



HM TREASURY

**TAKING ACCOUNT OF STATE AID
ISSUES IN POLICY MAKING
A RISK-BASED APPROACH**

JULY 2004

FACTORING IN STATE AID CONSIDERATIONS TO POLICY DECISIONS – A RISK-BASED APPROACH

EXECUTIVE SUMMARY

This paper sets out a framework for undertaking a balanced consideration of state aid issues. The paper recognises that in many cases the state aid implications of a proposed policy may not be clear cut and it provides an approach which takes account both of our obligations under European Union (EU) state aid rules and domestic policy aims.

2. To constitute a state aid under EU rules, a measure must meet the four following criteria:

- be by with or through state resources;
- favour a particular undertaking or the production of certain goods;
- distort or threaten to distort competition
- affect intra community trade

However, whether a measure meets these tests is not always clear. This paper sets out the factors to be considered when making a risk-based assessment as to whether a measure constitutes aid or not

3. It is necessary to be aware of other factors, such as the likelihood of a challenge to an unnotified measure. The types of risk involved, such as financial risk for recipient companies who may have to repay any aid granted illegally, and risk to the overall success of the project if aid is or is not given will also need to be borne in mind.

4. Judgments on state aid issues should always be performed in conjunction with a state aid expert. The DTI state aid branch provides state aid advice across the UK public sector, and many individual authorities, departments and bodies now have their own in-house expertise. If a measure is judged to be state aid, it will need to be notified to the European Commission before it can be implemented. The DTI have produced a separate publication detailing this process (available on-line at <http://www.dti.gov.uk/bbf/state-aid/index.html>), and can provide further advice as necessary.

INTRODUCTION

5. Making a proper assessment of the state aid issues is becoming an increasingly important and frequent aspect of policy making right across government. Failing to take proper account of the state aid rules can have major implications for the delivery of government policies, including stopping a scheme from being implemented, damage to the overall objectives of the policy or, in the worst case, requiring funds paid under a scheme to be recovered. However, an overly-cautious approach to state aid can lead to unnecessary delays in policies being implemented or can lead to sub-optimal policy-making. It is therefore important that proper consideration of state aid issues is given to policies before they are implemented.

6. It is not always clear, even with experience, whether a given measure is a state aid and, if so, how it should be treated under the rules. There may be a lack of state aid precedents in a particular policy area, or even be contradictory precedents, and consequently conflicting legal advice on whether a measure is an aid. Perhaps because of the potential severity of the implications for getting state aid decisions wrong, it is often easy to seek comfort by adopting a very cautious stance towards state aids. However, this in itself can be unnecessary, and lead to the delay, or even failure to implement policies that will contribute to public bodies achieving their objectives. Government ministers have made it clear they want a “risk-based” approach adopted to decision-making, which both respects our legal obligations and focuses on target delivery. This means state aid decisions should be based on what is ‘credible’ rather than necessarily what is ‘cast-iron’. However, decision-makers may need to consider the extent to which any risk would be borne by business instead of or in addition to government and ensure that the level of risk is one which business as well as government can live with.

7. The purpose of the paper is to outline a risk-based approach to decision-making in state aid cases. It is designed to help all those involved at every stage of the process from planning a measure to its actual implementation, and it applies to aid givers in all levels of government - including Regional Development Agencies and non-departmental public bodies. However, it does not – and cannot – provide a blueprint for every decision.

POLICY CONTEXT

8. Rules constraining the use of state aids apply to all members of the EU¹. Most state aid must be notified to and approved by the European Commission, and there are a series of frameworks setting out the rules for the various types of aid. The purpose of the state aid regime is to prevent governments from giving financial advantage to firms in a way which could distort competition. This enables British firms to compete on a level playing field with those in other EU countries. The use of state aid in the long run can also lead to a persistence of inefficient and unproductive industries, preventing the emergence of new high growth firms which could deliver better products more cheaply, and so damaging the country's long term prosperity. And of course, if taxpayers money is not being used to subsidise inefficient enterprises, taxes can be lower or public spending can be increased in other areas, such as health and education. The Government therefore strongly supports the need for state aid rules to remove abuses and create a genuinely open and competitive market, and is pressing the Commission to enhance its focus on tackling the most distortive aids.

