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Competitive Neutrality and the Role of the State in The Market: Could there be any Parallels with EU State Aid Rules?

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Competitive Neutrality and the Role of the State in The Market: Could there be any Parallels with EU State Aid Rules?

By Nicole Robins[1]

The OECD's recommendation on competitive neutrality aims to ensure a level playing field between enterprises. To achieve this, a number of insights could be drawn from EU State Aid rules, which are designed to avoid government actions that unduly distort competition within the EU in order to ensure a level playing field across the EU.

What Is The OECD's Recommendation on Competitive Neutrality?

In May 2021, the OECD adopted a recommendation on competitive neutrality, with the aim of achieving a level playing field between state-owned and privately-owned enterprises, as well as between privately-owned enterprises.[2]

The OECD recommends that governments avoid granting measures that selectively favor certain enterprises (such as loans or loan guarantees that are not on market terms).[3] If, however, government support is provided that is not on market terms in order to achieve a public policy objective, the OECD recommends that the compensation is transparent, proportionate and periodically reviewed. In particular, according to the OECD, compensation provided by governments to enterprises for fulfilling public service obligations should be proportionate to the value of the services provided, among other requirements.[4]

What Insights Could be Drawn from EU State Aid Rules?

EU State Aid rules were originally designed to avoid state support for specific enterprises triggering retaliatory support from other member states, which could result in a "subsidy race."[5]

Within the EU, support provided by governments to economic enterprises typically falls within the scope of State Aid rules. In order for government support to constitute aid, among other criteria, it must confer an economic advantage on the enterprise concerned.[6] In this context, economic and financial techniques are often used to assess whether the government's intervention is on market terms.[7] In particular, in order to rule out the presence of an economic advantage, it is often assessed whether the State is acting in the same way as a private market operator in similar circumstances (the so-called market economy operator principle, or "MEOP").[8]

In the State Aid context, the MEOP has developed into a key instrument that is used to assess a broad spectrum of measures provided by public authorities, including capital injections, loans and guarantees, among others. Two key methods that are commonly used to assess whether measures from public authorities comply with the MEOP, and hence are on market terms, are benchmarking and profitability analysis.

- Benchmarking compares the price as well as the other terms of a measure provided by a

[1] Nicole Robins, Partner and Head of the State Aid team, Oxera, is an invited speaker at the 2022 OECD Competition Open Day's panel which will discuss this topic on February 23, 2022. For more information and to register to the event, please follow this link.

[2] OECD (2021), "Recommendation of the Council on Competitive Neutrality," May 31, available at https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0462.

[3] OECD (2021), op. cit., May 31.

[4] OECD (2021), op. cit., May 31.

[5] Bacon, K. (2017), "European Union Law of State Aid, Third Edition," Oxford University Press, para. 1.04.

[6] According to Article 107(1) of the Treaty on the Functioning of the European Union, support provided by public authorities is classified as State Aid if the following four criteria are met: i) there is an intervention by the state or through state resources; ii) the intervention distorts, or threatens to distort, competition and trade between member states; iii) the intervention is selective by favoring certain undertakings or certain goods; and iv) the intervention confers an economic advantage on the undertaking.

[7] For further details, see Robins, N. & Puglisi, L. (2020), "The market economy operator principle: an economic role model for assessing economic advantage," in Hancher, L. & Piernas López, J., J. (eds), *Research Handbook on European State Aid Law*, Second Edition, Edward Elgar.

[8] European Commission (2016), "Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union," C 262/0119, *Official Journal of the European Union*, July 19, section 4.2.2, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN.

public authority with similar transactions undertaken by comparable private companies. To be in line with the MEOP, the terms of the transaction from the public authority should lie within the range of possible values from similar transactions.

- Profitability analysis is used to compare the expected commercial return to the public authority from the transaction with the level of return that would be required by a private investor under similar circumstances. If the expected return is higher than, or in line with, the return that a private investor would require from projects involving similar risks, this suggests that the MEOP is met.

