

Annexe C - European state aid control

Recommendations not taken forward

November 2005

© **Crown copyright 2005**

This publication (excluding the OFT logo) may be reproduced free of charge in any format or medium provided that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as crown copyright and the title of the publication specified.

CONTENTS

<i>Chapter</i>	<i>Page</i>
1 Introduction	1

1 INTRODUCTION

- 1.1 Before reaching our final proposals for changes to state aid control several options were considered. This Annexe describes the alternative options that we rejected. Like the final proposals, the options considered were aimed at improving the effectiveness of state aid control, making the rules more effects based and reducing the administration burden on the Commission. Though all these proposals have some merit, they were not found suitable for taking forward at the present time.
- 1.2 The first section considers possible changes to the system of control, the second section considers alternative forms of our preferred two-phase approach and the third section discusses alternative questions that were considered for inclusion in the phase one assessment.

Changes to the system of control

Complaints based system for state aid control

- 1.3 The complaints based system was proposed to replace the existing system of notification and approval.¹ Instead of notifying subsidies in advance, subsidy providers would be expected to assess for themselves whether their aid was compatible with the Treaty before granting it. In the event that a firm was adversely affected by state aid that it considered to be illegal, that firm could make a complaint to the Commission (or NCA if the system was also decentralised). If the Commission found in the complainant's favour, the aid would need to be

¹ At present, any interested party may inform the Commission of any alleged unlawful aid and any alleged misuse of aid (i.e. make a complaint) under Article 20(2) of Council Regulation (EC) No 659/1999 (1). Thus a limited form of complaints system exists currently, but does not replace the need for approval. Further, as an alternative, or as well as submitting a complaint to the Commission, it is usually possible for third parties whose interests have been adversely affected by the grant of an unlawful aid to pursue the matter before the national courts.

recovered. Such a change would mirror the recent changes in the application of Article 81 EC of the Treaty.²

1.4 A complaints based system offers the following advantages over the existing system:

- it would eliminate assessment and approval of notified aid by the Commission, thus reducing the administrative burden on parties
- it would reduce the risk that state aid meets the guidelines but distorts competition as those disadvantaged would be able to complain and have the aid terminated
- the control would be focused on the aid that causes distortion to competition, and
- it would put the onus on Member States to consider the competition effects of state aid.

1.5 However, this proposal was not taken further because of a number of problems:

- the only punitive outcome of a successful complaint against an illegal state aid is its recovery by the donor Member State. This is unlikely to be a strong sanction as it only returns the recipient and Member State government to their original positions. Hence the incentive is limited for a Member State to ensure that the aid is legal

² Under Regulation No 17/62 First Regulation implementing [then] Articles 85 and 86 of the Treaty (OJ P 13, 21.1 1962, p. 204), undertakings could notify the Commission of agreements between them, for the purpose of seeking an individual exemption under Article 81(3) EC from the prohibition of anti-competitive agreements in Article 81(1) EC. This was replaced by Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 by the Treaty [2003] OJ L1/1, which abolished the notification procedure.

- the complainant does not benefit from making the complaint, other than having the aid recovered. The Aid that is recovered goes to the government. Hence many complainants may not think it worth the cost and effort of making a complaint
- there could be cultural differences between Member States regarding propensity to lodge complaints hence many distorting aid might continue without complaint
- when a complaint is made it may be difficult to demonstrate that the detriment experienced or likely to be experienced is as a consequence of the aid. Our case studies support this concern. Hence it may be difficult to provide sufficient proof to support a legitimate complaint.
- it may also be more difficult to address the effects of incompatible aid ex post, when it has been granted, acted upon by its recipient(s) and distortive effects have been caused, than to address the issue ex ante by notification (to ensure adverse effects do not arise). Such a difficulty would only exacerbate those which already exist around the recovery of unlawful aid
- such a system would not offer the same level of legal and practical certainty as a properly applied ex ante notification procedure. In the latter, the recipient of a duly notified and approved aid can, in reliance on his legitimate expectations, act on it without fear it will be recovered. In a complaints based system aids and aid schemes could be vulnerable to challenge at some future date. In the absence of an indication an aid or scheme is lawful, providers may be less inclined to grant/establish them and, perhaps more particularly, potential recipients less inclined to receive them (given the risk of

needing to repay them at some future date). This may lead to aids/schemes that would otherwise be beneficial not being granted³

- it is also conceivable that firms will be more likely to seek aid themselves than to complain about them, and only to complain if they do not get them. This would undermine the efficacy of a complaints based system in identifying and eradicating unlawful aid. Where firms are minded to complain, they may do so vexatiously, causing a backlog of unmeritorious complaints, and
- any move to a purely complaints based system would require substantial revision of the EC Treaty, which in Article 88 provides for the ex ante notification procedure.

Greater transparency allowing business to be aware of proposed state aid

1.6 In order to increase the opportunity for businesses to express concerns prior to the award of an aid, we considered whether subsidy providers should be required to provide public information about proposed aid. This would allow business an opportunity to comment on a proposed state aid before the aid was approved and without concern about future repercussions. Specifically greater transparency would:

- provide an opportunity for proposed aid recipients' competitors to inform a subsidy provider about how the subsidy is likely affect them and raise any concerns they may have with the proposed subsidy. This feedback could help the project appraisal team in its subsidy design, and

³ We note that this concern was also raised when the application of Article 81 EC was changed (see footnote 1), however we are unaware of any research that indicates how much of a problem this has been in practice.

