Chapter 8
Financing Services of General Economic Interest: The European Commission's Economic Tests

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Abstract The object of the revised SGEI package is to specify the conditions under which State aid for such services can be found to be compatible with Article 106(2) TFEU. Within the package, the revised SGEI Framework establishes a more prescriptive methodology for determining the compensation to the undertaking entrusted with offering the SGEI, as well as enhanced efficiency incentives. This chapter surveys the revised financial and economic tests for determining appropriate SGEI compensation, commenting on the theoretical basis and practical implementation of these tests.

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The views expressed in this chapter are personal.

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8.1 The Commission's Revised Economic Approach

In December 2011, the European Commission adopted a revised package of EU State aid rules for the assessment of public compensation for services of general economic interest (SGEI). The new SGEI package included a 'Communication',[1] which clarified basic concepts of State aid that are relevant for SGEI, a 'Decision'[2] and a 'Framework'.[3,4] SGEI have been defined by Member States in many sectors, including obligations on airlines to operate routes that are not commercially viable, an obligation to distribute post across a national territory at a uniform tariff, and the provision of private medical insurance at an affordable price. Other SGEI are found in areas such as gas, electricity and telecoms, all of which provide services that are considered 'essential' to consumers.

The objective of the revised SGEI package is to specify the conditions under which State aid for such services can be found to be compatible with Article 106(2) TFEU. The revised SGEI package exempts governments from the obligation to notify compensation for the running of social services, and for services receiving public compensation of less than €15 m a year.[5] In some of the relevant sectors, such as transport, SGEI compensation is also addressed in separate sector-specific rules.[6] The main focus of the revised SGEI Framework is to establish a more prescriptive methodology for determining the compensation to the undertaking 'entrusted' with offering the service on behalf of the public sector, as well as enhanced efficiency incentives. By exempting smaller amounts of SGEI compensation, and strengthening the assessment of larger awards of compensation, the overall package leads to a change in the way that the Commission will handle these cases. As the Vice President of the European Commission, Joaquín Almunia, has noted:

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[1] European Commission, *Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest OJ* 2012 C 8/4.

[2] European Commission, *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*, *OJ* 2012 L7/3.

[3] European Commission, *Communication from the Commission, European Union framework for State aid in the form of public service compensation*, *OJ* 2012 C8/15.

[4] European Commission, 'State aid: Commission adopts new rules on services of general economic interest (SGEI)', Press Release IP/11/1571, 20 December 2012.

[5] Almunia, J. 'Reform of the State aid rules for Services of General Economic Interest (SGEI) and decisions on WestLB, Bank of Ireland and France Telecom', speech to Brussels press conference, 20 December 2011.

[6] Regulation (EC) No 1370/2007 of the European Parliament and of the Council of 23 October 2007 on public passenger transport services by rail and by road and repealing Council Regulations (EEC) Nos 1191/69 and 1107/70, *OJ* 2007 L 315/1. See the chapter by Maxian Rusche and Schmidt in this volume.

> The new SGEI package follows three objectives: clarification, simplification, and a focus on services that receive big amounts of money and have a greater potential to distort the conditions of competition in the single market…my experience to date shows that the Commission is all too often asked to decide or arbitrate on small cases with little or no impact in the internal market. I believe there is a need to set priorities and use our resources to control the subsidies that have a real potential to distort competition in Europe.[7]

The controls on compensation to be adopted by the Commission (as with other mechanisms in State aid, such as Regulation 1370/2007, which provides similar rules in the public transport sector[8]) will require considerable economic analysis, such as:

- determining the costs and revenues of the undertaking with and without the obligation to provide the service;
- the allocation of costs between commercial and entrusted (subsidised) activities;
- establishing a benchmark rate of return ('reasonable profit'), against which the profitability of the entrusted party can be measured; and
- establishing how to incentivise and measure efficiency in service provision.

This chapter describes the approach that the Commission has determined in its revised SGEI Framework to each of the above areas. It is structured as follows: Section 8.2 describes the economic rationale for controlling SGEI compensation; Sect. 8.3 sets out the financial tests for appropriate compensation; Sect. 8.4 outlines the enhanced efficiency incentives to be included in SGEI contracts; Sect. 8.5 concludes.

8.2 The Rationale for Controlling SGEI Compensation

Governments require SGEI to be provided in order to fulfil certain policy objectives. One such objective might be the provision of a universal postal service, whereby sending a letter has the same price regardless of the distance it travels. Other SGEI examples include public service broadcasting, health insurance provision for the chronically sick, and ferry and air routes to remote islands.