If, however, government support is deemed to constitute aid, unless it meets certain criteria, it must be approved in advance by the European Commission. It is generally accepted that State Aid may distort competition by interfering with the level playing field by, for example, potentially crowding out private investment or affecting the production and location decisions of enterprises. In order for aid to be approved by the European Commission, the positive effects of the aid in terms of overcoming a market failure in order to achieve an objective of common EU interest must outweigh the negative effects in terms of distortions to competition and trade.[9]

In order to evaluate whether the positive effects of the aid outweigh its negative effects, the Commission considers i) whether the aid is aimed at a well-defined objective of common EU interest, and ii) if the aid is well-designed to address the identified market failure.[10] To answer this latter question, it is assessed whether the aid is appropriately designed to achieve its objective, is likely to incentivize the aid recipient to change its behavior, and if the aid is limited to the minimum amount necessary. As a final step, it is assessed whether any distortions to competition and trade are limited such that the overall balance is positive.[11] In order to evaluate potential distortions to competition and trade, the likely impact of the aid on the recipient's competitors and suppliers is compared against what would have been likely to occur in the counterfactual scenario without the aid.[12] While ideally the balancing of the positive and negative effects of aid would be undertaken using quantitative analysis, the parameters determining the final outcome from the balancing test are not always estimated.

Under State Aid rules, among other criteria, compensation provided to enterprises that undertake public service obligations must not exceed the associated costs plus a reasonable profit.[13] Member States are required to carry out regular checks to ensure that enterprises are not overcompensated, with any overcompensation clawed back.

State Aid rules have been reformed significantly over time, most notably in 2005 and following the economic and financial crisis in 2012. Among other aspects, the reforms were designed to facilitate aid that fosters growth and efficiency through the adoption of common economic principles for State Aid control in order to balance the benefits of government intervention against potential distortions, as well as to focus enforcement on the larger, more distortive, cases.[14]

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[9] European Commission, "Common Principles for an Economic Assessment of the Compatibility of State Aid Under Article 87.3," para. 4, available at https://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

[10] European Commission, op. cit., para. 9, available at https://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

[11] European Commission, op. cit., para. 9, available at https://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

[12] European Commission, op. cit., paras. 17 and 51, available at https://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

[13] European Commission (2012), "Commission Decision of 20 December 2011 on the application of Article 106(2) of the Treaty on the Functioning of the European Union to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest," *Official Journal of the European Union*, January, 11, Article 5, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012D0021&from=en, and European Commission (2012), "Communication from the Commission, European Union framework for State aid in the form of public service compensation," *Official Journal of the European Union*, paras. 21-46, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012XC0111(03)&from=EN (2021).

[14] Commission of the European Communities (2005), "State Aid Action Plan, Less and better targeted State Aid: a roadmap for State Aid reform 2005–2009," COM(2005) 107 final, 7 July, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52005DC0107&from=EN. European Commission (2012), "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee

These initiatives have led to a greater role for economic and financial analysis to evaluate whether government involvement is on market terms and therefore does not constitute aid, as well as to assess whether the positive effects of the aid outweigh its negative effects in terms of the impact on competition.[15] In particular, sophisticated financial analysis now plays an important role in assessments of whether government involvement is on market terms (i.e. in order to determine the existence of aid) as well as in assessments of the compatibility of aid.

While the role for competition economics has been more limited compared to other areas of competition law, its use in State Aid analysis has developed over time.[16] This trend has been accelerated by the reforms described above, which have introduced the requirement for *ex post* evaluations of aid schemes; of which a key aspect is the assessment of the actual impact of the aid on competition and trade.[17] Such *ex post* evaluations enable lessons to be learnt about the effectiveness of aid schemes.[18]

Therefore, there are a number of insights from State Aid rules that could help to design a regime to achieve competitive neutrality, particularly in relation to the assessment of whether government support is on market terms, as well as the design of government measures that are not on market terms in order to mitigate their negative impact on competition.

