

# An Introduction to State Aid

## WEBINAR TRANSCRIPT

### Overview

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This webinar covers the European law topic of state aid. It reviews the key principles and legislative frameworks for determining whether state aid exists and, if it does, whether it is compatible with the European Treaty. The webinar also provides an overview of the enforcement mechanisms.

The training aims to educate viewers about state aid and the importance of identifying it early in policy development. It gives a framework for viewers to determine whether a proposal is likely to involve state aid and how to ensure giving the aid will not breach the European Treaty. It also highlights the process for obtaining state aid approval from the Commission and what is likely to happen if errors are made.

In particular, it covers:

- The key principles of the state aid test – state resources, undertakings and selectivity
- The market economy operator principle and routes for compatibility (including the key block exemptions)
- When approval must be sought from the Commission
- The potential consequences of providing aid in breach of the Treaty

## Introduction

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**Alan Evans:** Welcome to this webinar – an introduction to state aid. I am Alan Evans; I am a director in the Legal Services Group at the Department for Business, Innovation and Skills. I will be chairing this webinar and I am joined by three lawyers from BIS who currently advise on state aid – Becky Fife, Cinead O'Sullivan and Richard Lewis.

This webinar aims to give an overview of the principles of state aid. We will look at the rationale for the state aid rules which are part of European law and what the test is for determining whether something is state aid. We will also look at how you can ensure that where there is aid it is compatible with the state aid rules and what practical steps you need to take. Finally, we will look at the potential sanctions if aid is given unlawfully.

## State aid: basic principles

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First, I will invite Becky to tell us about why we have rules on state aid and what the key principles are.

**Rebecca Fife:** Thanks Alan. Well we will start by first looking at why we have state aid rules. State aid forms part of wider EU competition law. It sits alongside merger control and other rules against anti-competitive behaviour.

State aid can have an anti-competitive effect because it could give recipients an unfair advantage or artificially protect unproductive firms. The state aid rules are therefore intended to support the internal market by prohibiting unfair subsidies or other competitive advantages. There are however certain exceptions to this and we will learn more about those later in this webinar. Some state aid is allowed where legitimate EU objectives are promoted in a proportionate manner.

So what is state aid? State aid is a member state's financial aid to undertakings which meets all of the criteria set out in Article 171 of the Treaty of the Functioning of the European Union. I will start by setting out what Article 171 says and we can then discuss the various elements in more detail. Article 171 provides that any aid in whatever form which could distort competition and affect trade between member states by favouring certain undertakings or the production of certain goods is incompatible with the internal market unless the Treaty allows otherwise.

State aid within the meaning of Article 171 has four basic elements and these comprise the so-called state aid test. First, the aid is provided by the state or through state resources. Second, the aid favours certain undertakings or the production of certain goods. Third, the aid distorts or threatens to distort competition. And fourth, the aid affects trade between member states. All four elements must be satisfied in order to meet the state aid test. If the test is met the aid will be in principle state aid which is incompatible with the internal market.

So if we take each of the four elements in turn. This aid must first be granted by the state or through state resources. For these purposes the word 'state' should be understood in the widest possible sense and includes central Government and also all levels of local and regional Government, non-departmental public bodies and state corporations. There must also be a transfer of state resources and the most obvious

example of this is where the Government makes a grant, or loan, or capital injection. However the concept of state resources does not just include funds coming from the state budget. It can also consist of other less direct forms of assistance. For example, preferential interest rates, guarantees and indemnities have all been held to be state aid. If land and buildings are purchased on favourable terms this could also amount to a transfer of state resources. There might also be state aid where revenue is foregone or there is a renunciation of state resources that would otherwise have been collected; for example, tax advantages and sales at an under-value could also amount to a transfer of state resources.

It is important to note that Article 171 draws a distinction between aid granted by a member state and aid granted through state resources. This is intended to catch aid which may be granted by a public or private body established by the state. It is therefore important to look at whether the aid is granted directly or indirectly through state resources, in addition to whether it is made out of funds which the state controls.

If we move onto the second element of the state aid test; the aid must favour certain undertakings or the production of certain goods. There are essentially two elements to consider here: first, whether the aid measure confers a selective advantage; and secondly, what is meant by an undertaking. The key here is to look at the effect of the measure not its form and always the devil will be in the detail. In terms of selectivity, aid is likely to be selective if it is made available to certain undertakings in a member state but not to others in a comparable position. For example, if a measure targets individual sectors or regions or is made specifically to one or more undertaking it is likely that it will be selective. In contrast, general measures which apply to all undertakings within a member state without making a distinction between them are unlikely to meet the second element of the state aid test.