The need for governments to define SGEI arises when the required services would not be provided by the market, which might be for two main reasons. First, the cost of provision exceeds the revenues. Second, the market does not provide such services at a socially acceptable (e.g, uniform) price. A 'reverse definition' of SGEI is given by the Commission in its SGEI Framework:

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[7] Supra n 5.

[8] Supra n 6.

> Member States cannot attach specific public service obligations to services that are already provided or can be provided satisfactorily and under conditions, such as price, objective quality characteristics, continuity and access to the service, consistent with the public interest, as defined by the State, by undertakings operating under normal market conditions.[9]

In other words, if the service can be provided by the market at a price and level of access that are compatible with the public interest, it is *not* an SGEI.

Having defined a service as being of general economic interest, the public sector needs to establish who is going to provide the service: itself, or a private sector party. Since, by definition, such services will be loss-making, if the government wants them to be provided by another party, it will need to subsidise the provider.

The purpose of then controlling SGEI compensation, or subsidy, is twofold. The first purpose is to avoid SGEI cross-subsidising commercial activities, which could distort competition in adjacent, non-SGEI markets. The second is to avoid overcompensation of the SGEI activity, which could waste taxpayers' money and implicitly is not the outcome expected under competitive conditions for the provision of SGEI (e.g., if SGEI contracts were systematically put out to competitive tender).

8.3 Financial Tests in the New SGEI Framework

As set out in the new SGEI Framework, the appropriate financial tests should ensure that the compensation method meets two objectives: first, 'the amount of compensation must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit' (para 21); second, the method of compensation 'must introduce incentives for the efficient provision of SGEI of a high standard, unless [the Member States] can duly justify that it is not feasible or appropriate to do so' (para 39).

Ensuring these objectives requires a calculation of the appropriate net cost of provision of the SGEI and the level of reasonable profit. In calculating the costs and revenues, the Commission is open to using cost and revenues actually incurred, or those that are expected to be incurred, or a combination of the two; the choice depends on the efficiency incentives that the Member State wants to provide. Where expected costs are used, the cost estimates should incorporate the expected efficiencies over the lifetime of the entrustment (para 23).

[9] Supra n 3, para 13.

8.3.1 Calculating the Net Cost of Provision of the SGEI

The Commission's preference is that a 'net avoided cost methodology' be applied in order to determine the extent of compensation required under an entrustment, and that the methodology be based on a forward-looking assessment covering the lifetime of the contract between the state and the provider, which is described in the contract (the 'entrustment act' in the Commission's terminology).

The methodology envisaged is similar to Directives in the communications sector, and amounts to calculating ex ante 'the difference between the net cost for the provider of operating with the public service obligation and the net cost or profit for the same provider of operating without that obligation' (para 25).[10] In theory this involves envisaging the costs and revenues of a business operating purely in a competitive market without SGEI obligations, and comparing that hypothetical business with the actual one, which provides the SGEI envisaged under the entrustment act. For example, a ferry service operating to a holiday island might operate only during the summer months without government support, but is obliged by the government to operate all year to serve islanders. The new SGEI Framework would, in principle, require the government to compare the 'summer only' business plan with the 'year round' business plan. The net avoided cost is then the difference between net costs in the two business plans.

Applying this logic may require an element of judgement. While the Commission may reasonably expect that a business will understand which parts of its activities make certain levels of contribution to overheads, it is a difficult line to draw between what would, and what would not, be provided without an entrustment act. This is particularly the case where the obligations placed on an SGEI provider change over time, which is likely when government policy, or economic conditions, evolve to a significant extent. It is also problematic when a business runs a complex network, such as a national railway service, where it is difficult to envisage the counterfactual of that business operating without SGEI obligations.

Where it is not feasible or appropriate to apply the net avoided cost methodology, an alternative approach suggested by the Commission is what it calls the 'cost allocation methodology'. Under this approach, the net cost of provision is calculated as 'the difference between the costs and the revenues for a designated provider of fulfilling the public service obligations' (para 28). In calculating the costs, all costs necessary to operate the SGEI should be taken into account. This includes any investment cost (for e.g., infrastructure costs) and other direct costs necessary for the operation of the SGEI, as well as 'an appropriate contribution' to any indirect costs common to both the SGEI and to other activities of the entity being entrusted.