- ensure that all competitors, which are operating or likely to operate in the market in which the subsidy is offered, are made aware of the policy and have an opportunity to respond.
- 1.7 The OFT is aware of the possible merit in such increased transparency. In its initial response to the Commission's Action Plan the OFT expressed a favourable view on it. However, it has further considered the matter.
- 1.8 The proposal for consultation with business was not taken forward because publication of the proposal could involve the disclosure of commercially sensitive information (especially if it concerns aid to an individual undertaking). Such disclosure might deter firms from entering into discussion about subsidies, especially if the subsidy was not guaranteed to be granted at that stage. Furthermore, disclosure of this type of information may be legally restricted within a Member State.

In-depth assessment of all state aid using the effects based approach

- 1.9 If the commission made an in-depth analysis of all notifications it could carry out a more accurate assessment of the competition effects of all proposed state aid. Only the aid that had little potential for distortion to competition would be allowed. This would also reduce the risk that characteristics specific to the aid were overlooked during assessment under the guidelines.
- 1.10 There are two drawbacks in this proposal. First, it would place a significant burden on the Commission to carry out an in-depth analysis of all aid. With the number of notifications that are currently made each year, an in-depth analysis of each case would completely overload the system, resulting in very few aids being considered and approved or prohibited. Second, this system would reduce the administrative efficiency and certainty derived from a system of block exemptions and guidelines, the advantages of which would, the OFT suggests, be maximised were the Commission to adopt the changes proposed in this report.

Changes to the aid ceilings in the existing rules

- 1.11 The ceilings in the current guidelines do not reflect economic principles concerning likely distortion to markets and could therefore allow distortive state aid to be given in some markets. We considered whether ceilings could be changed to reflect such principles.
- 1.12 To make the aid ceilings more effects based, these would need to be set according to a view of when the subsidy's share of total investment led to distortion in the affected market. To achieve this, the ceilings would need to be related to the market the state aid was likely to affect. Hence a whole range of ceilings specific to different markets would need to be established and kept up to date. This would also place a considerable burden on the Commission in terms of setting the most appropriate ceilings.

Have an explicit prohibition on state aid to sensitive markets

- 1.13 This recommendation was proposed because it appeared to provide a simple way of screening aid that was likely to distort competition. However, it was not taken up because of practical difficulties in identifying markets that would be at risk of competition distortion and keeping the 'sensitive market' definition current. Furthermore, there may be ways of designing aid so that it does not distort competition, even in sensitive markets.

Placement of phase one assessment of distortion to competition

- 1.14 Three options were considered with regard to how the phase one assessment of distortion to competition would fit with current guidelines:
- to apply the assessment to aid that did not meet current guidelines before it was subject to an in-depth analysis

- to replace existing guidelines with the assessment, or
- to incorporate the assessment into the guidelines.

The third option was taken and is described in the main report.

- 1.15 Applying the assessment to aid not meeting current guidelines would allow a quicker decision route for aid of this type. However, it would not change the aid currently being approved under the guidelines and, following our research, we think that some of this aid distorts competition significantly and should be better controlled.
- 1.16 Replacing the guidelines with the phase one assessment would give the benefit of simplicity. The assessment sets out the generic conditions for the approval of aid. However, the guidelines are a familiar tool for subsidy providers and the Commission and can be used to accommodate the assessment, so we propose that they are revised rather than being replaced.

Alternative characteristics for inclusion in phase one assessment

- 1.17 In Chapter Four we proposed a number of characteristics to be used in the phase one assessment, and explained why these characteristics were suitable. We considered all the characteristics developed in our first stage of work, and some variations on these. The following section discusses why the other characteristics were thought unsuitable for the phase one assessment.
- A large subsidy in absolute terms – this is a very approximate measure of likely competition impact unless combined with other market data and hence would not be a useful part of an assessment in isolation
 - The subsidy affects costs directly- the phase one assessment includes a question concerning whether the subsidy addresses a market failure. This picks up the recent thinking by the Commission set out in the action plan. Given the overlap between whether a

subsidy affects costs directly and whether it addresses market failure, a question considering the former was not included

- The subsidy is repeated - the existing rules already prevent repetition of support for the same investment or rescue and restructuring support for the same firm. Although firms in some circumstances can obtain subsidy for each new investment they receive, if this only addresses a market failure specified in the phase one assessment it should not lead to additional distortion. Furthermore it is difficult to identify a practical rule to limit repetition of subsidy without increasing monitoring burdens significantly and creating an incentive for firms to adopt strategic behaviour concerning the support that they can receive.
- The remaining characteristics on the list concern the nature of the market that the subsidy will effect. There are several reasons why they would not be suitable for the phase one assessment
 - market characteristics become more important if selectivity and size criteria are not met: The characteristics of the market are relatively unimportant in terms of the impact of competition if the subsidy is small relative to the market and generally available to the firms in the market. This would suggest they were an important part of an in-depth analysis but were less important for the phase one analysis
 - market characteristics require a significant level of work to identify and hence would make the phase one assessment very onerous
 - the effects of these characteristics, particularly product differentiation and market concentration interrelate in a complex way so their combined effects need to be considered. This would also make the initial assessment complex.

1.18 We also considered whether a condition could be incorporated into the phase one assessment that limited the size of the subsidy relative to the size of the market. A condition of this type would be a very good indicator of whether the subsidy would change the behaviour of the

recipient in a way that would affect the market. However, there were specification problems with this condition: Market size equals the total value of sales from competitors in a market. It is possible that the size of a market is large but the value added at a particular stage in the production chain is low, for example the value added by car distributors is low relative to the value of cars. Limiting the size of the subsidy relative to the size of the entire market would allow subsidies that could distort competition significantly at one point in the chain. This could reduce the overall efficiency of the chain.

- 1.19 In light of this reasoning, we considered whether we could limit the size of a subsidy relative to the value added in the recipient's market. We concluded that the differences in vertical integration between competitors would make this impractical.