9. However, not all state aid has such negative effects, and the EU's state aid rules allow for beneficial types of aid to be paid, which are deemed to be 'compatible with the Common Market'. These are broadly regional aid for disadvantaged regions, and aid for 'horizontal' purposes (i.e. aid that can be paid across all sectors and all of the member state) such as for environmental improvements, R&D and training. Where relevant guidelines exist, the Commission will follow them very closely when determining whether a particular aid is compatible or not. These state aid frameworks have evolved over time, and will continue to do so, and in this context, the UK Government is pressing the Commission to make its definition of permissible aids more focused around the concept of market failures – that is aid should be permissible where government intervention leads to a better allocation of resources than that from the market acting alone. But these issues are not for this paper, which is focused on the handling measure in the context of the current state aid rules.

¹ A more detailed account of the state aid rules and processes can be found on the DTI website <http://www.dti.gov.uk/bbf/state-aid/index.html>

A RISK-BASED ANALYSIS

Risk

10. Risk can be defined as the possibility of being exposed to danger or difficulty. A risk assessment therefore needs to include both a quantification of how likely an event happening is and what the impact would be if it did. This purpose of this is to inform what the appropriate handling response should be.

- The impact of any unnotified measure being later found by the Commission to be incompatible state aid is fairly uniform – removal of the scheme and possible recovery of any aid already given (see paragraphs 28 to 33 for more detail). However, this does not mean all measures that are potentially state aid require handling in the same way. It is also necessary to consider the probability that introducing a measure without Commission approval will prompt complaint or a Commission enquiry, and if this could lead to a Commission investigation into the measure.

11. The credibility of the argument that a measure is not aid will depend largely on how much there is by way of supporting precedent from other cases, and consistency with the Commission's state aid policy as set out in its various communications. If there is a credible argument that the measure is not aid, the likelihood of Commission or third party action will also influence the decision whether to seek the certainty of a formal notification. This in turn will depend, amongst other things, on, the sector involved, the location of the aid recipient and whether there is an aggrieved competitor.

Factors to consider in risk assessment

Is state aid involved?

12. The starting point for any state aid analysis must be the four tests for a state aid:

- by with or through state resources;
 - favouring a particular undertaking or the production of certain goods; and
 - distorting or threatening to distort competition.
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- Affecting intra community trade

13. The state aid rules are concerned primarily with the effect on competition and trade, not the form of a measure, nor the intention behind it. The fact that a given measure may deliver strong benefits for a particular region or sector is unlikely to be sufficient if this is at the expense of significant harm to competitors in other Member States.

14. A state aid will only exist if all four tests are met. However, whether a measure meets a test is not always clear, so it may be very difficult to conclude that a measure is definitely not a state aid. However, there may be scope for determining that there is a credible argument that a measure does not constitute aid. The following sets out ways in which the Commission has interpreted each of the four tests, and as such demonstrates factors that can be considered when making a risk-based assessment as to whether a measure constitutes aid or not. Further information on specific cases is given in the annex.

State resources

15. This test is usually fairly clear cut – money from any public body directly or indirectly constitutes state resources. It can also encompass European structural funds as the state has direct control over these² and funding from the National Lottery as the state also has control over how these funds are spent. Foregoing or deferring revenue as in a tax or rate rebate or selling public land at undervalue also counts as using state resources – i.e. it is not actually necessary to spend money.

16. Advantages which are funded directly from private resources do not count as state resources even if the funding is in response to a legal requirement laid down by the state. This can be seen in the Preussen Elektra case which is quoted in the annex. A similar scheme - the Renewables Obligation³ was introduced in the UK in 2002, without any need to notify as a state aid.

² Structural Funds are not state aid but Council Regulation 1260/99 Article 12 requires the Structural Funds must conform with competition rules, including the rules on state aid.

³ The Renewable Obligation calls on all licensed electricity suppliers in England & Wales to supply a specified and growing proportion of their electricity sales from a choice of eligible renewable sources. The Renewables Obligation Scotland is the equivalent instrument in Scotland

Commercial advantage/distortion of competition

17. An undertaking is an entity which is engaged in economic activity. Economic activity is anything which a private company could potentially perform for profit. In determining whether an entity is an undertaking it is important to look at the activity and not the form. Publicly owned entities, charities, charitable companies and not-for-profit companies, even Government Departments, can all be classed as undertakings if they are performing an economic activity.

