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State aid and the financing of public services: A comment on the Altmark judgment of the Court of Justice

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Abstract

On 24 July 2003, the European Court of Justice handed down its judgment in the Altmark case, ending the controversy surrounding the application of the EC state aid control regime to compensation granted to undertakings in consideration for public service obligations imposed on them.

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State aid and financing of public services

A comment on the recent *Altmark* judgment of the Court of Justice

By *Frédéric Louis and Anne Vallery, Wilmer Cutler & Pickering**

On 24 July 2003, the European Court of Justice handed down its judgment in the *Altmark* case, ending the controversy surrounding the application of the EC state aid control regime to compensation granted to undertakings in consideration for public service obligations imposed on them.

The Court held that such compensation does not confer an advantage on the undertakings concerned, and hence does not constitute state aid within the meaning of the EC Treaty, provided four conditions are satisfied:

- first, the beneficiary has effectively been entrusted with clearly defined public service obligations
- second, the parameters for calculating the compensation must be established in advance in an objective and transparent manner
- third, the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the revenue such obligations may generate and the fact that the beneficiary is entitled to make a reasonable profit for discharging these obligations
- fourth, either the undertaking selected to discharge the public service obligation is chosen pursuant to a public procurement procedure or, failing this, the level of compensation is determined on the basis of an analysis of what it would cost a typical, well-run undertaking to discharge these obligations, again taking into account the revenue such obligations may generate and the right for the beneficiary to make a reasonable profit

This judgment will enable member states to organise public services without having to submit their financing mechanisms for prior European Commission scrutiny under the state aid control rules. However, the Court has been careful to provide for a number of safeguards to make sure that its ruling is not used by member states to favour certain undertakings under the guise of compensating them for the costs incurred in discharging public service obligations.

The mechanism of state aid control under the EC Treaty

Article 87(1) introduces a general prohibition of state aid, while providing for a number of compulsory or discretionary exemptions to this prohibition under article 87(2) and (3). For a state measure to be caught by the prohibition, it must meet four conditions:

- there must be a financial intervention by the state or through state resources
- this intervention must confer an advantage on the beneficiary
- it must distort or threaten to distort competition
- it must be liable to affect trade between member states

In the past, there was some controversy among legal authors as to whether all four of these conditions had to be met for a state measure to fall within the definition of state aid under article 87(1). Some authors felt that only the conditions of state intervention and of advantage to a company were part of the definition, while the conditions of distortion of competition and of effect on trade between member states were not part of the definition but conditions to be met in order for state aid to be prohibited under article 87(1).

The Court had given some indications on this issue in the past, but the *Altmark* judgment puts an end to all controversy by making it clear that all four conditions have to be met for a state measure to fall within the definition of state aid. This has consequences notably for the obligation to notify state aid measures to the Commission under article 88(3).

State aid can take the form of a straightforward subsidy, an interest-free or low-interest loan, a state guarantee, a tax exemption or an exemption from the obligation to pay social security or other charges, favourable prices for goods or services provided by public undertakings, etc.

Under article 88(3), member states are obliged to notify the Commission of their intention to grant aid before they finally adopt the aid measure. In addition, they must respect a standstill obligation until the Commission decides whether the notified measure constitutes state aid and, if so, whether such aid is compatible with the common market, i.e. whether it meets the conditions for one of the exemptions provided for in article 87(2) or (3).

State aid granted in violation of the notification or standstill obligations is deemed to be illegal aid. If the Commission finds that such illegal aid is furthermore incompatible with the common market, it will – save in exceptional circumstances – order the guilty member state to recover the amounts of aid (including interest at commercial rates as from the moment when the aid was illegally granted) from the beneficiary. In addition, the Commission is empowered to make a provisional decision ordering the offending member state to suspend or provisionally recover the unlawfully granted aid.

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Member states' courts are not empowered to rule on the compatibility of a state aid measure with the common market. However, they can decide whether or not a contested measure constitutes state aid within the meaning of article 87(1) and, where such aid has been unlawfully granted in violation of the notification or standstill obligations, they must pronounce on the illegality of the aid and take all measures to undo its effects.

Beyond the specific exemptions from the prohibition of state aid provided for by article 87(2) and (3), article 86(2) provides for a general exception to the application of the Treaty rules to undertakings entrusted with the operation of services of general economic interest where the application of such rules would obstruct the performance, in law or in fact, of the particular tasks entrusted to these undertakings, provided this exception does not affect trade between member states in a way that would be detrimental to the interests of the Community.

