article 87(3) guidelines. The phase one assessment would approve aid supporting the carrying out of a non commercial activity, but which is not compensation for a public service obligation, where that aid addresses a market failure and meets the other criteria set out in the guidelines.

developing. In this case there are no participants in the market so existing competition cannot be distorted. However, there are likely to be a number of firms who would enter the market if subsidised to do so. Providing aid on a competitive basis gives these firms equal opportunity to enter the market and should ensure that the aid is the minimum necessary for entry to happen.⁴³

- 4.43 Competition for subsidy for an activity that is already being carried out by the private sector, but the subsidy provider wants to increase, carries greater risk of distorting competition. For example, if several firms are already purchasing and developing land in an area, then a subsidy to develop part of this land will give one firm an advantage over the others, even if it is competitively tendered. In this situation the unsubsidised developers may be forced to reduce the rents on the developed property in order to attract tenants in competition with the subsidised developer. This aid would be unlikely to have acceptable selectivity criteria.⁴⁴ The aid would not pass the phase one assessment if it was given to a firm with large market share. If not given to a large market player, the size of the aid would need to be limited to pass the phase one assessment.
- 4.44 Finally, the phase one assessment would not put limits on the magnitude of aid given through competition to undertake a non-commercial activity as, through effective competition, the aid would be equal to the amount necessary to have the activity undertaken. When providing aid through this route, subsidy providers should also be required to show how the design of the aid allows for competition at the current time or in the future. For example, an aid for building and running a business park might only cover building costs and short term operating costs. Thereafter, the aid recipient would need to compete with others entering

⁴³ Ideally the aid should be designed such that it does not foreclose the market in the case that the market becomes commercially attractive in the future. The bidders for the aid will be aware of the extent to which the aid recipient is likely to gain a first mover advantage should the market become commercially viable in the long term, and should reduce their need for aid accordingly.

⁴⁴ Depending on how tightly the Commission defines market failure, this aid may not meet the market failure criteria.

the market if it becomes commercial for them to do so. Alternatively, aid might be awarded to several companies that could emerge as competitors.

How to define the market

- 4.45 It is often necessary for the phase one assessment to define the market that will be affected by the subsidy.⁴⁵ Identifying the relevant market that will be affected by the subsidy is straightforward in some situations and complex in others. Some subsidies are targeted at particular markets or activities that only relate to specific markets. Other subsidies are to known firms with a limited product range. In these situations the identification of the relevant market should be straightforward.
- 4.46 In this section we consider how market definition is applied to subsidies generally and then discuss the treatment of subsidies that can affect multiple markets.

The application of market definition to subsidies

- 4.47 Market definition is used extensively in the application of Articles 81 and 82 of the Treaty which present the EC legal framework addressing anti-trust problems. In the case of subsidies, the market that we are interested in is the group of firms that compete with the recipient firm. A firm in receipt of a subsidy is likely to change its behaviour. This change, at least in the short term, is likely to be a price reduction, an increase in output, entry or investment in research and development by the recipient. The effects on competitors are likely to be a loss of sales or margins, the size of which would depend on the size of the subsidy and the nature of competition. These may lead to greater changes in strategy in the longer term or act as a deterrent to entry by potential competitors. The firms that are likely to be most affected by the recipient firm are

⁴⁵ For example, for the purposes of assessing whether aid is available to all firms in the market a very general understanding of the possible recipients is required. For the purposes of assessing whether a selected recipient had significant market share a more robust analysis of the market would be required.

those that compete and could reduce its profitability.⁴⁶ As these are the firms that consumers would switch to if the recipient raised prices, they are also the ones that consumers would switch away from if the recipient lowered prices. These firms are used to define the market.

- 4.48 In defining the market it is also important to consider the appropriate geographical area. The profits of some firms are only affected by local competitors, in which case a local market definition is required. Other firms may compete actively with firms in Europe or other parts of the world. The correct geographical area is established through considering the location of the subsidy recipient's competitors. In this way the effects of the subsidy on the correct set of competitors and consumers is assessed.
- 4.49 Competition analysis has developed a way of testing which firms are in a position to place a competition constraint on each other's behaviour through the hypothetical monopolist test.⁴⁷ While it may not be necessary to undertake a full test for the purposes of subsidy assessment, it is a useful framework for thinking about the issue.

Handling multiple markets

- 4.50 The particular market affected by a subsidy may be difficult to identify
- in the case of a support for a conglomerate which has products in a range of markets, or

⁴⁶ Upstream and downstream firms may also be affected. See previous section for a discussion on this.

⁴⁷ In December 1997 the Commission issued its 'Notice on 'relevant market definition' for the purpose of competition law' 97/C372/03 which, in summary, says the relevant product market comprises all products or services considered by consumers to be interchangeable or substitutable, having regard to characteristics, price and intended use. In defining this product market the Notice focuses on applying the hypothetical monopolist test to demand side substitution.

- in the case of a subsidy scheme that offers subsidy without specification of the market the recipient needs to operate in, for example, a subsidy addressing a factor such as energy or labour.

4.51 Quantifying the impacts in all possible markets that could be affected would be extremely onerous in administrative terms and alternatives are likely to be impractical or risky.

4.52 The formulation of the phase one assessment enables certain subsidies to be approved on the basis of their low level of selectivity. For example, aid available to all firms across a range of markets would be approved at phase one without the need to define the affected markets. For subsidies with a higher degree of selectivity, market definition for every market would be required. We anticipate that, as this exercise might be difficult, it would incentivise subsidy providers to redesign the aid to secure easier approval. For instance, subsidy providers could make aid available more widely across a market or could target the aid towards a particular market.⁴⁸ In our view, such incentives are desirable to reduce the risk of distortion to the market.

⁴⁸ If targeting a particular market, subsidy providers would monitor to ensure that the subsidy was achieving its objective in that particular market and not being used elsewhere.

5 PHASE TWO ASSESSMENT

Introduction

5.1 The effects based approach to state aid discussed in Chapter 3 proposes a two-phase test of whether proposed state aid is likely to distort competition to the detriment of the common interest. Chapter 4 described the first phase of this process, under which aid that is unlikely to distort competition significantly is identified and approved based on several key questions. This chapter sets out the objectives and key aspects of the phase two assessment and proposes that the Commission applies these in a consistent and transparent manner.

Approach to the phase two assessment

5.2 Phase one sifts out subsidies that are unlikely to distort competition significantly. Proposed state aid that is subject to further analysis is considered likely to have a significant impact on competition. This proposed state aid could still be approved however, for one of two reasons:

- although the sift characteristics indicated the potential for significant competition effects, there are other characteristics of the state aid and market that offset these, hence the state aid is not likely to have a significant effect on competition and as such can be approved, or
- the distortion to competition from the state aid, although significant, is outweighed by the benefits in the European common interest.

5.3 It is the role of the phase two assessment to consider whether state aid should be approved on either of these grounds.

5.4 We propose that a case-specific approach is applied when undertaking a phase two assessment. This is the approach taken by the Commission and NCAs in undertaking economic effects based analysis in competition cases, specifically for Article 81 and 82 EC cases and in considering the

competition effects of mergers. The case by case approach is also appropriate for state aid notifications, as a wide range of cases and situations needs to be assessed. A formulaic approach would not be able to address the specific aspects of a particular aid that might determine how great any effect on competition might be.