18. Non-economic activities can be funded without being state aid. Unfortunately, these are not easily defined. And indeed, as the European economy has developed, the definition has shifted over time to reduce the scope of activities that are genuinely non-economic. Useful guidance as to what the Commission regards as economic and non economic can be found in the Commission's 2000 Communication on Services of General Economic Interest.⁴ The latter category includes not only areas such as national defence, but also national education and compulsory basic social security schemes, and even charities and non-governmental organisations (NGOs) in so far as they are not engaged in commercial activities.

19. There may be other areas where it is possible to plausibly argue that the activity is non-economic. For example, if contaminated land has been disused for many years, one can mount a strong case that the cleaning up of that land by a state body does not represent commercial activity. Although once it reached the point where the land could be sold off and developed by the private sector, it is in the realms of economic activity.

20. One needs to be careful when assessing whether an activity is commercial - some areas that one might consider to be non-economic, such as healthcare provision, have been deemed to fall within the state aid net where they contain an element of commercial activity (see annex for further examples).

21. In addition, transactions involving a state body done at commercial rates will not represent a commercial advantage. It is important to be able to provide evidence that any such transactions are indeed at commercial rates. Auctions or tenders are ways in which this can be demonstrated, and in some cases having a price set by an independent valuer, such as a surveyor, may

⁴ COM/2000/0580 final

be sufficient. There is scope to use this in public-private partnerships, and it can also be useful at a regional and local level (see further details in the annex).

Specificity

22. The state aid rules apply only if the aid is limited to specific undertakings. Outside of tax matters, this is a fairly clear test. If a particular funding scheme gives aid to any undertaking without discretion in the entirety of the Member State (not just in the whole region) then it is a general measure and not caught by the aid rules. However if the aid only applies to a certain region or to a certain sector or certain type of undertaking (e.g. SMEs) this would show specificity and be an aid. Thus for example aid to all companies in Wales would still count as state aid and not a general measure as it concerns aid in part of the Member State. This remains the case even if the measure is introduced by a sub-national level of government, for example in this case, the National Assembly of Wales.

23. The issue of different tax rates within a member state is more contentious. If the UK government were to decide to lower corporation tax in one part of the UK, that would certainly constitute state aid (as it is equivalent in effect to offering grants to firms established in that area). However, taxes set at sub-national level where there is no national reference rate are not considered selective if they differ. The grey area is where sub-national levels of government have the power to vary national tax rates. In a case relating to the Azores, the Commission concluded that such variations did represent selectivity⁵. However, this is now under challenge in the European Court of Justice⁶, and the UK has intervened arguing that such interventions should not be considered selective if the region concerned bears the fiscal burden of the lower tax rates. The outcome of the case is expected in 2005.

Effect on Intra-Community Trade

24. There is only a relatively small set of activities that can be judged to not affect trade between member states at all, and therefore not meet this criterion. "De minimis" aid is considered to be so low that it does not affect trade and is therefore defined not to be state aid – this allows undertakings in all sectors (except for agriculture) to receive €100,000 over a rolling three-year period. But clear records of de minimis aid payments must be kept, and

⁵ OJ 2003 L 150/52.

⁶ Case C-88/03.

it must be cumulated to ensure that aid to an individual undertaking does not breach the €100,000 ceiling (though de minimis aid is allowed in addition to any aid under approved schemes).

25. Case law suggests there is very little beyond this which does not meet the effect on trade test. This is because the Commission only need conclude that there is potential to affect trade, it doesn't actually have to demonstrate that it is affecting trade. Even if a company receiving aid does not export itself, this could be considered to affect intra-community trade if the product or service is traded within the EU.

26. There is some limited scope to consider there is no potential to distort trade if the aid is limited to financing "local activities", though such activities are not clearly defined. The deprived urban areas guidelines (although these have now been withdrawn, the underlying principles still apply) do contain a list of 'local activities', defined as small enterprises operating in areas such as construction, hotels and restaurants. There has also been some more recent case law where the Commission has concluded other activities do not have the potential to affect trade, though these remain fairly limited in scope (further details can be found in the annex).