When considering selectivity it is important to consider all of the potential beneficiaries of the aid. A good example of this is where the Government decide to invest capital. In this case you would not only need to consider the undertaking which receives the capital investment, but also any other investors or any fund or vehicle through which the investment is made. Deciding whether aid is selective can be particularly difficult in the context of tax measures. General measures such as taxation or tax deductions are unlikely to constitute state aid. Likewise, aid which is provided to all undertakings or productions on the basis of uniform and objective criteria will not meet the selectivity test. Having said that, if an aid measure provides any sort of exception or different treatment in favour of certain undertakings but not others it will, on the face of it, be state aid.

So what is meant by an undertaking? The Treaty does not actually give a definition, but there have been a number of cases where the term has been discussed. The key is to look at the effect rather than the form of the business. The classic definition of an undertaking can be found in *Höfner and Elser v Macrotron* [1991] E.C.R. I-1979. In that case it was held that the concept of an undertaking in the context of competition law covers any entity engaged in an economic activity regardless of the legal status of the entity or the way it is funded.

Put simply, an undertaking means any entity which is engaged in an economic activity. And 'economic activity' means any activity for which there is a market for comparable goods and services. The term 'undertaking' might therefore include companies, partnerships, trade associations and state corporations. It could also include voluntary or non-profit making entities because crucially profit status is not a determining factor. Whether or not a company chooses to see a profit is not material to whether it will be an undertaking. This means that 'not for profit' bodies such as charities may still be undertakings if they undertake commercial activities. It also means that the same entity may act partly as an undertaking and

partly not depending on what activities it undertakes. This can give rise to some complex issues in relation, for example, to universities or statutory bodies. These entities might receive state funding in respect of certain of their public activities, but also undertake other more commercial activities.

Where an entity undertakes both public functions and commercial activities the risk of state aid can sometimes be mitigated by creating a separate legal entity for the trading arm of the business. The recipient would also want to ensure that it maintains separate accounting mechanisms to ensure that state funds are ring-fenced and do not subsidise the commercial arm of the business. It is also worth noting that the definition of undertaking may extend to self-employed professionals and sole traders but generally will not include employees unless the aid benefits their employers.

Moving onto the third and fourth elements of the state aid test, the aid must distort or threaten to distort competition and it must affect trade between member states. In practice these tests tend to be considered together and the thresholds for both tests are very low. The presumption is that any aid granted to an undertaking could distort competition. The approach taken by the court in *Philip Morris v the Commission* [1980] E.C.R. 2671 was that unless exceptional circumstances exist, any public aid granted to an undertaking distorts competition or threatens to distort it where the aid is only proposed and has not yet been granted. Having said that, despite this presumption the Commission is at least required to carry out some minimal analysis as to whether there has been a distortion of competition. The Commission must show that the aid would have a real rather than a wholly theoretical impact on the market. Furthermore the Commission must also show that the recipient of the aid has gained an appreciable advantage over its competitors.

In terms of the effect of aid on trade between member states, this may vary depending on the aid in question. There does need to be an actual impact on trade; it is sufficient to meet this limb of the state aid test if there is a potential impact. In reality almost any aid in respect of a business or economic activity is capable of affecting trade between member states. So even if the recipient of the aid did not directly trade with other member states there is a potential for the aid measure to affect trade. The Commission has however acknowledged previously that there may be some exceptions to this. Where you have a small enterprise which carries out local activities in an area which is not close to the border of a member state, it may be that the potential to affect trade is very remote. Examples might include hairdressers or dry cleaners which operate in a purely local market.

So that is a rundown of the basics of state aid. Let me know if you have any questions.

**Alan Evans:** Becky, thank you. Now to explain, the key question in determining whether something is an undertaking is whether it is carrying out economic activity. But that is not always going to be clear. So to take an example, is running an airport an economic activity?

**Rebecca Fife:** In principle, yes, operating an airport is an economic activity. The airport operator makes facilities available to retailers and airlines and it receives rent and charges in return. So a Government grant or soft loan to an operator would be state aid. But there are some activities at an airport which may form part of the state's prerogatives or core activities rather than being economic. Examples include border control, security checks or air traffic control. Funding of these activities probably would not constitute state aid provided that it is ring-fenced from the other commercial activities.

**Alan Evans:** Okay, and would it make a difference if the airport was owned by a local authority?

**Rebecca Fife:** No it would not, because the analysis depends on the activity in question; the nature of that activity, not who is carrying it out.