- 5.5 Within a case by case approach, assessments must still be undertaken in a consistent and transparent manner to ensure that providers and recipients are aware of how the proposed phase two assessment would work. Consequently, this chapter provides some general comments on undertaking a competition assessment of proposed state aid, and identifies an indicative and non-prescriptive list of issues that are likely to be important in determining the likely impact on competition. Such issues are not intended to be a comprehensive list of all the factors that would need to be considered as part of a detailed competition analysis. The aim is simply to highlight potentially important characteristics for consideration when assessing the likely competition effect of state aid, and which we propose the Commission should generally apply in the phase two assessment.

Objective of competition analysis of state aid

- 5.6 The detailed assessment of the competition effects of state aid is undertaken to examine the effects of proposed state aid in markets. This includes an analysis of the position in the market with and without the state aid being provided.
- 5.7 The assessment of state aid is undertaken before it is provided and, as such, requires estimation of the effects likely to occur once the state aid is provided. This may be of particular importance for state aid that is provided in staged payments over a period of time, whose assessment would involve the need to consider the position before the state aid is granted, the likely effect during the period in which state aid is provided and afterwards. In many cases, staged payments can occur for a number of years after agreement is reached to provide state aid.

Definition of the relevant starting point

- 5.8 At the beginning of the assessment it is necessary to identify what would have occurred in the market if the state aid had not been provided (the counterfactual). In some cases this will be simply the prevailing market conditions in the absence of the state aid, although in other situations, the relevant starting point will be more complex to analyse. It may be the case that investment or entry will take place without state aid but, with the state aid, the investment or entry will occur on a larger scale.
- 5.9 The starting point of the assessment therefore depends on the effect of the state aid on the activities of the recipient, compared to the recipient's activities without the aid. This is the same starting point that is used when considering the likely effects of a merger on competition.⁴⁹

General principles of competition analysis

- 5.10 The precise nature of a detailed competition analysis of state aid will vary in particular cases depending on the type of state aid and the market(s) affected. There are nonetheless likely to be some common aspects of a competition assessment which we propose the Commission should generally apply in such an analysis.

⁴⁹ The EC's guidance, 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings' is available from: http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/c_031/c_03120040205en00050018.pdf

The OFT's guidance, *Mergers – Substantive assessment guidance* is available from: www.offt.gov.uk/NR/rdonlyres/283E1C2D-78A6-4ECC-8CF5-D37F4E4D7B22/0/oft516.pdf

- 5.11 There are notable parallels between the analysis we propose and that undertaken currently by the Commission and NCAs in the assessment of merger cases. Both look ex-ante at changes in markets to predict the economic effects on markets and consumers that would be likely to occur if the change were allowed to take place. The remainder of this chapter draws on the experience and guidance from both the Commission and the OFT on the assessment of mergers, given the relevance of such guidance.
- 5.12 The first step in the proposed phase two is to define the market to which the state aid is to be provided. Market definition has two elements, the product and geographic market, and both of these should be considered. Chapter 4 examines the process of market definition, including citing the guidance issued by the Commission concerning this issue.
- 5.13 The second step is to consider the factors in the market that may constrain the behaviour of the state aid recipient and prevent it from acting in a way that does not benefit consumers, that is, the factors in the market that prevent the recipient from raising prices or force it to innovate. Examples of such factors include the number of competitors, or the degree of product differentiation in the market. These need to be considered both in the situation with the state aid being provided, and also in the hypothetical case of where the state aid was not provided. This allows the effect of the state aid on the market to be assessed. In addition, the assessment could cover the intentions and incentives of competitors in the market, whether the state aid has any effect on their plans to expand or whether they would seek to leave the market as a result of the state aid.
- 5.14 Third, in addition to considering the effects of the state aid in the market, the effect of firms that may wish to enter the market would need to be considered. This includes looking at the likelihood and significance of such potential new entrants in the market.

5.15 Following this general analysis, there are specific factors that would be useful in determining the effects of state aid on competition. These are both the subsidy and market characteristics, as outlined in Chapter 2. Details of the analysis of these characteristics are presented below.

State aid characteristics

State aid size

5.16 This indicates the scale of potential advantage being conferred on the recipient(s) and the possible scale of any effect on the market. However, it is vital to set this in a relevant context, for example relative to the size of the firm's total costs, or the proportion of total investment represented by the state aid. For example, state aid of £100,000 to a firm with costs of £2m per annum will generally have a smaller effect on the firm than the same state aid given to a firm with costs of £500,000 per annum.

5.17 There are numerous different ways in which context may be put on the size of the aid provided. These include:

- total value of the market
- the total investment value – where some investment will be undertaken in addition to, or absent the state aid provided
- the costs of the firm – fixed costs, variable costs or total costs, dependent on which of these the state aid is targeted at
- the time-span over which state aid is provided – the time-span of the state aid and investment can provide an indication of the longevity of any effect on the market.

Selectivity

- 5.18 As discussed in Chapter 4, this characteristic is concerned with which firms would be eligible to receive state aid. Additional selectivity beyond that necessary to address the relevant market failure would be likely to restrict competition. However, the fact that some degree of selectivity may be justified makes this characteristic more difficult to assess. The phase two assessment is likely to need to consider the impact of selectivity in more detail as a proposal that has failed phase one is likely to have more selectivity than is necessary.

Targeted state aid

- 5.19 The analysis in our first stage of work suggested that state aid more closely targeted at the particular policy objective, would be less likely to have a significant effect on competition. The intuitive reason for this is that if state aid was granted with few restrictions on its use, the firm may choose to use it in the most profitable area of its business, rather than to achieve the benefit envisaged. Therefore, it is useful to consider whether the state aid is targeted and its use restricted and to what extent the firm can use state aid other than in the way it was intended.⁵⁰

Effect on costs

- 5.20 Different types of state aid are likely to affect firms in different ways, with some state aid packages having a direct effect on the marginal costs of firms,⁵¹ while other state aid packages may focus more on assisting with fixed set-up costs of establishing or expanding production.

⁵⁰ If state aid was approved on the grounds that it was directed at a particular use, such as basic training, but the recipient used it for other investments then this would amount to 'misuse of state aid' (under Article 1(g) of Council Regulation 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 88 of the EC Treaty, OJ 1999 L83/1) and the state aid could become recoverable.

⁵¹ Marginal costs are the additional costs for a firm of an extra unit of production or output.

- 5.21 A change in a firm's marginal costs is passed on to consumers as a change in price or output. Such a change is likely to have an immediate effect on the competitive process, including the relative strengths of firms receiving and not receiving aid. A change in fixed costs will have no such direct effect on prices. However, this may make entry and or exit more or less viable for firms, which is generally a long term effect.

Recurring payments

- 5.22 There is likely to be a difference between the effects of providing state aid on a one-off basis, and providing state aid (of the same value) over a longer period of time. Providing recurring state aid over a period of time relative to a one-off lump sum is more likely to affect firms' entry and exit decisions, possibly in addition to price and output decisions. This effect could arise from fewer firms seeking to enter the market. Alternatively, it could prevent efficient rationalisation, with more efficient firms leaving, while the subsidised one only remains in the market due to receiving state aid on a continuing basis despite lower levels of efficiency. Furthermore, when considering the effects of any recurring subsidy, it is the size of the total payments over time (where the state aid is paid in stages) that is important rather than just considering the size of the annual payment.

Market characteristics

The extent of market concentration

- 5.23 This refers to both the number of firms in the market and their size or share of the market. In general, the fewer the firms, the larger their share of the market, and the less competition one would expect to observe.⁵² Market concentration is analytically an easy concept to

⁵² It is important to note however, that assessing the level of concentration is not always an accurate measure of the level of competition taking place in a market, with some markets having active competition despite there being few firms present.

calculate from simple market and firm level information,⁵³ once the more difficult task of defining the relevant market has been undertaken.⁵⁴ This property and its value as an indicator of market power mean that it is commonly used for analysing market structure and competition.

