OFT response to the Commission's action plan

1 INTRODUCTION

1.1 The Office of Fair Trading (OFT) welcomes the Commission's initiative to undertake a comprehensive reform of state aid policy. We believe that reform is important to place state aid control on a strong economic footing, similar to that under Article 81 and 82 of the EC Treaty.

1.2 The Commission has set out broad reform proposals in its State Aid Action Plan. We would encourage the Commission to act boldly in reforming guidelines and block exemptions to ensure that these are underpinned by a rigorous framework that ensures that aid is permitted which addresses market failure in the most efficient manner without distorting competition significantly.

1.3 We would caution the Commission against any changes that would permit aid in areas of European policy without application of a rigorous framework of this type. Such changes could become a backdoor industrial policy in which aid is channeled into broad priority areas without proper consideration of its costs and benefits.

1.4 The OFT has looked in some depth at the risks to competition posed by subsidies[1]. In our view state aid controls prevent a lot of subsidies that have the potential to distort competition but gaps remain that present a risk to competition. The reform of state aid control should take an economic approach to ensure that aid that poses a significant risk to competition are prohibited and aid that does not pose a risk is approved.

1.5 The OFT is therefore particularly interested in the following areas aspects of the Action Plan:

- Economic approach to competition distortion and market failure,
- Roles for independent national authorities.

The majority of our response focuses on these.

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[1] Public Subsidies: A report by the Office of Fair Trading, November 2004 http://www.oft.gov.uk/Business/Market+studies/subsidies.htm

2 VIEWS ON THE ECONOMIC APPROACH

Distortion to competition

2.1 Paragraph 19 of the State Aid Action Plan indicates that in assessing whether aid is compatible with the common market, "the Commission balances the positive impact of the aid measure (reaching an objective of common interest) against its potentially negative side effects (distortions of trade and competition)."

2.2 The OFT is strongly of the view that a more economic approach is required when considering distortions to competition. The current approach is inadequate; it permits some aid that distorts competition significantly, and prohibits other aid that only has minor competition effects.

2.3 The OFT's views are based on research it has been carrying out in the last year. In its first stage of work on public subsidies, the OFT commissioned the economics consultancy Frontier Economics to examine how public subsidies could adversely affect competition in principle. The OFT then considered the extent to which state aid controls prevented aid that was likely to distort competition significantly. We concluded that state aid controls prevented many potentially distorting aids but that the existing guidelines did not sufficiently capture the characteristics associated with distortion to competition.

2.4 Frontier Economics concluded that almost all subsidies have some impact on competition. The extent of this impact, however, depends on two broad sets of factors: the characteristics of the subsidy and the characteristics of the market(s) in which the recipients operate.

2.5 The main characteristics of a subsidy that affect the size of the competition distortion are:

- the absolute size of the subsidy as well as its size relative to the costs of the activity being subsidised,
- the level of selectivity of the subsidy, i.e. whether it is provided to one, some or all firms in a market,
- whether the subsidy affects the recipient's costs directly, and

- whether the subsidy is provided on a recurring basis.

In terms of market characteristics, the likelihood of significant distortions depends on:

- the extent of concentration in the market,
- the level of product differentiation,
- the symmetry (or asymmetry) of firm size in the market,
- the presence of barriers to entry, or
- whether firms in the market compete on research and development.

2.6 As part of its second stage of work on public subsidies, the OFT has commissioned the economic consultancy NERA to undertake a number of case studies into the effects of subsidies on competition in practice. The results of the first phase of case studies supported the view that distorting aid could be permitted while non-distorting aid was sometimes prohibited.

2.7 For example, one of the case studies examined the provision of regional aid to a manufacturing firm. The aid has contributed towards significant levels of excess capacity and has assisted and incentivised the firm to remain in the industry at a time of significant rationalization. This distorts the market in an unintended way by preventing it from adjusting fully. The aid may also deter entry when the market starts to pick up again.

2.8 Another case study into the provision of a substantial research and development grant to a firm involved with product design, supports the view that it is the size of the aid relative to the market that is important. This particular grant was small relative to the market so did not distort competition significantly. Whilst this aid was approved (under regional guidelines), we understand that in the case of Regione Autonoma Friuli-Venezia Giulia v Commission[2] the Court of First Instance held that the aid amounted to a distortion of competition despite it being argued that the recipient had only a marginal share of the market and so the effect of aid on competition would be insignificant.