Conformity with state aid rules

27. The factors set out above can therefore be used to assess the extent to which something might be considered a state aid. But while the question of whether or not a measure constitutes a state aid is the primary consideration, other factors will need to be considered when there it is not certain that a measure is not state aid. For example, two different measures may both be credibly argued to not constitute state aid, but if one is clearly approvable even if it were found to be an aid, and the other not, then this would prompt a different handling approach. And, In extreme cases, there can also be a need to pay aid in advance of formal clearance, for example in rescue cases.

Other factors

28. Where introducing a measure, it is also important to consider the likelihood of a state aid challenge. An aggrieved competitor may make a complaint to either a national court or direct to the Commission, or the Commission may be prompted by member states' policy announcements. The factors that will determine whether a third party or the Commission itself feels inclined to make and pursue enquiries about the legitimacy of a measure

will include the size of the benefit, the extent to which the measure could be judged to distort trade and competition, whether the aid is available to firms in sensitive sectors, and the intensity of competition in the sector.

Types of Risk

Financial

29. The Commission has the power to seek recovery of any payment of impermissible aid, which extends back for ten years. This financial risk is of course borne by the companies receiving any money. Illegal aid has to be repaid with interest regardless of the effect on the recipient – even if a company is forced into bankruptcy. Even comparatively small amounts of money could have an unfortunate effect on companies if they had to be reclaimed - firms may have entered into contracts on the basis of receiving government assistance which still have to be honoured even if the aid is later withdrawn. Consequently firms can be keen to see the state aid status of financial assistance clarified before accepting the monies. So if a proper state aid assessment is not undertaken, firms may be unwilling to make use of the scheme, rendering it ineffective.

30. The fact that it may be administratively difficult or expensive for the state to reclaim any aid is also not a sufficient reason to avoid recovery. The one reason why the Commission might not require recovery of an impermissible aid is if it would breach the principle of legitimate expectations – in short if a diligent business had grounds for believing assistance it received was state aid compliant. If the Commission has been aware of the award of an aid (the fact that a policy has been publicly announced is not sufficient to argue this, there needs to have been some public signal on the part of the Commission of which businesses would be aware), and has given the impression that it would not object to the aid, for example by unduly delaying taking steps to recover it, then there would be strong grounds for arguing recovery of aid granted subsequently is not appropriate. For example, if the UK copied exactly a scheme which had been cleared as non-aid for another member state but the Commission subsequently changed its mind both on the original scheme and our scheme then we would have grounds to argue legitimate expectation.- this is what happened in the case of French and Irish co-ordination centres which had copied the example in Belgium which had originally been cleared as non-aid.

31. Departments are also at some financial risk as a complainant could win damages against them in the UK courts if they could prove that they had been harmed by the award of unnotified aid. But adopting an over cautious approach can also have financial implications – obviously waiting for Commission clearance for a scheme will delay the distribution of the assistance. In more extreme cases, not paying rescue aid before Commission clearance could put a company into liquidation, so aid will have to be paid even before it has been approved by the Commission. A delay in paying any aid whilst waiting for approval could also have an effect on the company's balance sheet.

Delivery and reputational

32. A decision not to notify a measure carries significant risk to the overall delivery of policy objectives if it is later found to be incompatible. Ministers can expect a tough time from a Select Committee if this has resulted in a company having to repay aid. More important, a Minister could be brought to court on a charge of misfeasance in public office if he/she knowingly allows aid to be paid which they know not to be legal. If a Minister insists that an unnotified state aid be given then he/she will need to seek approval from the Ministerial Sub-Committee on European Issues (EP), and then issue a Ministerial Direction to the Accounting Officer. It could also be damaging in terms of our reputation with the Commission, and might colour their view of future UK schemes and notifications.

33. Member states are still required to notify and await Commission approval for measures even where it is already known they are almost certainly approvable. In cases where it is a borderline decision whether the measure is an aid at all, but either way it is strongly believed to be compatible, there may be a strong policy reason for notifying the aid ex post. For example, in the case of the rescue of British Energy, there was a need for intervention before Commission approval could be obtained to prevent a shortfall in the country's electricity supply. However, it is important not to let this become anything but the exception – should we gain a reputation with the Commission as “serial unnotifiers”, we will lose credibility and likely find that they question many more unnotified schemes than they do at present.