- 5.24 Concentration is important in the assessment of state aid as, in general, the more concentrated a market, the more likely it is that a selective subsidy would have a significant effect on competition. This would arise as in a concentrated market, the recipient and its competitors would each account for a large proportion of the total market. Therefore competitors would be more likely to be affected significantly by the state aid, such that they would need to respond, and any such response would also be likely to be larger in magnitude.⁵⁵

The level of product differentiation

- 5.25 This considers how similar or different the products supplied in the relevant market are. In general, products that are more differentiated (less similar) are less substitutable from consumers' points of view, and so the intensity of price competition and non-price competition in a market of differentiated products may be lower than in a market full of near-identical products.
- 5.26 If state aid is provided in a market with differentiated products, all other things being equal, the effect on competition may be less than providing state aid in a market with less differentiated (more similar) products. The relationship between differentiation and the effect of providing state aid

⁵³ Many organisations that conduct competition assessments have guidance on accepted ways to calculate and examine the issue of concentration (including the EC and the OFT guidance referred to in paragraph 5.11). Two such methods include calculations of concentration ratios and the Herfindahl-Hirschman Index (HHI).

⁵⁴ Chapter 4 gives an overview of how to define a relevant market.

⁵⁵ See: Garcia, J A and Neven, D 'Identification of sensitive sectors in which state aids may have distorting effects', Final Report to HM Treasury, April 2004, and Annexe C of the OFT's Stage One Report.

may not always be this simple. For example in the extreme case where products are identical, again few competition effects may be expected from providing state aid. This is because markets with identical products often have a large number of firms present of a similar size, and thus the effect of state aid provided to one firm would be small relative to the size of the market.

Symmetry of firm size

- 5.27 Markets usually consist of firms of a variety of different sizes and market shares. The degree of symmetry can be important because subsidising firms of different sizes in a market can have very different effects.
- 5.28 For example, providing state aid to a small firm in a market may allow it to compete more effectively with its larger competitors. However, providing state aid to a large firm or market leader may make competitors less able to compete with the state aid recipient, such that they may leave the market. These examples are not the only possible effects of providing state aid to different size firms, and there may be other potential effects depending on the number of firms of different size that exist in the market in question.
- 5.29 Similar arguments to those regarding firm size and competitive effects also exist for state aid given to assist new firms entering the market.

Non-price competition

- 5.30 In many markets, competition does not just take place on price, it takes place on other factors. These include the innovative nature of the product, the brand of the product or numerous other characteristics. In many markets, firms compete actively on the non-price characteristics of their products.⁵⁶ In these markets, it is important to consider whether the state aid would enable the recipient to improve its quality or brand or other non-price characteristics and gain a competitive advantage over other firms other than through altering prices or output. This is an

⁵⁶ Such markets are likely to be those where there is some degree of product differentiation.

important characteristic for examining product differentiation and as such these characteristics should be considered together.

Barriers to entry and exit

5.31 Barriers to entry refer to any feature of a market that may give established firms an advantage over potential entrants, such that established firms can increase prices⁵⁷ without potential entrants viewing entry as a profitable opportunity. Barriers to exit refer to the costs that are incurred when a firm ceases production and exits the market.

5.32 As explained in the OFT's Mergers – Substantive assessment guidance,⁵⁸ barriers to entry may take numerous different forms, including:

- absolute advantages - for example where regulations, licensing or other concepts are used to limit access to a particular market
- strategic advantages – where incumbent firms have advantages over new entrants due to their established position, or if incumbent firms would be likely to respond to new entry
- large levels of sunk costs – the costs of entering a market are more likely to be deter entry where a significant proportion of those costs are sunk, that is, the costs cannot be recovered if the entrant fails and is forced to exit
- economies of scale – these will arise where average costs fall as the level of output rises. In some circumstances, such scale economies can act as a barrier to entry, particularly where the fixed costs are sunk.

⁵⁷ Increased prices are used here as an indication of market power of the firm. In practice there are several different indicators, though price is the main one.

⁵⁸ See page 29 of:

www.offt.gov.uk/NR/rdonlyres/283E1C2D-78A6-4ECC-8CF5-D37F4E4D7B22/0/oft516.pdf

5.33 These concepts are important in many different competition assessments, and are important for the assessment of state aid. One potential effect of barriers to entry would be a reduction in the efficiency of the market, as firms that did not receive the state aid but are more efficient than current producers may not enter the market. However, it should be noted that in some situations, state aid can be provided specifically to overcome the barriers outlined above, and allow new firms to enter a market.

Interaction between different characteristics of the subsidy and the market

5.34 The above characteristics cannot be considered in isolation from one another. Instead their combined effect needs to be considered in the detailed competition assessment so as to reach the appropriate conclusion.

5.35 One example of a link between different characteristics would be between product differentiation, market concentration and non-price competition. If the assessment were restricted to a subset of these characteristics, it is likely that misleading conclusions may be reached regarding the level of competition in the market and the potential effect of a particular state aid proposal. In the case of a concentrated market with firms providing differentiated products where competition is taking place on non-price factors, one may not predict much active competition by looking at the concentration and differentiation. However, if the assessment also covered non-price competition, then the more active competition could be seen.

Conclusion

5.36 The main objective of the phase two assessment is to ensure that the economic effects on consumers from state aid can be examined in detail, and that the approach to this analysis is both transparent and consistent, while retaining the case by case element as referred to in paragraphs 5.4 and 5.5. The proposed approach draws on established guidance on the ex-ante assessment of mergers from the EC and the OFT. It proposes some principles for a general competition analysis of the effects of state aid, as well as considering in more detail some more specific characteristics that should be examined on a non-exclusive basis.

6 REFORM OF THE INSTITUTIONAL FRAMEWORK

Introduction

- 6.1 Chapter 6 discusses the potential role NCAs could play in state aid controls.
- 6.2 The chapter concludes that, while the OFT does not see a role for NCAs as proposed by the Commission in its Action Plan, it does envisage a potential role for NCAs in facilitating the Commission's aim of placing state aid control on a stronger economic basis, whilst maintaining a level playing field across the single European market.
- 6.3 The chapter proposes that NCAs could give formal advice concerning whether proposed state aid met the economic conditions of the guidelines.

Background

- 6.4 A key element in the Commission's Action Plan for state aid reform was the proposal for 'sharing responsibility with Member States' in respect of state aid control. The Commission envisages a role for independent national authorities, possibly NCAs, in state aid enforcement, specifically:
- a role in monitoring for unlawful and misused state aid. Unlawful state aid includes state aid that is not notified to the Commission and misused State aid is that not given according to the terms on which it was approved by the Commission,⁵⁹ and
 - a role in the recovery of unlawful and misused state aid. This would involve a NCA taking the recipients to court to secure recovery following a decision by the Commission that the state aid should be recovered.

⁵⁹ See Articles 1(f) and 1(g) Council Regulation (EC) 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 88 of the EC Treaty, OJ 1999 L83/1.