Are there any Limits of State Aid Rules that Might Need to be Overcome?

State Aid rules have been tested both during the 2008 economic and financial crisis, and most recently, during the COVID-19 pandemic.

Following the economic and financial crisis, there was debate about whether the safeguards that had been introduced into State Aid rules in order to preserve competition were sufficient. In particular, concerns were highlighted that the structural and behavioral remedies that were required with the view of mitigating the effects of large amounts of aid to financial institutions on competition, such as divestments of loss-making activities, were not sufficient to reduce the risk of moral hazard (i.e. that financial institutions are not appropriately incentivized to mitigate risks as they are at least partly protected from its consequences).[19] According to some commentators, such measures were only effective where moral hazard was sufficient to alter an institution's behavior and/or whether structural and behavioral remedies constituted a sufficient deterrent to risky activities.[20]

As discussed below, concerns about the distortive effects on competition of the large amounts of aid provided by some member states during the COVID-19 crisis have also arisen.

At the start of the pandemic, the Commission responded very quickly to introduce a framework to guide State Aid interventions.[21] More

and the Committee of the Regions, EU State Aid Modernisation," COM(2012) 209 final, May 8, available at https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0209:FIN:EN:PDF.

[15] For further details about the assessment of the impact of aid on competition, see Oxera (2017), "Ex post assessment of the impact of state aid on competition," November, available at https://ec.europa.eu/competition/publications/reports/kd0617275enn.pdf.

[16] Koopman, J. (2015), "Economics in the SAM and future challenges," Conference on Economics of State Aid Control, 23 September, slide 15.

[17] For certain aid schemes, an evaluation has to be undertaken of whether the aid has achieved its intended objectives. For further details, see European Commission (2014), "Common methodology for state aid evaluation," Commission Staff Working Document, 28 May, and Oxera (2018), "The impact of state aid on competition: an economic framework for the European Commission," Agenda, January, available at https://www.oxera.com/wp-content/uploads/2018/07/The-impact-of-state-aid-on-competition_2.pdf.

[18] Brandtner, B. and Vidoni, D. (2018), "State Aid Evaluation, State of Play and Ways Forward," European State Aid Law Quarterly, 17: 4, pp. 475–482, available at https://estal.lexxion.eu/article/ESTAL/2018/4/0.

[19] See, for example, Lyons, B. and Zhu, M. (2013), "Compensating Competitors or Restoring Competition? EU Regulation of State Aid for Banks During the Financial Crisis," Journal of Industry, Competition and Trade, 13(1), available at https://econpapers.repec.org/article/kapjincot/v_3a13_3ay_3a2013_3ai_3a1_3ap_3a39-66.htm.

[20] For further discussion, see Shamsi, S., Solomon, P. and Robins, N., "Compensatory measures in the banking sector," in Laprévote, F-C., Gray, J. and De Cecco, F. (2017), *Research Handbook on State Aid in the Banking Sector*, Edward Elgar Publishing, pp. 151-185.

[21] See European Commission, "The State Aid Temporary Framework," available at https://ec.europa.eu/competition-policy/state-aid/coronavirus/temporary-framework_en and European Commission, "Notification template for State aid measures notified under Article 107(2)(b) TFEU in the context of the COVID-19 outbreak," available at https://ec.europa.eu/competition-policy/system/files/2021-05/template_TF_notification_107_2_b_0.pdf.

generally, the Commission's guidance set out the State Aid rules for measures targeted at ensuring companies' short-term liquidity and long-term solvency, such as state guarantees, subsidized loans, compensation for damages suffered due to, and directly caused by, the pandemic and recapitalization aid, among other aid instruments.