34. Balanced against this is the legitimate desire on the part of ministers to ensure beneficial measures aim at achieving departmental objectives and Public Service Agreements (PSAs) are not unnecessarily delayed or not implemented at all by an overly-cautious stance on the state aid position.

Managing risk

Internal advice

35. The best way to manage state aid risks is to consider these factors at an early stage. Aid givers need to consider the state aid potential as a scheme's aims and conditions are being drafted, particularly as the Commission can interpret the four tests differently depending on the circumstances. The case law of the Court will also directly affect the way that the Commission assesses cases and this can change.

36. An early discussion with either in-house state aid experts if they exist, or the state aid team in DTI can often allay concerns or highlight points that need further consideration. As this is a particularly specialised area, it is important to seek expert advice where there is doubt as to the status of the measure. Seeking this at an early stage can prevent longer delays further down the line.

Informal advice from the Commission

37. If felt necessary for any reason, an informal opinion from the Commission can be sought. This is off the record and the Commission cannot be bound by anything they say at such a meeting. However it is useful to get the broad thrust of their thinking and to raise awareness of any potential obstacles, although it does not give the legal certainty of a formal notification. If you think that it would be useful to have such a meeting you should first seek advice from DTI state aid branch and UKREP.

Advising ministers

38. Any advice to ministers must be honest and give a balanced view. If there is doubt about the legality of a measure it is important to set out the arguments and the balance of risks. Ministers should only be advised on a particular course of action if there is a reasonable argument for it being consistent with the state aid rules.

Conclusion

39. The above sets out some of the issues to take into account in risk-based analysis. In deciding whether to seek the certainty of a notification, aid givers will need to first weigh up the strength of the argument that the

measure is not aid, and second the likelihood of legal challenge or of the Commission finding out (if the state aid verdict is unclear). The other thing to bear in mind is what the consequences of such a decision would be and directly linked to this how difficult it would be to rectify the situation. In summary, the following questions are the ones to ask and answer when making state aid decisions:

- How firm is the assessment that the measure is likely not to be an aid?
- Are there other policy reasons for implementing quickly rather than waiting for a notification to be approved?
- What impact would an adverse finding have on companies which had already received aid?
- Would not notifying the measure introduce uncertainty with the recipients which would make it unlikely it would have its desired effect?
- How significant is the assistance in terms of its relative size and impact ?
- What is the extent to which the aid would affect intra-community trade?
- Which sectors does the aid apply to – does it include the sensitive sectors and/or is there previous history within the sectors concerned, which are more likely to trigger complaints?
- What is the extent of competition in the sectors?
- How easy would it be to recover the aid if an investigation found it to be a state aid?
- What would be the wider implications for the credibility or delivery of the policy or its objectives if there was a negative decision after the aid had been introduced?

**Department of Trade and Industry/HM Treasury
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Annex: Interpretation of the Four Tests : Precedents from Case Law and Commission Communications

A Commission decision on whether a measure meets the definition of a state aid, and whether the Commission followed the correct procedures in reaching a state aid verdict can be appealed to both the Court of First Instance and the European Court of Justice. However, the Courts do not rule on whether a state aid is compatible with the Treaty or not – this decision is left exclusively to the Commission.

State Resources

The Preussen Elektra case involved German legislation which compelled regional electricity supply companies to buy a proportion of their needs from renewable sources at an additional cost. There was a mechanism in the legislation for allocating these extra costs between the suppliers and the network operators – the cost was therefore met entirely from private resources. The Court found that neither the statutory obligation introduced by the German rules, nor the allocation of the financial burden between private supply undertakings and private operators of upstream electricity networks involved a direct or indirect transfer of State resources.

In Cases C/67,68 and 70/85 Gebroeders van der Kooy v Commission which concerned an allegedly preferential gas tariff for the Dutch horticultural industry the Court examined the ownership and management of the Dutch gas company Gasunie. The Dutch state owned 50% of the shares of the company and was also empowered to approve their tariffs. These factors demonstrated that the contested tariff was the result of action by the state and was caught by the state aid rules.