- 6.5 A major driver of the Commission's proposals is the desire to reduce the caseload falling on DG Competition to enable them to focus on more complex cases.
- 6.6 The OFT published a response to the Commission's Action Plan earlier this year.⁶⁰ In our response, we expressed the view that:
- there is little benefit in transferring monitoring of unlawful and misused state aid from the Commission to national authorities, and
 - that independent authorities would not be any more effective in enforcing recovery decisions than Member States' governments.
- 6.7 The OFT is of the view that it is neither appropriate nor is there benefit in transferring monitoring from the Commission to national authorities. State aid control comes from the need to maintain a level playing field for all firms within the EU. Such a move would introduce a risk that national authorities would monitor with differing levels of rigour, and may be subject to political pressures, leading to an asymmetric application of state aid controls throughout the EU.
- 6.8 Secondly, the transfer is unlikely to reduce the Commission's workload in practice as would still need to be involved with a significant number of these cases. This is because national authorities would need to take a view about whether a complaint about unlawful or misused state aid was justified. In a simple case of un-notified aid, this would prompt the subsidy provider to make a notification. However, if the subsidy provider did not agree with the national authority's analysis, the case would need to be addressed by the Commission as is the case at present. The Commission would then still need to rule that the aid was incompatible with the common market and require recovery, if appropriate.

⁶⁰ A copy of the OFT's response paper to the Commission's Action Plan can be found on our website at:
www.offt.gov.uk/NR/rdonlyres/47D7A373-8E9B-4145-A3FD-3C5F4C3019FC/0/oft820.pdf

- 6.9 In relation to enforcing recovery decisions, the OFT does not think that independent authorities would be any more effective in this than Member States' governments. This is because independent authorities are likely to have no stronger an incentive to recover the state aid. In addition, independent authorities could come under pressure from Member States' governments over politically sensitive cases where recovery may have a detrimental effect on the firm that has received the state aid in the first place. This may therefore reduce their determination to recover aid.
- 6.10 Finally, recovery by an independent authority might reduce the political embarrassment to the Member State's government of having to recover illegal aid. This might mean that governments become more willing to give subsidies illegally in the first place.

OFT proposals for the role of national competition authorities

- 6.11 The OFT proposes that NCAs should act in an advisory role concerning the competition effects of state aid.
- 6.12 NCAs could provide advice to subsidy providers about whether a proposed state aid is likely to have significant adverse effects on competition. NCAs could give an expert view concerning whether the proposed state aid was compatible with the Commission's revised guidelines. This would assist the subsidy provider who could use the assessment to decide whether to modify the aid before notifying it. The NCA's assessment could also be provided to the Commission as part of the notification procedure. The Commission could then use the assessment to assist in its decision on whether or not to approve the aid.⁶¹

⁶¹ If the involvement of NCAs in the notification procedure were made a compulsory requirement of that procedure legislative changes may be required, for example to Regulation 659/1999 and/or Commission Regulation 794/2004 of 21 April 2004 implementing Council Regulation (EC) 659/1999 laying down detailed rules for the application of Article 88 of the EC Treaty, OJ 2004 L140/1.

- 6.13 The OFT is of the view that responsibility for determining whether a subsidy is compatible with the Treaty and approving it should remain with the Commission for the reasons stated in paragraphs 2.4 to 2.10. However, the Commission could use the NCA's advice on the possible competition impacts of the subsidy and, if it rated the quality of the advice, could use it to inform its decision.
- 6.14 NCAs, such as the OFT, are well placed to play the role proposed here. The OFT has considerable experience in assessing the effects on competition in a range of contexts, for example applying Articles 81 and 82 EC Treaty, under the Modernisation Regulation,⁶² and the corresponding provisions of the UK's Competition Act 1998.
- 6.15 There are also some similarities between our proposed approach and the current support offered by the OFT to UK central government on Regulatory Impact Assessments (RIA). The RIA process examines how new UK regulations may affect competition. In this process, the OFT advises policy makers from other UK Government departments on the potential risks to competition.⁶³
- 6.16 In the OFT's current role of advising policy makers on RIAs, it gives advice before action had been taken in order to minimise any adverse effect on competition prior to the introduction of the regulation.

Why NCAs should play an advisory role and how it would operate

- 6.17 At present, when notifying proposed new state aid, subsidy providers give the Commission information about the state aid, including information the Commission needs to assess the state aid 'in accordance

⁶² Council Regulation (EC) 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ 2003 L1/1.

⁶³ Further details of the Regulatory Impact Assessment can be found on the cabinet website at: www.cabinetoffice.gov.uk/regulation/ria/index.asp
Guidance on the competition assessment can be found on the OFT website at: www.offt.gov.uk/Business/regulations/default.htm

with regulations, guidelines, frameworks and other texts applicable to state aid.⁶⁴

- 6.18 We envisage that, if our proposals for reforming the state aid regime were adopted, subsidy providers would, on notifying proposed new state aid, provide information relating to its compliance with revised guidelines.
- 6.19 While the subsidy provider would perform this initial assessment and provide the information directly to the Commission, we believe that input from NCAs could ensure that this is completed effectively and thereby speed up the approval process. This is because that initial assessment will involve at least a degree of assessment of the market that will be affected by the proposed state aid and may require some analysis of whether any intermediaries benefit from it. Both these issues may be difficult for a subsidy provider to assess and hence some assistance with applying the initial assessment could be required.
- 6.20 Furthermore, certain aspects of the initial assessment are inevitably susceptible to a degree of discretion in reaching a view on the proposed subsidy's compliance with the guidelines. Review of the assessment by a NCA would reduce the risk of abuse of the assessment by the subsidy provider. The Commission could use the NCA's assessment to verify what had been reported in the subsidy provider's assessment (to the extent that the Commission viewed the NCA's assessment as helpful).
- 6.21 Our proposed role for NCAs therefore overcomes these potential risks to the introduction of an economics based approach. There are also further benefits in adopting the proposed role for NCAs.
- 6.22 First, NCAs' advice and assistance to subsidy providers could enable the subsidy provider to identify less distorting ways to provide a state aid.
- 6.23 Secondly, advice would help subsidy providers assess competition effects at the design stage, reducing the potential for the state aid to be

⁶⁴ See Commission Regulation 794/2004 Article 2 and notification form in Annexe A of the said Regulation.

deemed incompatible with the common market (and so prohibited) at a later, more developed, stage by the Commission.

- 6.24 In making this recommendation we recognise the risk that, unless the NCAs' advice is used by the Commission in considering the compatibility of aid with guidelines, the proposal could add to the burden on subsidy providers. The decision concerning whether to involve NCAs in state aid assessment, therefore lies with the Commission. We are of the view that NCAs could act an advisory role concerning the competition effects of state aid in a way that improves the efficiency of the approval process for state aid.

Future evaluation of reforms

- 6.25 The OFT is of the view that any significant changes to state aid rules, such as those proposed should be monitored to ensure that they are working effectively and that state aid is not being permitted that can significantly distort competition.
- 6.26 The OFT envisages that the same evaluation process is undertaken to that stated in the 'Community Framework for state aid in the form of public service compensation'.⁶⁵ In the Framework it states that after four years, the Commission undertakes an impact assessment based on factual information. We would therefore expect the same mechanisms to be introduced into any future changes to state aid rules.

⁶⁵ See Article 9 of the draft Decision on the application of Article 86(2) of the Treaty to state aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, and paragraphs 22 and 23 of the Community Framework for state aid in the form of public service compensation.