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[2] Case T-288/97 [2001] ECR II-1169

2.9 Specifically, the OFT considers the problem in paragraph 2.8 above may arise because of the failure of state aids controls to apply a consistent economic assessment of distortion to competition. That is, aids falling within Article 87(3), but within a Commission guideline, may be permitted notwithstanding that they create a certain level of competition distortion. However, in the absence of transparent economic criteria for their assessment, aids falling within Article 87(3), but outside a guideline, may be prohibited even though they only create a similar level of distortion or, more particularly, where they create only a very low level of distortion to competition.

2.10 This situation may arise because of the low level of competition assessment the Commission is required to carry out in order to find that an aid distorts competition. In *Leeuwarder*[3] the Court did say the Commission could not rely only on a presumption that an aid distorts competition. Instead, it must give reasoning for its decision and is required to analyse and, in its reasoning, set out, information concerning the situation of the relevant market, the place in that market of the undertaking receiving the aid, the pattern of trade between Member States in the products in question and the relevant undertaking's exports. But, in *Philip Morris*[4] the Court said that when state financial aid merely strengthens the position of an undertaking compared with others the proposed aid would be likely to threaten to distort competition. As a result, the level of competition distortion necessary for an aid to be unlawful is set at a low level and an aid falling outside the guidelines can be found unlawful despite having an insignificant effect on competition.

2.11 More generally, existing state aid controls generate these perverse outcomes because approval of aid is not based on an economic view of distortion to competition. Current guidelines set ceilings on the amount of aid that can be given relative to the amount of investment being undertaken. While this prevents company expansion or development being entirely state funded, to the detriment of competitors, it does not take into account the fact that the subsidy may allow the recipient to compete on an unequal footing. Hence ceilings are only a very rough approximation of the potential for subsidies to distort a market.

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[3] Case C-296/82, 318/82 *Leeuwarder Papierwarenfabriek BV v Commission* [1985] ECR 809

[4] *Philip Morris Holland BV v Commission of the European Communities Case 730/79 [1980] ECR 2671*

2.12 Economic characteristics associated with competition distortion similar to those identified in our stage one report are recognized in paragraph 20 of the Commission's Action Plan. However, no detail is provided concerning how the Commission will operationalise these characteristics as criteria that will inform approval of aid measures.

2.13 The OFT is developing proposals for applying a more economic approach to distortion to competition within state aid control, which it considers would address the problems referred to above. Our proposal is to add economic filters to state aid guidelines for aid falling within Article 87(3). Under these proposals, in order to be approved under a guideline, an aid would need to be given in a way that minimizes the distortion to competition either by virtue of being relatively non-selective or competitive in terms of who receives it or by being given to a recipient with low market share.

2.14 We further propose that, for aid that falls within Article 87(3) but does not meet any of the guidelines, a more in depth analysis would be undertaken. We propose that a transparent set of criteria, which would include factors such as barriers to entry, should be applied to determine whether the aid is in the common interest.

2.15 The aim of this proposed two-stage approach is to improve the economic rigour of state aid without requiring extensive analysis for the majority of supports. This should facilitate quick assessment of the majority of aid and more detailed assessment of a few aids for which this is justified on economic grounds.

2.16 These proposals, and the results from our case studies, will be presented in more detail in a forthcoming report.

2.17 We support the retention of block exemptions for small aid that addresses particular market failures. The Commission's proposals for simplification and consolidation of these should help with rapid approval of aid that is unlikely to distort competition, although care should be taken to ensure the correct balance is struck between speed and protection of market incentives. We would encourage the Commission to monitor the effects of changes to block exemptions to ensure that that these permit the types of aid which have only minor impacts on competition.

Market failure

2.18 The OFT shares the Commission's view that government intervention to promote efficiency and growth needs to be targeted at market failure. The use of state aid is one way to address such market failures. As such it makes sense for state aid guidelines to permit proportionate aid that addresses genuine market failures.