While the Commission suggests that the appropriate allocation of common costs is determined by reference to market prices for the use of the resources or the

[10] The net cost calculation should take into account the costs that the service provider is expected to avoid as well as the revenues it is expected not to receive, in the absence of the pso.

expected profits of the non-SGEI activity, it is open to other methodologies, as appropriate (para 31). In addition, where an undertaking is providing activities other than those required simply to deliver the SGEI, its accounts must show costs and revenues arising from the SGEI separately from those relating to the other activities.

8.3.2 Calculation of Reasonable Profit

The Commission requires that 'the amount of compensation must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit' (para 21). In order to establish what is a 'reasonable' level of profit, two main issues need to be considered: how to measure profitability; and how to assess the appropriate benchmark against which to compare profitability.

The approach advocated by the Commission is to assess reasonable profits from an ex ante perspective (i.e based on forecasts), in order to provide appropriate efficiency incentives. The Commission's preference is to measure profitability using an internal rate of return (IRR) approach, in which the IRR is calculated over the lifetime of the entrustment. This is consistent with appropriate methods to assess economic profitability in competition cases more generally.[11] Alternative measures to assess profitability—return on equity (ROE), return on capital employed (ROCE), return on assets (ROA) or return on sales (ROS)—should only be used if 'duly justified' (para 34).

The advantage of these alternative measures is that they are based on more readily available accounting data. Hence they are often used in profitability measurement, despite their drawbacks.[12] The ROCE is calculated by dividing earnings before interest and taxes (EBIT) by total capital (i.e., debt and equity). The ROE employs the same data, but is calculated by dividing net earnings after tax by equity-funded capital employed. Figure 8.1 shows these accounting relationships.

Both the ROE and the ROCE involve measuring equity capital, either in isolation or as a component of total capital (equity plus debt). Where a business does not have equity capital, which is likely in the case of a state-owned entity, there are two options. First, a proxy for equity capital can be estimated from various items on the balance sheet, depending on which of the items are akin to equity capital and total capital in a privately owned company. Alternatively, a proxy for equity capital can be estimated by first considering the capital structure of comparator companies, and then applying this hypothetical capital structure to the SGEI undertaking.

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[11] Oxera (2003).

[12] The drawbacks are described in Niels et al. 2011, p. 156.

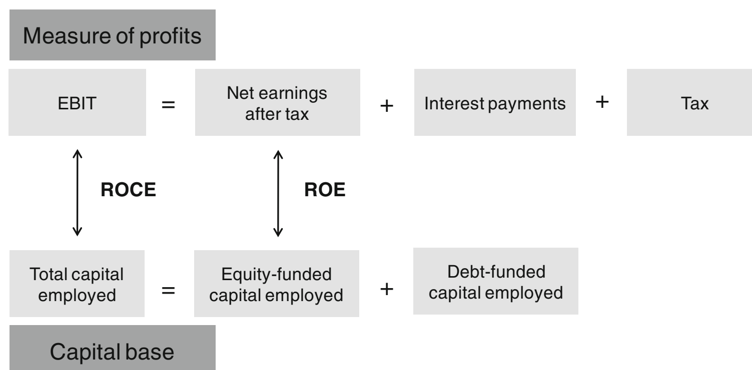

Fig. 8.1 ROCE and ROE. *Source* Oxera

8.3.3 Benchmarks for Profitability

8.3.3.1 Safe Harbour

In assessing the appropriate benchmark against which to compare observed profitability, the Commission draws on regulatory and financial economics. It notes that benchmarking reasonable profit under the SGEI entrustment should take into account the level of risk, which 'depends on the sector concerned, the type of service and the characteristics of the compensation mechanism' (para 33). However, it also provides a 'safe harbour' rate of return, which does not account for risk:

> A rate of return on capital that does not exceed the relevant swap rate plus a premium of 100 basis points is regarded as reasonable in any event (para 36)

The relevant swap rate is viewed by the Commission as an appropriate rate of return for a non-risky investment.[13] By providing this safe harbour, the Commission seems to be aiming to balance the need to ensure an economically robust benchmark with the practical considerations of providing clear guidance.

Since the swap rate safe harbour takes no account of risk, a more robust approach for a benchmark is to measure the cost of capital for the entity providing an SGEI, or to draw a benchmark rate of return from evidence on returns achieved by comparator firms providing similar services. Given the general scarcity of evidence on the financial performance of SGEI contracts awarded in competitive tenders, there are practical problems with applying the comparator firms approach. In some cases it may be more transparent and robust to rely on an estimate of the cost of capital as the competitive benchmark. This fits naturally with the standard approach to assessing profitability in competition cases, where it is normal to compare a rate of profit earned against a cost of capital benchmark.[14]

[13] Supra n 2, para 19.