ANNEXES

A LIST OF PARTIES CONSULTED

Government organisations

Department of Culture, Media and Sport

Department of Enterprise, Trade and Investment (NI)

Department of Trade & Industry

Department for Education and Skills

Department for Work and Pensions

HM Treasury

National Assembly for Wales

Office of the Deputy Prime Minister

Scottish Executive

Secretary for State for Northern Ireland

Small Business Service

Regional Development Agencies in England

London Development Agency

North West Development Agency

South West of England Regional Development Agency

Yorkshire Forward

Development Agencies in the other nations of the UK

Scottish Enterprise

Welsh Development Agency

Invest Northern Ireland

Others

Confederation of British Industry

Chinese in Britain Forum

DG Competition

DG ECFIN

Ethnic Minority Businesses

Federation of Small Businesses

National Audit Office

B EUROPEAN STATE AID CONTROL

B.1 This annexe aims to outline the current European State Aid Control.⁶⁶

This annexe is split into two parts:

- **Part I** - an overview of the rules including relevant legislation, the notification process, and challenges and complaints, and
- **Part II** - a description of the State Aid guidelines published by the Commission.

B.2 This annexe provides an overview only. For the detail, refer to the full copies of the provisions of the Treaty, regulations and guidelines, which can be downloaded from the Commission website.⁶⁷

Part I: Principles of European State Aid Control

B.3 Articles 87-89 of the Treaty establishing the European Community ('the EC Treaty') underpin European State Aid control. The EC Treaty starts from the principle that all State Aid should be prohibited. Thus, Article 87(1) states that '...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, in so far as it affects trade between member states, be incompatible with the common market.'

B.4 There is no definition given of what constitutes aid. However, Article 87(1) can be broken down into four tests which the Commission considers in order to establish if a measure constitutes a State Aid. A State Aid is a government measure which fulfils four criteria:

- **a transfer of State resources** – either a cost or loss of revenue

⁶⁶ Here we refer to the European State Aid Control as covering the relevant legislation, block exemptions and Commission guidelines.

⁶⁷ http://europa.eu.int/comm/competition/index_en.html

- **conveys an economic advantage** to certain undertakings or on the production of certain goods, that is, is selective in availability
- **distorts or threatens to distort competition** – even a limited advantage is likely to raise a risk of distortion, and
- **affects trade between member states** – the relevant product or service is or could be subject to intra-Community trade.

B.5 All State Aids which distort competition are in principle prohibited. However, the rules make allowances for instances where State Aid may be justified according to the aims of the Common Market. Articles 87(2) and 87(3) EC Treaty provide for a number of exemptions where State Aid is, or may be, permitted. Article 86(2) EC Treaty also provides an exception for certain aids relating to 'services of general economic interest' (SGEI). This is explained below.

B.6 Article 87(2) states that the following types of aid **shall** be allowed:

- aid having a social character, granted to individual consumers, granted without discrimination related to the origin of the product concerned
- aid to make good the damage caused by natural disasters or exceptional circumstances, and
- aid granted to compensate certain areas of Germany for the economic disadvantages caused by its division into East and West.

B.7 Article 87(3) states that the following **may** be allowed:

- aid to promote economic development of areas with abnormally low standards of living or serious unemployment
- aid to promote an important project of common European interest, or to remedy severe disturbances in the economy of a Member State
- aid to facilitate the development of certain economic activities, or certain areas, where the aid does not adversely affect trading conditions to an extent contrary to the common interest

- d. aid to promote heritage and culture conservation where the aid does not adversely affect trading conditions and competition to an extent contrary to the common interest, and
- e. such other categories of aid as may be specified by the European Council.

B.8 The Commission passes regulations and publishes procedural guidelines that describe in more detail the type and level of aid that are likely to be considered acceptable, and the procedures they intend to follow when looking at State Aid proposals. These regulations and guidelines are discussed in more detail in Part II of this annexe. It is however useful to give a very brief overview here.

B.9 Currently the European regulations and guidelines can be separated into:

- block exemption regulations, where the presumption is that the aid is compatible with the Common Market as long as it fulfils certain criteria
- generic horizontal guidelines, which apply to specific types of firms such as small and medium sized enterprises (SMEs) or to activities across the whole economy
- rescue and restructuring guidelines which are used to aid firms whose closure would cause detriment to the economy
- regional guidelines, determining where and how regional aid may be granted
- specific sectoral guidelines, which adapt Community guidelines to take account of specific sectoral features, and
- guidelines on SGEI, which apply where firms are compensated by Member States for performing public service obligations. They would tend to cover such things as transport networks, energy and communications.

B.10 Generally, a State Aid measure has to adhere to one of the regulations or guidelines in order to comply with the Treaty and be permitted. However, a Member State (MS) may also submit a scheme to which no regulations or guidelines apply. In this situation the Commission must examine it directly on the basis of Article 87(3) EC Treaty,⁶⁸ and may choose to allow the aid.

The commission's powers

B.11 The powers of the Commission to act on these principles of European State Aid Control are set out in Article 88 EC Treaty. This gives the Commission the powers to:

1. carry out reviews and to issue new guidelines and frameworks to take account of the developing needs of the Common Market
2. require MSs to abolish or change aid if, after investigation, the aid is judged by the Commission to be incompatible with the Common Market, and
3. require MSs to notify proposed aid in advance for clearing.

B.12 Under powers granted by Article 88(3), MSs must notify proposed State Aid to the Commission in advance for clearance, allowing the Commission time to investigate whether the aid is compatible with the Common Market and thus permissible.⁶⁹ Aid which is not notified is unlawful, and the Commission may order it to be repaid with interest.

⁶⁸ In this report, we have referred to such assessment as, 'direct assessment'

⁶⁹ This applies to all aid not covered by the block exemptions or the Commission Decision relating to aid for SGEI, which can be implemented without prior notification, as to which see below.

B.13 These powers are supplemented by procedural regulations passed under Article 89 EC Treaty.⁷⁰ These set out the detailed requirements and obligations for notifying the Commission of proposed State Aid.

The notification process

B.14 Notification is made through a standard form, which asks for certain information about the proposed State Aid. This information includes:

- the aim of the scheme, for example, horizontal, regional or sectoral
- details of the beneficiaries' location, size and sector
- the forms of aid, for example, grant, low interest loan, tax relief etc
- the costs which the aid may contribute to
- the level of expenditure and the period it covers
- whether recipients may cumulate the aid with that from other sources, and
- the justification of why the scheme is compatible with the Treaty.

⁷⁰ See Council Regulation (EC) 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 88 of the EC Treaty, OJ 1999 L83/1 and Commission Regulation (EC) 794/2004 of 21 April 2004 implementing Council Regulation No 659/1999 laying down detailed rules for the application of Article 88 of the EC Treaty.

- B.15 Once a notification is received, the Commission must make a decision within two months whether to allow the aid, or start a fuller investigation. However, the Commission may, and usually does, seek further information during the two month period if it considers that the notification is incomplete. Any questions will re-set the clock and a fresh two-month period begins from the date of receipt of the reply. It may decide to allow the aid on the basis of the notification form, supplemented where appropriate with further information requested from the MS.
- B.16 Alternatively, the Commission may decide that a more in depth investigation is necessary, at which point it would start the procedure referred to in Article 88(2) EC Treaty. This involves inviting comments from other MSs and interested parties, and publication of a summary of the notification in the Official Journal of the European Union (OJEU). The whole process may take up to 18 months. There are four possible results:
- the measure is not a State Aid, and is therefore not prohibited
 - the measure is a State Aid but is compatible with the Common Market, and is therefore allowed
 - the measure is a State Aid but is compatible with the Common Market under some conditions laid down by the Commission, and is therefore allowed under those conditions, or
 - the measure is a State Aid and is not compatible with the Common Market, and so is not allowed.