2.19 The Action Plan does not explain how state aid controls will be changed to permit aid targeted at market failure. We encourage the Commission to clarify its approach in this area as a matter of priority. While subsidies that address market failure can contribute towards improving growth and employment, there are a number of risks that arise, including;

2.19.1. the definition of a market failure may be misused in order to push through aid that is aimed at benefiting particular firms, rather than addressing a true market failure, and

2.19.2. subsidies may be badly designed, harming competition even when they are targeted at market failure.

2.20 In the Action Plan, the Commission sets out the origins of market failure. In our view the Commission should use these origins for specifying guidelines to address certain market failures. It should also permit member states to make rigorous cases for market failures that are specific to the circumstances of certain areas, based on the same economic framework.

2.21 Guidelines could be changed to permit aid that addresses market failure in the particular industries or activities where Europe-wide market failure is recognized. For example, guidelines for environmental aid could be revised so they permitted aid to overcome externalities only in the situation where the polluter pays principle could not be employed. (Having the polluter meet the cost of rectifying adverse environmental impacts is important to provide polluters with the incentive to reduce pollution in the first place.) Box 1 elaborates this example.

Box 1: Example of a market failure based approach to environmental concerns

Environmental externalities exist because firms often do not pay for the wider costs that their production incurs on the environment. There have been moves to force producers to meet these costs (polluter pays principle), through economic instruments, clean up obligations or, more approximately through caps on pollution. The requirement on producers to reduce pollution or pay the price of this pollution should incentivise growth in the market for environmentally less-damaging products.

This suggests that government may need to intervene i) when the polluter cannot be made to pay (e.g. the polluter has gone out of business before environmental impacts were recognized), ii) when there is a failure of take-up of environmental technology due to risk aversion or high discount rates by firms rendering environmental technology non-cost effective or iii) when the polluter pays principle is not fully established in an area and as a result environmental products are less competitive than non environmental products. Subsidy to the environmental product may be an option, but for this reason should be transitory.

Environmental guidelines on state aid should be revised to permit the failures outlined above to be addressed. Subsidy to develop environmental technology should be addressed under R&D guidelines.

2.22 In addition to changes to the guidelines, Member States should be given the opportunity to convince the Commission of other, more localized market failures that may exist within their countries. If the Commission agreed with the assessment of the Member State, aid could be granted to address this failure based on the same economic principles underlying the Commission's guidelines.

2.23 We support the Commission's pressure on Member States to consider the range of options for addressing market failure, such as deregulation, rather than assuming that aid will be the most appropriate solution. Although requiring such an approach is beyond the scope of state aid controls, in our view, it should be an area of importance for Member States.

2.24 Member States may still wish to provide subsidies for redistribution purposes rather than market failure purposes[5]. There is still an important role for economic analysis in considering such subsidies as these can have unintended consequences including distortion to competition. It is important that the objective of such aid is made clear and that any adverse impacts on markets are taken into account when considering approval.

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[5] It should be noted that often an apparently redistributive subsidy will have market or government failure as its basis.

3 ROLES FOR INDEPENDENT NATIONAL AUTHORITIES

3.1 The Commission has indicated that it wishes to share certain responsibilities with Member States, which could include roles for independent authorities. The OFT believes that independent authorities could have a role in state aid control, but not in enforcement where there is a risk of differential application between member states.

3.2 We suggest that the Commission considers the scope for competition authorities to provide support for state aid control in an advisory capacity. The Commission has indicated that it plans to take a more economic approach to state aid control. If the approval of state aid is based on an economic view of whether the aid achieves common interest objectives without distorting competition disproportionately, competition authorities could assist subsidy providers and the Commission with the assessment of the likely distortion to competition of a particular aid. Our forthcoming paper sets this role out in greater detail.

3.3 The OFT currently provides advice to government departments on the potential competition impacts of proposed legislation, through its role with Regulatory Impact Assessments[6]. National competition authorities could have a similar advisory role with respect to state aid. Their advice could be used by subsidy providers and the Commission, though neither party would be required to act on the authority's advice, allowing full control to remain with the Commission.