**Alan Evans:** And how does this work for education say, because some of that is paid for and looks economic and some isn't?

**Rebecca Fife:** Well, this is a difficult area. But state funded national education is usually not treated as being economic; the state is simply carrying out its duty to its citizens rather than running a commercial activity. But where education or even training of workers is funded mainly through fees or through commercial revenues, then that is probably an economic activity.

**Alan Evans:** We should also look at the question of state resources in a bit more detail. What happens if the state requires a private enterprise to provide the resources. And I will give you an example. If the state puts a legal obligation on energy companies to purchase electricity from renewable sources at fixed minimum prices and this helps the renewable suppliers because they receive more than the market price, is that state aid?

**Rebecca Fife:** Probably not, because the excess payments over the market price are being funded by the purchasing energy companies. So state resources are not being used either directly or indirectly. There is actually a famous case on this called *PreussenElektra* [2001] E.C.R. I-2099. But this is a difficult area. So, for example, it might be different if the payments are organised through a central fund or mechanism which is established by the state. These might then be treated as state resources because the state controls them.

**Alan Evans:** Okay and you also talked about selectivity of undertakings. But Government often wants to implement policies across whole sectors. Is there selectivity and therefore state aid where funding is given to all businesses in an entire sector without discrimination?

**Rebecca Fife:** Yes, that could still be state aid because selectivity could be based on one sector rather than another, or indeed one geographical place rather than another. So for example, if a scheme was set up to help the road haulage industry this could be state aid and there was a case in Italy which established this (*Italy v Commission of the European Communities* (173/73) [1974] 2 C.M.L.R. 593). Remember aid to road hauliers could distort the transport market as a whole – so as against rail, shipping or air transport as well.

### Is it aid and is it compatible?

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**Alan Evans:** It is clear then that the state aid definition has a far reach. Yet there will be occasions when Government will want to invest or provide funding in other ways to undertakings. I will now ask Cinead to explain how this can be done.

**Cinead O'Sullivan:** Thanks Alan. Yes, so the next question really is if the state really does want to provide funding to a particular undertaking, which it often does, can it do that? And the short answer is yes. There are two main ways that we will talk about in which it can do this. The first is if the state is investing on terms and conditions that would be acceptable to a market economy operator; this is not considered to be aid. Secondly, if it is aid it may still be compatible with the Treaty.

So what is the first, the market economy operator principle? Well this is when a public authority invests in an enterprise on terms and conditions which would be acceptable to a private investor operating under normal market conditions. This is not considered to be aid because there is no advantage to the undertaking; the undertaking could have obtained the same financing in the markets. Examples of when this is used are where the state might want to increase the supply of funding to a particular technology or if the state is an existing shareholder of a company that needs more investment.

Although you do not need to notify this because it is not aid, this market economy operator principle should not be considered to be an easy option. It can be difficult to evidence. The best evidence is if a market economy investor is making an investment alongside the state on the same terms for at least 50%. So the state goes in hand-in-hand with a private investor on the same terms. The state must take the same upside and downside risks. For example, the state cannot take 'first lost' or accept a lower rate of return than the co-investor.

So that is the best evidence – somebody going alongside you. But what if it is not on market terms and you cannot meet the tests of the market economy operator principle? I also said that you could give aid to an undertaking if it is compatible with the Treaty. So how does that work? Firstly, it could be automatically compatible; Article 107(2) of the Treaty sets out limited categories of aid which are compatible. For example, aid to make good damage caused by natural disasters.

There are also special rules for services that the market would not carry out itself but which are considered to be essential by the state. For example, if a bus company is required to provide an unprofitable service to rural communities. Then there are regulations which form part of the hard law of state aid. These determine categories of aid that are compatible as long as they comply with the conditions the Commission sets out and we will look at some of the main regulations shortly. Then there are guidelines, frameworks and communications which form part of the soft law. And the Commission here sets out the criteria that it will apply to certain aid categories so that you can have confidence that if you apply those frameworks and communications your aid will be compatible.

And then there is potentially compatible aids. This has to be notified to the Commission for consideration on a case by case basis and again these provisions are set out in the Treaty. And they include aid to promote regional development; to support an important EU project; to remedy serious disturbance in the economy; to promote culture and heritage conservation; and to facilitate development of certain economic activities, as long as that does not adversely affect trading to an extent contrary to the common interest. So if you are notifying potentially compatible aid the Commission will also apply a balancing test. And it will look at the positive effect of your aid as well as the appropriateness, proportionality and incentive effect of the aid. The incentive effect means that the aid should give the beneficiary an incentive to develop, for example, new activities and projects.