Challenges and complaints

- B.17 The Commission's decision to allow or refuse aid can be challenged by any MS or interested party within two months of the decision, under Article 230 EC Treaty. To be successful, the appeal must demonstrate that the Commission did not follow its own requirements when making the decision. The party who submits the complaint will need to show that, had the Commission followed its own obligations and procedures properly, it could not have reached the decision it did.

- B.18 The European Court of First Instance (CFI) judges complaints about State Aids, while the European Court of Justice (ECJ) deals with cases concerning the interpretation of the law and procedural issues (including appeals from the CFI on points of law). The ECJ also looks at State Aid issues which have been referred to it by the national courts under Article 234 EC Treaty.⁷¹
- B.19 In relation to the enforcement of State Aid decisions, Article 88(2) EC Treaty gives the Commission or any MS the right to refer directly to the ECJ if they do not feel a Commission decision is being complied with following the scrutiny procedure referred to above. Under Article 228 EC Treaty the ECJ ultimately has the power to fine MSs for failure to comply with decisions made by the Commission.

Part II: State aid regulations and guidelines

- B.20 This part outlines the various European regulations and guidelines that set out the criteria under which the Commission will recognise that a State Aid is compatible with the Common Market and is permitted. Two types of aid are identified by the EC Treaty that can be compatible and permitted: a limited set of very exceptional forms of aid which 'shall be compatible' with the Common Market (under Article 87(2) EC Treaty), and a broader group which, at the Commission's discretion, 'may be' compatible with the Common Market (under Article 87(3) EC Treaty). As noted above, Article 86(2) EC Treaty also permits certain State Aids relating to SGEI (this is described in more detail below in relation to the SGEI guidelines).

⁷¹ Article 234 EC Treaty enables MS's national courts to seek from the ECJ (preliminary) rulings on questions relating to the interpretation of the EC Treaty and acts of the Community institutions like the Commission, amongst other things.

B.21 In describing the regulations and guidelines, this annexe distinguishes between two sets of exemptions:

- **block exemptions** – State Aids that meet the criteria set out in these regulations are presumed to be compatible with the Common Market, and
- **discretionary exemptions** – where the Commission decides on the compatibility of State Aids falling within the categories in Article 87(3) EC Treaty, dependant upon the specific circumstances of the aid, considered against published guidelines.

B.22 This annexe also deals with the Commission's guidelines on SGEI under the heading of 'Discretionary exemptions' even though, as noted above and explained below, they are concerned with Article 86(2) EC Treaty.

Block exemptions

B.23 The block exemptions described in this section set out a small group of State Aids that are seen to be compatible with the Common Market.⁷² The regulations were passed by the Commission (under powers given to them by the European Council, regulation 994/98)⁷³ to allow MSs to distribute certain forms of aid without prior notification, so long as the requirements of the regulations are met. Schemes or payments that conform to block exemption regulations are, therefore, not subject to any additional assessment by the Commission.

⁷² In the case of *de minimis* aid, it is not treated as a State Aid at all – see below.

⁷³ Council Regulation (EC) No 994/98 of 7 May 1998 on the application of Articles 87 and 88 of the Treaty establishing the European Community to certain categories of horizontal State Aid, OJ [1998] L142/1.

B.24 The key features of the regulations are:

- there is no need to pre-notify the European Commission of aid which fits all the terms of the regulation,⁷⁴ and
- the regulations are legally binding and directly applicable in MSs. This means that aggrieved third parties could bring actions in a national court. If the court were to agree with the aggrieved parties, the aid would be unlawful and might have to be repaid with interest.

B.25 There are two types of block exemption: de minimis (DM) rules which completely exempt very small payments,⁷⁵ and specific rules which define when aid to SMEs, training aid, and employment aid are exempt. These are described in more detail below.

De minimis aid

B.26 Under the DM rules government bodies can grant up to €100,000 (currently around £60,000) of aid cumulatively to a firm over a rolling three-year period without notification to the Commission at any point. This aid can be granted regardless of the size of the firm and may be used for a range of purposes.⁷⁶ Enterprises must be informed that the aid is de minimis and government bodies must ascertain that the new award does not breach the threshold. The government body is also required to keep detailed records of the awarded aid for 10 years.

⁷⁴ All State Aids passing through a block exemption must however be notified after implementation, except de minimis aid which is not considered to be State Aid.

⁷⁵ Commission Regulation (EC) 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid, OJ [2001] L10/30.

⁷⁶ De minimis aid cannot be given for export related activities (except attendance at trade fairs), transport, agriculture and fisheries or aid favouring domestic goods over imports.

B.27 The rationale underlying the DM rules is that small amounts of aid are likely to have a negligible impact on trade and thereby inter state competition. DM payments are therefore not considered to be State Aid for the purposes of Articles 87-89 EC Treaty, so there is no requirement to notify the Commission before or after implementation, unlike the other forms of block exemption aid.

Specific block exemptions

B.28 Three further block exemptions exist, covering SMEs,⁷⁷ training⁷⁸ and employment,⁷⁹ on the basis that the benefits of some State Aids are seen to outweigh any potential cost from the loss of competition.⁸⁰ Each exemption has a specific set of characteristics, in terms of the forms of aid that are permitted. These are set out in the table below.

⁷⁷ Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises, OJ [2001] L 142/1.

⁷⁸ Commission Regulation (EC) no 68/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to training aid, OJ [2001] L 10/20.

⁷⁹ Commission Regulation (EC) no 2204/2002 of 2 January 2003 on the application of Articles 87 and 88 of the EC Treaty to employment aid, OJ [2002] L 337.

⁸⁰ For the purposes of State Aid, the Commission defines an SME as a firm that:

- has fewer than 250 employees
- has an annual turnover of less than 40 million euros (approx. £25 million in 2001), or an annual balance sheet total not exceeding 27 million euros (approx. £17 million in 2001), and
- is less than 25 per cent owned by one or more companies not falling within this definition.

Table B.3: Forms of aid permitted under block exemptions

	Region specific	Sector specific	Firm specific	Unlimited time period	Aid to large enterprises (in all circumstances)	Uncapped intensity ⁸¹	Uncapped total value	Aid to non-assisted areas ⁸²	Aid to all sectors
Training	✓	✓	✓	✓	✓	X	X	✓	✓
SME ⁸³	✓	✓	✓	✓	✓	X	X	✓	X
Employment	✓	X	X	X	X	X	✓	✓	X

Source: OFT analysis

B.29 The scope for passing schemes under the existing block exemptions is relatively broad. Under the SME and training block exemptions, State Aid can be distributed in any form, for any period of time to almost any market, with accessibility restricted on regional, sectoral or firm specific criteria. Scope is somewhat narrower for employment aid, where firm specific and sector specific payments are not exempt from notification, and a maximum two year time period is put on payments.

Discretionary exemptions

B.30 If State Aid does not qualify for one of the block exemptions it must undergo the full notification process (described in paragraphs B.12 to B.16). The Commission has published a series of guidelines setting out the various circumstances in which aid falling within the categories in

⁸¹ Intensity refers to the proportion of cost that can be subsidised.

⁸² The way in which assisted areas are defined is explained in the regional guidelines section.

⁸³ The SME block exemption has recently been extended to include R&D aid.

Article 87(3) EC Treaty will be allowed, and the criteria which the aid must meet. These are split into the following sections:

- horizontal guidelines, which apply to specific types of firms or of activities across the whole economy
- rescue and Restructuring (R&R) guidelines, which are used to aid firms whose closure would cause detriment to the economy
- regional guidelines, which deal with aid to specific areas of the European Union, and
- specific sectoral guidelines, which take account of specific sectoral features.