[14] Oxera (2003).

8.3.3.2 Cost of Capital as a Benchmark

The cost of capital is an estimate of the price a company must pay to raise the capital that it has employed—i.e. it is the return that private investors would require if they invested in the company. The standard measure of this is the weighted average cost of capital (WACC). This is the average of expected rates of return to debt and equity, weighted by the relative proportions of debt and equity in a company's capital structure.

WACC is straightforward to calculate for a company listed on a stock market and with debt that is publicly traded. For a non-listed company—such as one that is state-owned—the approach is to find a suitable set of listed comparators. For example, if the alleged aid beneficiary is a television broadcaster, it is possible to estimate the average rate of return on equity that investors require for listed European broadcasters. Although this exercise depends on finding comparators, and is therefore subject to the same practical problem of identifying suitable comparator firms, the measurement issue is less acute since the cost of capital takes data on comparators as only one input among several.

Table 8.1 shows how a cost of capital calculation is performed. In this example a comparison is made between the cost of capital for a relatively low-risk firm, a power generator, and for a higher risk firm, an airline. Inputs for this calculation are shown in the shaded boxes, and outputs in un-shaded boxes. Some of the detail behind the calculation is given in the text below the table. The cost of capital for the airline is considerably higher than for the utility, a result that is driven by the differences in the debt premium (i.e. the return demanded by creditors to the company over a risk-free rate), and by differences in the equity beta (which is a measure of the extent to which the company's returns follow the stock market). For a utility business, returns will tend to be fairly stable through time, yielding a low equity beta; for an airline, returns will tend to be more sensitive to wider trends in the economy, yielding a higher equity beta.

The risk-free rate represents the cost of 'risk-free' borrowing, which is usually approximated by redemption yields on government bonds (which normally, but not always, have very limited risk). The debt premium and the equity beta capture the riskiness of the company's activities, while the equity risk premium (ERP) captures a premium that investors, on average, require from investing in equities as opposed to risk-free assets. A multiple of the equity beta and the ERP captures the market risk premium of a particular company.

For state-owned and most other non-listed companies, the risk inherent in equity cannot be estimated directly. Instead, the approach is to identify relevant publicly listed comparator companies, and to estimate the equity beta for these as an approximation of the equity beta of the company in question. Similarly, the cost of debt can be obtained from yields on outstanding debt or credit default swaps of comparator companies. All of this information is entered into the WACC formula, which is worked out as follows:

Table 8.1 Example of a cost of capital calculation

INPUT		
OUTPUT		
	'Less risky' eg, power generator	**'More risky' eg, airline**
Cost of debt		
Risk-free rate (%)	3.00	3.00
Debt premium (%)	2.00	4.00
Cost of debt (%)	**5.00**	**7.00**
Cost of equity		
Risk-free rate (%)	3.00	3.00
Asset beta	0.30	1.00
Gearing (%)	60.0	60.0
Equity beta	**0.75**	**2.50**
Equity risk premium	4.50	4.50
Corporate tax rate (%)	28.0	28.0
Cost of equity (%)	**6.38**	**14.25**
WACC		
Pre-tax WACC (%)	**6.54**	**12.12**

Source Oxera

cost of debt = risk-free rate + debt premium
equity beta = asset beta/(1−gearing)
cost of equity = risk-free rate + (equity beta × equity risk premium)
pre-tax cost of equity = cost of equity/(1−corporate tax rate)
pre-tax weighted average cost of capital = cost of debt × gearing + ((1−gearing) × pre-tax cost of equity)

For the airline's cost of capital, we therefore have the following calculation:

cost of debt = 3 % risk-free rate + 4 % debt premium = 7 %
equity beta = 1.00 asset beta/(1 – 0.60 gearing) = 2.50
cost of equity = 3 % risk-free rate + (2.50 equity beta × 4.5 % equity risk premium) = 14.25 %
pre-tax cost of equity = 14.25 % cost of equity/(1−corporate tax rate of 28 %) = 19.79 %
pre-tax weighted average cost of capital = 7 % cost of debt × 0.60 gearing + 19.79 % pre-tax cost of equity × (1 – 0.60 gearing) = 12.12 %

If the state is a pure equity investor, the appropriate required rate of return is the cost of equity, rather than the WACC. Conversely, if the state provides only guaranteed debt, the appropriate rate of return is the cost of debt.