So for potentially compatible aid you need to notify to the Commission. But what does that involve? You first put in a pre-notification supported by evidence of why you think your aid is compatible and why it meets the tests set out in the Treaty. There will then be a period of discussion and negotiation with the case team in the Commission. This will be followed up by a final notification from the member states and that will then go through the internal processes at the Commission and they will produce a decision. But this can be a lengthy process and you should allow 12 to 18 months for the whole process from pre-notification to final decision. It is also important to note that when you are going through this route once

you have notified your aid you cannot grant that aid until it is approved by the Commission. This is set out in Article 108 of the Treaty and it is known as the 'standstill obligation'.

Now I said we would go back to the regulations which form part of the hard law of the Commission, and these are often referred to as 'block exemptions'. Although they have, for example, record-keeping requirements they do not have the long notification process that the potentially compatible aid with the Treaty has. There is a state aid modernisation process going on at the moment so the detail of some of these regulations may change during the course of 2014 but not the general principles that we are looking at today.

So these regulations are made under an enabling regulation which is adopted under Article 109 and there are two key block exemptions to consider. One for de minimis aid and one which covers a variety of categories of aid known as the general block exemption. So the De Minimis Aid Regulation – this applies to small amounts of aid that are not thought to have a material effect on trade between member states. They can be given in almost all sectors but there are some key exceptions, for example export related aid and aid to businesses in financial difficulties.

So how much aid can you give? Well the rule is €200,000 per undertaking over a rolling period of three fiscal years. From a timing perspective, aid is deemed to be granted from the moment the undertaking has the right to receive it, not from when it is paid. And it must be transparent. For example, a grant or a capital injection.

Then the second regulation is the General Block Exemption Regulation. Here there are categories of aid that the Commission has vast experience of dealing with and through its experience it has been able to identify the compatible criteria which is to apply. The general block exemption applies to, for example, regional aid, SME investment and employment aid, research and development and innovation aid, aid for risk capital, training aid and environmental aid. Again it could be given to almost all sectors, but there are key exceptions. It cannot be given to export related aid and there are a list of excluded sectors. For example, fish, agriculture, coal, steel and ship building. And again, you cannot give aid under the general block exemption to businesses in financial difficulty.

Aid can be given under this Regulation only if it meets the conditions set out. There are common conditions that apply to all categories of aid and specific conditions for specific categories. Some of the key common conditions are requirements relating to transparency, threshold requirements, incentive effect and aid intensity. Aid intensity means that you need to look not just at the amount of aid but at the proportion of aid compared to the total project costs.

**Alan Evans:** Cinead, thank you. That is quite a complex framework and quite a number of different routes for ensuring that Government can comply with the state aid rules.

**Cinead O'Sullivan:** Well that is right, but that is because different areas of intervention by the state represent different risks for the internal market. The framework reflects this. So where the Commission considers there is clear market failure they have experience of dealing with cases so they know what the compatibility requirements are. And [if] they are comfortable that the member state will not be crowding out private sector companies that want to invest then they are happy for member states to intervene without notifying them in advance. But where considerations are more finely balanced then they look for an increased role.



So essentially when you are faced with a potential state aid issue, you need to work through the four limbs that Becky described and then consider, firstly, are you acting like a normal market economy operator? If you are, you will not have any aid. If you are not, you do have aid and you need to look at whether this needs to be notified. For example, do any of the block exemptions apply – because we looked at de minimis and the general block exemption. And if those do not help you then you have aid and you need to notify it. And the question will be whether or not it is compatible with one of the Treaty provisions.

**Alan Evans:** And of course the other key message is to make sure that you think about state aid early so that you can factor in the frameworks and also think about how you deal with the Commission – you may need to consult them, you may need to seek their approval. The standstill period between pre-notification and approval could have a big impact on policy delivery.

### What if aid is given unlawfully?

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Richard is now going to tell us about the consequences of giving aid unlawfully.

**Richard Lewis:** Thank you Alan. So what happens if things go wrong? First of all what do we mean by unlawful aid? Well broadly speaking there are four possibilities.