B.31 The Commission has also issued guidelines on SGEI, which apply where firms are compensated by Member States for performing public service obligations. These set out the conditions under which aids for SGEI are allowed under Article 86(2) EC Treaty.

B.32 A brief description of the characteristics of each of these guidelines is set out below outlining the aim of each exemption, as specified in the guideline, followed by a brief description of the criteria necessary for aid to be allowed under the guidelines.

Horizontal guidelines

B.33 Horizontal guidelines apply to specific types of firm or activities across the whole economy. The horizontal guidelines are split into three areas: research and development (R&D),⁸⁴ environmental⁸⁵ and risk capital.⁸⁶

⁸⁴ Community framework for State aid for Research and Development, OJ [1996] C45/06, as amended by Commission communication amending the Community framework for State aid for research and development OJ [1998] C48/02.

⁸⁵ Community guidelines on State aid for environmental protection OJ [2001] C37/03.

⁸⁶ Commission communication on State aid and risk capital OJ [2001] C235/03.

These are described in turn below.

Research and development

- B.34 R&D guidelines enable MSs to provide aid aimed at fostering innovation, research and technological development. This framework aims to encourage new technology to be developed and disseminated between MSs.
- B.35 The guidelines work on the premise that the closer the R&D is to the market, the more significant may be the competition distortion caused by the aid. As such, the Commission makes a distinction between fundamental research, industrial research and pre-competitive development activity.⁸⁷ Different aid intensities are permitted depending on the category the R&D falls into.

⁸⁷ The activities are defined on the basis that:

- **fundamental research** is an activity designed to broaden scientific and technical knowledge not linked to industrial or commercial objectives,
- **industrial research** is planned research of critical investigation aimed at the acquisition of new knowledge, the objective being that such knowledge may be useful in developing new products, processes or services, and
- **pre-competitive development activity** is the shaping of the results of industrial research into a plan, arrangement of design for new, altered or improved products, processes or services, whether they are intended to be sold or used, including the creation of an initial prototype which could not be used commercially.

Environmental

B.36 MSs cannot give aid to help firms to meet mandatory Community environmental standards, or give tax exemptions which lead to lower tax rates than binding minimum community rates. However, aid aimed at achieving environmental standards over and above the minimum community standards will be considered compatible, under certain conditions.⁸⁸ Provided that the aid meets this requirement, the environmental guidelines permit aid for:

- investments in land, buildings, plants, production methods and equipment intended to reduce pollution
- consultancy or advisory services to SMEs concerning environmental protection, and
- operating costs for the management of waste and in the energy-saving field.

B.37 The allowed intensity of the aid is dependant upon its aim and the recipient. For example, where aid helps SMEs meet the transitional investment costs of new environmental standards, the maximum is 15 per cent of eligible costs for a maximum of three years. However, where investment aid helps firms to improve on European standards the maximum is 30 per cent of eligible costs (40 per cent for SMEs).

Risk capital

B.38 The Commission may authorize risk capital measures aimed at addressing the difficulties SMEs face in obtaining capital and credit. This is seen as one of the main handicaps suffered by SMEs, in particular for small enterprises and start-ups.

⁸⁸ These conditions include the requirement that State Aid must be considered necessary to ensure environmental protection without having disproportionate effects on competition and growth within the Common Market.

B.39 The form of aid is chosen by the MS. The Commission's assessment of such aid will consider whether it encourages market investors to provide risk capital to the 'target enterprises' and is likely to result in decisions to invest being taken on a commercial basis.

Rescue and restructuring guidelines⁸⁹

B.40 Rescue and restructuring guidelines allow MSs to assist firms that are unable to stem losses that would almost certainly condemn them to go out of business, to the serious detriment of the economy. In the case of both rescue and restructuring aid, the Commission applies a 'one time, last time' principle. Such aid may usually only be granted to a recipient once in a ten-year period. This is so that it is not used only to postpone what would otherwise be the inevitable exit of inefficient firms from the market. The other conditions applied to the grant of rescue and restructuring aid are, broadly, as follows.

B.41 Rescue aid is (that is, must be) by its nature temporary assistance, aimed at keeping the firm afloat long enough to work out a restructuring or liquidation plan, and must be reimbursed.⁹⁰ It can only be warranted on the grounds of serious social difficulties, and must not have any serious spill-over effects on other MSs.

⁸⁹ Communication from the Commission, Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ 2004 C244/02S.

⁹⁰ Rescue aid must be limited to loans or loan guarantees.

B.42 Restructuring aid has to be based on a feasible, coherent and far-reaching plan to restore a firm's long term viability, usually involving at least one of:

- reorganisation and rationalisation of the firm's activities, typically involving the withdrawal from loss-making activities
- diversification towards new and viable activities, and
- financial restructuring, although this cannot simply be aid designed to make good past losses without tackling to causes of those losses.

B.43 The Commission recognises that restructuring aid raises particularly serious competition concerns because of its potential to keep inefficient firms in the market. It therefore considers that this aid can only be granted if it can be demonstrated that the competition distortions thus caused will be offset by the benefits flowing from the firm's survival (for example, the associated redundancies would exacerbate employment problems, or disappearance of the firm would result in a monopoly or tight oligopoly situation).

Regional Guidelines⁹¹

B.44 MSs are allowed to give regional aid to address market failures that cause underperformance in specific areas of the country. Specifically, the EC Treaty allows two types of regional aid:

- article 87(3)(a) - to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment), and
- article 87(3)(c) - to facilitate the development of certain economic activities or areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

B.45 Regional aid must meet a number of criteria. It must:

- be exceptional in nature and limited in time
- be concentrated on the most disadvantaged regions, and
- ensure that the resulting distortions of competition do not outweigh the advantages of the aid in terms of economic development.

⁹¹ Guidelines on national regional aid, OJ [1998] C74/06 (amended by Amendments to the Guidelines on national regional aid, OJ [2000] C258/06, and read with, National ceilings for regional aid coverage under the derogations provided for in Article 87(3)(a) and (c) of the Treaty for the period 2000 to 2006, OJ [1999] C16/04). See also Communication from the Commission Multisectoral framework on regional aid for large investment projects (notified under document No C(2002) 315), OJ [2002] C70/04 (as modified by Commission communication on the modification of the Multisectoral Framework on regional aid for large investment projects (2002) with regard to the establishment of a list of sectors facing structural problems and on a proposal of appropriate measures pursuant to Article 88 paragraph one the EC Treaty, concerning the motor vehicle sector and the synthetic fibres sector, OJ [2003] C263/03). The Multisectoral Framework covers regional aid for large investment projects that are likely to have a highly distortive effect on competition. It imposes stricter rules than those outlined here.

B.46 The areas where regional aid is allowed are generally referred to as Assisted Areas (AAs). These are defined according to which Article they are being considered under:

- **Tier 1 AAs** considered under 87(3)(a) are very tightly defined as areas that had a GDP per capita below 75 per cent of the EU average (between 1994 and 1996), and
- **Tier 2 AAs** considered under 87(3)(c) are less clear-cut, as no specific quantitative thresholds are set, hence MS have greater discretion in designating them.⁹²

B.47 In evaluating aid given to AAs, the three key considerations are:

- The income generated directly by the project
- The displacement effects on firms (in terms of jobs and market shares) both in and outside the AAs, and
- The wider benefits to the 'competitiveness' of the economy at large.

B.48 The amount that can be provided varies depending upon the size of the intended recipient and the aim of the aid. For example, the aid ceilings are higher for aid to SMEs. Regional aid can be for both capital investment and as an aid to employment creation. Aid is available to most sectors of industry and commerce but restrictions apply to certain sectors where over-capacity exists in the market, as set out in the sectoral guidelines, outlined below.