8.4 Efficiency Incentives

In paras 37 and 38 of the SGEI Framework, the Commission expects that the nature of the compensation mechanism will have a considerable bearing on the rate of return that the service provider will earn over the lifetime of the entrustment. It contrasts instances where 'compensation takes the form of a fixed lump sum payment covering expected net costs and a reasonable profit' (para 37) with a situation where 'the *ex post* net costs are essentially compensated in full' (para 38). In the former, the Commission clearly expects risk to be higher, and for this risk to be rewarded with a higher return (i.e. greater compensation, and a higher level of 'reasonable profit'). The choice of compensation mechanism also affects efficiency incentives on the SGEI provider during the entrustment, to which we now turn.

The Commission requires that in devising a method of compensation, Member States must introduce incentives 'for the efficient provision of SGEI of a high standard, unless they can duly justify that it is not feasible or appropriate to do so'.[15] The Commission discourages the ex post provision of compensation, as this does not create efficiency incentives for an undertaking providing an SGEI. Specifically, the Commission expects that the ex post provision of compensation should be 'strictly limited to cases where the Member State is able to justify that it is not feasible or appropriate to take into account productive efficiency and to have a contract design which gives incentives to achieve efficiency gains'.[16]

The Commission does allow Member States some discretion in the design of efficiency incentives to suit the specificity of each case or sector, and provides examples of how efficiency gains can be incorporated in the entrustment act:

> …Member States can define upfront a fixed compensation level which anticipates and incorporates the efficiency gains that the undertaking can be expected to make over the lifetime of the entrustment act.
>
> … Alternatively, Member States can define productive efficiency targets in the entrustment act whereby the level of compensation is made dependent upon the extent to which the targets have been met. If the undertaking does not meet the objectives, the compensation should be reduced following a calculation method specified in the entrustment act. In contrast, if the undertaking exceeds the objectives, the compensation should be increased following a method specified in the entrustment act. Rewards linked to productive efficiency gains are to be set at a level such as to allow balanced sharing of those gains between the undertaking and the Member State and/or the users.[17]

The 'fixed compensation' option outlined by the Commission has the economic characteristics (and, therefore, incentive properties) of a price cap. Such an arrangement would provide incentives for the SGEI provider to find more efficient ways of delivering the required level of service over the course of the entrustment.

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[15] Supra n 3, para 39.

[16] Supra n 3, para 38.

[17] Supra n 3, paras 40–41.

The Commission requires at the same time that efficiency delivered during the entrustment should not come at the expense of quality of service.[18]

The second option, using 'productive efficiency targets', implies some variability in remuneration depending on the extent of outperformance relative to expectations. Depending on the method of compensation, there is a risk that, as the end of an entrustment approaches, the SGEI provider has limited incentives to improve efficiency, since the rewards will be considerably diminished. The Commission's suggestion of linking compensation more explicitly to the delivery of efficiency targets (if efficiency performance can be measured objectively) might go some way towards the aim of maintaining the strength of incentives throughout the entrustment period.

8.5 Conclusion

The discussion above has highlighted that the Commission's revised Framework employs a strengthened set of economic tests with the purpose of ensuring that SGEI providers earn only a reasonable profit and have strong incentives to deliver efficiency and innovation. The reform brings a greater degree of European Commission control over SGEI compensation, and with it an increased obligation on Member States to justify the financial terms of large SGEI contracts.

The new SGEI Framework will require competent authorities making major entrustments to ensure that SGEI provision is characterised by reasonable profitability, incentives for efficiency and transparent accounting. To a certain extent the Commission is encouraging a form of economic regulation in relation to SGEI provision—indeed, the Commission refers to compensation assessment relying 'where appropriate, on the expertise of sector regulators' (para 23). It remains to be seen whether the relationship between contracting parties in all Member States can easily comply with this more sophisticated model for SGEI compensation. Potentially the compliance obligation will encourage more Member States to use competitive tenders for SGEI contracts, with the result that those contracts may be deemed to fall under the *Altmark* criteria (no State aid) rather than the SGEI Framework (compatible State aid).[19]

References

Niels G, Jenkins H, Kavanagh J (2011) Economics for competition lawyers. OUP, Oxford
Oxera (2003) Assessing profitability in competition policy analysis. OFT Economic discussion paper 6 July

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[18] Supra n 3, para 43.

[19] CJEU, Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH ('Altmark*') [2003] *ECR* I-7747.