The first is that aid should be notified but is not so therefore there is a breach of the standstill obligation in Article 108(3) that was mentioned earlier by Cinead. That means probably that there is a state aid issue which has not been spotted or perhaps it has been spotted but the wrong judgement has been taken. The second possibility is aid which is notified but is then implemented before a decision is taken by the Commission; that is perhaps unlikely. The third possibility is aid which contravenes a negative decision which has been taken by the Commission; again it is relatively unlikely that that would happen, at least deliberately. And finally and more likely, there is the possibility of aid which is initially lawful but is then misused. Now the member state may not be at fault here at all, it may be the beneficiary that gets things wrong in misusing the aid. But there would still be a breach of our Treaty obligation and so we would deal with that risk first of all by seeking to impose conditions on the beneficiary as to the way in which it used the aid and secondly by monitoring compliance with those conditions.

What happens then if there is a complaint perhaps by a competitor to the Commission and the Commission investigates and finds that there was unlawful aid? Well the procedural regulation which was made in 1999 requires the Commission to decide in that case that the member state must take all necessary measures to recover the unlawful aid without delay. And that normally means within two to four months. So once a decision has been made that there was unlawful aid the Commission has no choice but to require the member state to recover it. The member state is also required to recover interest at a defined rate.

The object of the recovery is to eliminate the financial advantage which has been gained by the beneficiary unfairly and so restore the status quo. That rectifies the distortion of the market that may have arisen as a result of the unlawful aid. It is a long walk out of the wood if things go wrong because the procedural regulation limits the Commission's power to decide on recovery to ten years from the date of the award.

Going on now to the mechanics of the recovery; well the mechanics of recovery are left to the member state. Procedures under national law apply provided however that they allow immediate and effective



execution. Now different states deal with this in different ways, some have specific legislation to deal with recovery of unlawful aid; we do not, so we rely on other means. A clear contractual right is best. That simply means that the state is given the right to recovery if required by the Commission and that is a provision that can easily be included in a contract under which for example a grant is made. If we do not have a clear contractual right then we can fall back on more general principles such as unjust enrichment and the general supremacy of EU law, including the duty of loyal cooperation. But a clear contractual right is more straightforward than relying on these principles.

One thing which is clear is that national law, although it provides the mechanics of recovery, cannot be used to prevent recovery. So for example it would not be possible for a beneficiary to argue that it had a legitimate expectation that aid granted had been lawful. Nor would it be allowed to require any sort of indemnity from the state. Either of those things would of course defeat the objective of recovery. So the only thing that may prevent recovery is absolute impossibility. So for example if a company was in liquidation and had no recoverable assets it may simply be impossible to make recovery of the unlawful aid.

What happens if recovery is not made, what are the consequences of that? Well first of all the Commission could bring the case before the European Court of Justice, ultimately with the prospect of a penalty being imposed on member states if the state failed to respect the court's decision. And the other possibility is that a third party, perhaps a competitor which suffered loss as a result of the unlawful aid, may have an action for damages, that is *Francovich* damages, in the national courts. Although it may be difficult for the competitor to prove loss, especially if the unlawful aid had been recovered.

**Alan Evans:** Richard, thank you. The rules on recovery are clearly stringent, but what if it is not practical to recover the aid? So, for example, there may be hundreds of thousands of beneficiaries, or seeking to recover the aid might destroy the company financially.

**Richard Lewis:** Well as I say the circumstances in which the state is allowed not to recover the aid are very limited. Now it may be that, for example, in the case of a tax scheme there could be hundreds or even thousands of beneficiaries and the practical difficulties of recovery could be very great for the state. But that does not provide any excuse for the state, the state simply has to work through those practical difficulties and make recovery from everyone who has received the aid.

Similarly, financial difficulty does not provide a reason not to make recovery. Now this may seem harsh on the beneficiary, but the financial difficulty which arises for the beneficiary is considered less important than the distortion of the market which arises from the unlawful aid having been granted in the first place. So ultimately the member state may even be required to pursue the company into liquidation. And as I mentioned earlier, the only thing that would prevent recovery being required would be circumstances where the company was already in liquidation and perhaps it was clear that it had no recoverable assets.

## Summary

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**Alan Evans:** That brings us to the end of the topics that we are discussing in this webinar.

State aid is clearly something to think about early. There are a lot of things to consider and the consequences of getting things wrong are clearly serious. But there is also a lot of help available.

Alongside this webinar we will publish links to the BIS guidance on state aid. And if you have further questions then your policy colleagues can contact the State Aid Policy Unit at BIS.

And as Cinead mentioned, there is a state aid modernisation programme underway which will continue during 2014. So the detail of some of the block exemptions will be amended in due course. However, the overarching principles are unlikely to change.

Thank you for watching. We hope this has been a helpful overview of the principles of state aid.