Undertakings/effect on competition

The state aid rules do not apply to non economic activities. Useful guidance as to what constitutes a non- economic activity can be found in the Commission's Communication on Services of General Economic Interest. Matters which are intrinsically the prerogative of the state (such as air traffic control) are not of an economic nature; national education and basic social security schemes are fulfilling a social function; and other activities where the function is social rather than commercial (including trades unions, churches, charities and aid organisations). However, whenever such organisations engage in economic activities, state aid law is applicable.

The Commission ruled in the Brighton Pier case (N/ 56/01) that the operation of a heritage centre was an economic activity and that therefore the Pier Trust (a charity) was an undertaking.

In case N209 /2001 the Commission decided that local authorities in Ireland which provided low cost housing were an undertaking because they were active in the housing market.

In case N 543/2001 the Commission took the view that a hospital was an undertaking. This is particularly the case where the hospital is offering both private and public health care.

In Case C39/94 SFEI v La Poste, the Court ruled that in order to determine whether a state measure constitutes state aid, it is necessary to establish whether the recipient receives an advantage which it would not have obtained under normal market conditions. In case T123/96, Salomon SA v Commission, state controlled banks, along with private sector banks, agreed to reduce the debts of a debtor in difficulty. This did not constitute aid since the action of the public banks was justified on economic grounds.

Following a number of cases involving the sale of public land, the Commission issued a Communication (OJ 1997 C 209/3). This sets out that a sale of publicly owned land and buildings following a sufficiently well publicised, open and unconditional bidding procedure, comparable to an auction, accepting the best or only bid is by definition at market value and consequently does not contain state aid. If this open bidding procedure is not used, an independent evaluation must be carried out by one or more independent asset valuers prior to the sale negotiations in order to establish the market value on the basis of generally accepted market indicators and valuation standards.

Specificity

In Case 173/73 Italy v Commission, the Court ruled that the selective nature of a tax measure may be justified by 'the nature or general scheme of the tax system'. If so, the measure is not considered state aid. The Commission's Notice on the Application of the State Aid rules to measures relating to direct business taxation (OJ 1998 C384/3) sets out further how this is to be interpreted. A tax measure whose main effect is to promote one or more sectors of activity constitutes aid, and so a derogation from the base rate of corporation tax for an entire section of the economy normally constitutes state aid. However, measures whose economic rationale makes them necessary to

the functioning of the tax system may not constitute state aid. And the progressive nature of a profit tax scale is justified by the redistributive purpose of the tax.

Intra Community Trade

The Commission's guidelines on aid for Deprived Urban Areas (OJ 1997 C146/6) have now been withdrawn, but the Commission has stated the underlying principles of these still apply. They contain a list of 'local activities' – that is activities which could be considered not to affect intra community trade. These are the following activities – where undertaken by small enterprises:

- construction;
- sale maintenance and repair of motor vehicles; automotive fuel;
- retail trade; repair of personal and household goods;
- hotels and restaurants;
- health and social work;
- other community social and personal service activities; and
- social services.

As seen above the Commission did consider that the **Brighton Pier** Trust was an undertaking because running a heritage centre was an economic activity. However they decided that the activity of running a heritage centre was not likely to distort trade between Member States. They added that restoration of existing monuments did not affect trade.

Terra Mitica is a large holiday theme park near Benidorm. The Commission took the view that the size of the park meant that it was not a regional park but was a "destination park" i.e. one that tourists from other Member States would deliberately set out to visit and was thus capable of affecting intra-community trade. The fact that according to the Spanish authorities most of the visitors were from the local region was dismissed by the Commission who pointed out that there was active policy of attracting visitors from abroad.

However in the **Danish Rare Breeds Centre** , a small zoo in an obscure part of Denmark dealing only with Danish animals and where all the signage was in Danish, the Commission considered that this was unlikely to have any affect on trade as the vast majority of visitors would come from Denmark.

In case N258/2000 **Leisure Pool Dorsten**, the Commission found that a swimming pool provided recreational use in a small community in Germany was not likely to have any effect on trade.

In case NN136/2001 (**Ecomusee**) the Commission took the view that the activities of museums did not have any effect on trade.

End