3.4 The view of the OFT is that it is not appropriate and that there is little benefit to transferring monitoring from the Commission to national authorities. Such a transfer would introduce a risk that national authorities would monitor with differing levels of rigour, leading to an uneven application of state aid controls throughout the EU. The Commission expressed the view that the transfer would reduce its workload leaving it with more resources to deal with particularly controversial aid. However, we believe that in practice the Commission would still need to be involved with a significant number of these cases and hence the reduction in workload would be small.

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[6] Regulatory Impact Assessments set out the full impacts of a regulatory change that is being proposed including its costs and benefits, its impacts on competition and why the particular regulatory change was preferred over other policy options.

3.5 In terms of enforcing recovery decisions we do not think that independent authorities would be any more effective in this than Member States' governments. This is because independent authorities would have no stronger incentive to recover the aid, unless a system of penalties was applied to them. Also, as discussed in paragraph 3.4, there is a risk that some authorities would not pursue recovery with as much determination as others, leading to an unlevel playing field in state aid control.

4 COMMENTS ON OTHER AREAS

Innovation

4.1 There is a risk that a new guideline for innovation will open up the possibility for less discriminating aid to business. This could have a highly distorting impact on the development of good, innovative ideas.

4.2 It is not clear what a new guideline for innovation would be targeted at. In our view guidelines should be moved down lines closer to market failure. Thus more generic, market failure based guidelines for research and development and venture capital should permit the support for innovation that genuinely promotes the growth of markets.

Combining guidelines

4.3 At present situations often arise whereby a proposed aid almost meets the criteria of several guidelines, but does not fully meet the criteria of any one guideline. This leads to in depth investigations of a number of aids that contribute significantly to the common interest whilst having only a relatively small distortion on competition, but whose benefits are dispersed across a number of guideline categories.

4.4 This indicates strongly that either the number of guidelines should be kept low to minimize the risk of this occurring, or that a formal way of recognizing benefits across a range of guidelines should be developed[7].

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[7] Two ways of doing this would be i) to score the aid against each guideline objective so that an aid would score points according to its contribution to each objective. The combined score would be the aid's total contribution towards the common interest which could be compared with the distortion expected. ii) the (equivalent) financial support provided by the aid could be divided between all the relevant guidelines. The smaller amounts of aid would be approved if they met the requirements of the particular guideline.

Transparency

4.5 The Commission has indicated the importance of increasing transparency concerning state aid policy in order to improve enforcement. We would support any moves in this direction.

4.6 We also believe that transparency by subsidy providers concerning proposed aid could be improved. We think that greater transparency by subsidy providers would contribute to the assessment of whether that aid was likely to distort competition. The views of third parties are sought by the Commission when it opens up an Article 88(2) procedure but this is only used for a small subset of aid. By requiring subsidy providers to make information available concerning proposed subsidies prior to notification, potential adverse effects on competition could be identified earlier. Businesses that might be adversely affected would be aware of the subsidy and could highlight their concerns to subsidy providers.

4.7 Proposed subsidies could be made transparent by registering them on a dedicated website and inviting comments within a short period, such as ten days, to avoid adding significant extra time requirements into the process. In our stakeholder meetings with business representatives such a suggestion found favour and the selection of subsidy providers who we have met with considered that it would be possible provided that the exercise was not made into a formal consultation process.

4.8 Views of third parties could be used by subsidy providers in considering the appropriate design for their subsidies, by independent competition authorities in undertaking an initial assessment and by the Commission in the case that the aid required assessment under Article 88(2).

Monitoring/ review

4.9 Following reforms the process for state aid control we think that the Commission should actively review a selection of aids granted under new guidelines to ensure that the guidelines are set at the correct level. The system of notification and approval does not give firms hurt by approved aid any incentive to make a complaint. This is because, even if approved aid is subsequently declared illegal, its recovery would seem to be precluded by the principle of legitimate expectations, one of the general principles protected in

Community law. Hence, a competitor is unlikely to go to the effort of making a complaint.

4.10 Without complaints from firms there is no immediate way of reviewing whether the new guidelines permit aid that leads to significant distortions to competition. We therefore recommend that the Commission set up a mechanism for reviewing a selection of aids at the time the guidelines change in order to have the information to review the effects of the reform after a few years.