⁹² The Commission however stipulates that the means of identifying Tier 2 areas must be objective, transparent and based on up to five reliable indicators, and that identified areas must be display significant disparities from the average and have a minimum population of 100,000. The UK, for example, designated Tier 2 AAs based on four criteria: employment rate, unemployment rate, workforce unemployment rates, and local dependence on manufacturing.

B.49 The set of areas that are eligible for regional aid is being reviewed following the expansion of the European Union. This review may also give rise to changes in the aid ceilings permitted for different types of firms.

Sectoral guidelines

B.50 Specific sectoral guidelines exist in order to take account of the sensitive or unique nature of some economic sectors. The guidelines aim to control aid to sectors where State Aid may be particularly distortive, for example because it would prevent natural market rationalisation in the presence of over-capacity.

B.51 Guidelines vary significantly in terms of the aid they permit within a sector, but can be broadly categorised as enabling or restricting. Enabling guidelines increase the possibility to give State Aid in order to facilitate services of general economic interest or to tackle social objectives, whilst restricting guidelines are used to reduce State Aid to strategic industries within the Common Market.

B.52 Sectoral guidelines exist in a number of different sectors. These are:

- **audiovisual production** – guidelines set out the conditions under which the Commission assesses aids for cinema and television production under the Article 87(3)(d) EC Treaty derogation for cultural aids
- **broadcasting** - guidelines on the broadcasting sector permit State Aid payments to facilitate the provision of public service programming
- **electricity** - Aid aimed at compensating eligible stranded costs in the electricity sector is considered by the Commission to be

compatible with the Common Market⁹³. Guidelines are likely to become obsolete, as the stranded costs must predate 1997

- **postal services** – the Commission has issued guidelines on the application of Article 86(2) EC Treaty to aids given in respect of postal services
- **ship building** – State Aid to shipbuilding is subject to special guidelines due to the existence of overcapacity and depressed prices. These include a combination of restrictions and more lenient provisions. In particular, these guidelines enable MSs to deliver export credits, closure aid, and development aid for shipping yards
- **steel** - Under the Commission's 2002 Communication on a multilateral framework on regional aid for large investment projects, no investment in the steel industry is eligible for regional investment State aid during the lifetime of the framework (until 31 December 2009). The Communication on rescue and restructuring aid for the steel sector, indicates that it regards closure aid as compatible with the Common Market but rescue and restructuring aid to the steel industry as incompatible.

⁹³ Stranded costs are investment or other commitment costs incurred by the electricity industry prior to the liberalisation of the electricity sector, which can not be recovered due to the liberalisation process. For example, commitments or guarantees of operation such as long term purchase contracts or investments undertaken with an implicit or explicit guarantee of sale.

Services of general economic Interest

- B.53 The Commission has recently adopted new guidelines on State Aids that consist of payments (or other aids) by a Member State to undertakings entrusted with the performance of SGEI (those payments/other aids are referred to here as 'public service compensation'). These guidelines consist of a Commission Decision⁹⁴ and a Commission Framework.⁹⁵ The Decision and Framework will come into force after their publication in the OJEU, though some of their provisions will not take effect for a year thereafter.
- B.54 As indicated above, rather than set out the circumstances in which such aids are compatible with the Common Market under Article 87(3) EC Treaty, the Decision and Framework are concerned with a different exception to the Article 87(1) EC Treaty prohibition of State Aids, namely that in Article 86(2) EC Treaty.
- B.55 SGEI are the kind of services a state considers necessary in the public interest but which the market may not provide because they are not economically viable. Because of this public interest, the state may impose obligations on undertakings to perform the services and compensate them for doing so.

⁹⁴ Commission Decision of 13 July 2005 on the application of Article 86(2) of the Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, see: http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html

⁹⁵ Commission Framework (adopted on 13 July 2005) for State aid in the form of public service compensation, see: http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html

- B.56 Under Article 86(2) EC Treaty, the rules on State Aid apply to SGEI only to the extent that those rules do not obstruct the performance of the relevant services. In any event, the development of trade must not be affected to an extent that would be contrary to Community interests.⁹⁶
- B.57 In other words, Article 86(2) provides an exception to the State Aids rules for aids that are necessary for the performance of SGEI, as long as the development of trade is not affected to an extent contrary to Community interests. As stated, the Commission Decision and Framework set out the conditions under which that exception will apply (that is, under which State Aids that comprise public service compensation to undertakings entrusted with the performance of SGEI are permissible under Article 86(2) EC Treaty).
- B.58 However, before one considers the Decision and Framework, one must first consider whether a public service compensation payment for performance of a SGEI is a State Aid at all. If it is not, none of the State Aids rules apply and there is no need to consider the Decision and Framework.
- B.59 According to the ECJ in *Altmark*,⁹⁷ public service compensation is not State Aid if all these four conditions are met:
- the recipient undertaking has clearly defined public service obligations to perform

⁹⁶ Article 86(2) EC Treaty says, '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 this Treaty, 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 Community'.

⁹⁷ *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH*, [2003] ECR I-7747.

- the parameters on which the public service compensation are calculated are established in advance in a transparent and objective manner
- the compensation does not exceed the cost of performing the obligations, taking into account relevant receipts and a reasonable profit, and
- the recipient undertaking was chosen to perform the SGEI in a public procurement procedure allowing performance of the services at the lowest cost or, if not, the level of compensation needed is based on the costs of a typical, well run undertaking with adequate transport.

B.60 Only where one or more of these conditions is not met is the public service compensation a State Aid. Only then do the Commission Decision and Framework become relevant.

B.61 Under the Commission Decision public service compensation that amounts to State Aid is permitted (that is, falls within the Article 86(2) exception and is compatible with the Common Market) and so does not need to be notified to the Commission⁹⁸ if:

- it is less than €30 million per annum paid to undertakings with annual turnover of less than €100 million, or it is paid to hospitals or social housing undertakings or certain small air or maritime undertakings, airports and ports carrying out SGEI⁹⁹

⁹⁸ Article 3.

⁹⁹ Article 2.

- there is some official act (like a statutory rule) specifying, amongst other things, the undertakings' precise public service obligations, the parameters for calculating, controlling and reviewing the public service compensation and the arrangements for avoiding and repaying any over-compensation,¹⁰⁰ and
- the amount of public service compensation does not exceed the costs involved in performing the public service obligations, taking into account relevant receipts and a reasonable profit and the compensation is used only for the SGEI concerned.¹⁰¹

B.62 Public service compensation that amounts to State Aid but which does not meet the conditions in the Decision must be notified to the Commission in the usual way. The Framework then sets the conditions under which that aid will be permissible (that is, fall within Article 86(2) and be compatible with the Common Market).

B.63 The conditions set out in the Framework are all but identical to those in the Decision. The key difference is that State Aids falling within the Decision need not be notified. Those outside the Decision and so subject to the Framework, perhaps because they are bigger or to bigger recipients, must be notified. This enables the Commission to scrutinize them,¹⁰² to ensure the relevant conditions are met. This scrutiny is necessary because such aids have more potential to distort competition.

B.64 Where a State Aid is given in respect of a non-economically viable activity that falls outside both the Decision and the Framework, it may, depending on the circumstances, still be permitted under Article 87(3) EC Treaty, on the basis of other guidelines or a direct assessment under Article 87(3).

¹⁰⁰ Article 4.

¹⁰¹ Article 5.

¹⁰² and impose conditions on their approval, if necessary.