However, in contrast to assessments of the compatibility of aid during non-crisis times, for most types of aid measures granted under the State Aid rules that were introduced in response to the COVID-19 pandemic, an assessment of the impact of the aid on competition is not required. This is despite the fact that some aid measures — particularly, damages compensation — can be provided to companies that were in financial difficulty prior to the onset of the COVID-19 pandemic. For recapitalization aid, however, if the aid exceeds €250m and the beneficiary has significant market power, the Commission requires remedies to be introduced, with the view of mitigating the negative impact of the aid on competition and trade.[22] In the aviation sector, typical examples of such remedies adopted to date include slot divestments.[23] However, identifying appropriate remedies can be a challenging exercise, particularly in the transport sector, where the post-pandemic market equilibrium may be very different from that observed prior the onset of the pandemic in 2019 due to changes in travel preferences.

Since the start of the pandemic, the Commission has approved over €3.1 trillion of aid.[24] There are, however, substantial differences between Member States in terms of the amount of aid that has been approved.[25] For example, as of December 31, 2020, the amount of aid approved by the Commission for Germany and Italy represented over 45 and 20 percent of each member state's GDP respectively compared to less 3 percent in the Netherlands and Ireland.[26] While the EU's Recovery and Resilience Facility may partly mitigate some of the divergences by making funds available to all Member States, the asymmetric response risks leading to distortions to competition across the EU. Indeed, commentators have highlighted that the differences in the amount of aid could distort competition and may artificially support non-productive (so-called "zombie") enterprises.[27]

To overcome these concerns, an evaluation of the likely impact of the aid on competition could be given greater prominence in State Aid assessments going forwards. In addition, *ex post* evaluations of the impact of aid granted during the pandemic could also help to identify lessons for the design of future aid measures and schemes, particularly during crises.

[22] European Commission (2021), "Communication from the Commission, Temporary Framework for State Aid Measures to Support the Economy in the Current COVID-19 outbreak," November 18, para. 72, available at https://ec.europa.eu/competition-policy/system/files/2021-11/TF_consolidated_version_amended_18_nov_2021_en_2.pdf.

[23] For example, in the case of recapitalization aid to Deutsche Lufthansa AG, LH Group was required to divest up to 24 slots per day at Frankfurt and Munich airports. See European Commission (2020), "State Aid SA.57153 (2020/N)—Germany—COVID-19—Aid to Lufthansa," C(2020) 4372 final, June 25, available at https://ec.europa.eu/competition/state_aid/cases1/202202/SA_57153_20D4E27D-0100-C648-ACF8-2DA836120F59_537_1.pdf.

[24] European Commission (2021), "Remarks by Executive Vice-President Vestager on the Communication on a competition policy fit for new challenges," November 18, available at https://ec.europa.eu/commission/presscorner/detail/en/speech_21_6115.

[25] Banque de France (2021), "Les aides d'État dans la crise Covid-19: un dilemme européen," Bulletin de la Banque de France, 238/3, November/December, p. 3, available at https://publications.banque-france.fr/sites/default/files/medias/documents/bulletin-banque-de-france_238-3_aides-d-etat.pdf.

[26] Banque de France (2021), "Les aides d'État dans la crise Covid-19: un dilemme européen," Bulletin de la Banque de France, 238/3, November/December, p. 4, available at https://publications.banque-france.fr/sites/default/files/medias/documents/bulletin-banque-de-france_238-3_aides-d-etat.pdf. It should be noted that these figures may not necessarily take into account that the amount of aid could differ according to each type of aid instrument, such as direct grants, guarantees and loans. For example, a €10m direct grant and a €10m loan would be counted as €10m of aid, even though the aid element is likely to be lower in the latter case assuming that the principal on the loan will be repaid. The figures do not also capture other forms of government support that are not classified as aid, such as payroll support that might be available to all firms.

[27] Banque de France (2021), op. cit., 238/3, November/December, p. 3 and Les Echos (2021), "La fin des aides d'Etat l'an prochain s'annonce périlleuse," December 26, available at https://www.lesechos.fr/monde/europe/la-fin-des-aides-detat-lan-prochain-sannonce-perilleuse-1374879.