Compensation for public service obligations: the issue and its relevance

In the *Altmark* case, a local bus company benefited from 18 licences to operate bus passenger services in a German district for which it received a subsidy from the public authorities. A competitor challenged the grant of the licences, arguing *inter alia* that the beneficiary could not survive without the subsidy.

The German Federal Administrative Court queried whether the subsidy constituted state aid and put a question to this effect to the European Court. It should be noted that the *Altmark* case raised a number of issues relating to the treatment of public service obligations and state aid in the transport sector, which is subject to a specific regime under the EC Treaty. These issues are not discussed here.

Although the referring German court was primarily interested in knowing whether state financing to a local transport company could affect trade between member states within the meaning of article 87(1), the Court briefly confirmed that this was the case since this condition has traditionally been interpreted very broadly.

It chose rather to concentrate on a different issue, namely whether compensation granted by a member state to an undertaking in consideration for the public service obligations it has been entrusted with constitutes state aid and is therefore subject to the Commission's prior approval.

The net result of deciding that such compensation constitutes state aid would be twofold:

- (i) in the case of notification, such compensation could not be granted until the Commission had approved it,
- (ii) if the compensation was granted in the absence of a notification to the Commission, or in violation of the standstill obligation, any interested party could object to the payment of such compensation before national courts.

On the other hand, should it be decided that compensation granted in consideration for the discharge of a public service obligation does not constitute a real advantage to the undertaking entrusted with the obligation and therefore does not constitute state aid, then such compensation measures would entirely escape the discipline of the state aid control mechanism.

Over recent years, national courts have put a number of preliminary questions to the Court, illustrating the relevance of the issue the Court decided in *Altmark*:

Ferring: In the *Ferring* case, a pharmaceutical company argued that it should not have to pay a tax levied on direct supplies to retailers, which had been introduced in France to offset the disadvantage that wholesalers in pharmaceutical products suffered as a result of the public service obligations imposed on them by the French state. These obligations were not imposed on pharmaceutical companies' direct deliveries to retailers. The pharmaceutical company argued that the scheme constituted state aid in favour of the wholesalers. Since the scheme had not been notified to the Commission, it argued that the French courts should refuse to apply it and hence that it should not be made to pay the tax. The French state argued that the scheme did not constitute aid since it merely offset the costs supported by the wholesalers as a result of their public service obligations.

Enirisorse: In the *Enirisorse* case, an Italian company challenges a port tax on the grounds that part of the proceeds of the charge went to public undertakings entrusted with dock-side loading and unloading of goods at certain ports, despite the fact that it had not made use of the services of these undertakings. One of the arguments put forward is that this constitutes unlawful state aid, while the Italian authorities argue that the charge was necessary to distribute the costs of the public loading and unloading services provided by the beneficiaries.

Gemo: In the *Gemo* case, a French supermarket contests a meat purchase tax imposed on supermarkets but not on small meat retailers. Revenue from the tax is meant to finance a public service for the collection and disposal of animal carcasses and dangerous slaughterhouse waste, provided free of charge to farmers and slaughterhouses by private carcass disposal undertakings remunerated by the state under contracts awarded after public procurement procedures. The supermarket's contention is that this scheme constitutes state aid for the farmers and slaughterhouses (and the small meat retailers), which is unlawful since it has not been notified to the Commission. It therefore asks the French courts to set aside its obligation to pay the tax. The French authorities argue that the scheme compensates the disposal operators for their public service obligations and therefore does not constitute state aid.

In all these cases, there is an additional issue – whether article 86(2) may not provide a solution to a finding that the financing scheme for public service obligations constitutes unlawful state aid. As mentioned above, article 86(2) contains an escape clause for undertakings entrusted with a service of general economic interest not to be subject to the Treaty rules where this would obstruct the performance of their tasks.

However, it is not clear that article 86(2) could be relied on by national courts as a reason not to set aside aid measures granted in violation of the notification and standstill obligations imposed by article 88(3). In a previous judgment, the Court has indeed already decided that member states could not rely on article 86(2) to evade the notification and standstill obligations.

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Divided opinions

The Court of First Instance has taken the view in a number of cases that measures granted in compensation for a public service obligation constitute state aid and are therefore subject to the discipline of the state aid control regime instituted by the EC Treaty, although they may be declared compatible with the common market under one of the exemptions provided for in article 87(2) or (3) (by the Commission, following a notification) or may be held to benefit from the exception laid down in article 86(2).

Faced with the question on the tax on direct sales to retailers by pharmaceutical companies in the *Ferring* case, the Sixth Chamber of the Court of Justice, adopting the opinion of Advocate General Tizzano, took the opposite view from the Court of First Instance and decided that the tax at issue would only constitute state aid to the exempted wholesalers in pharmaceutical products “to the extent that the advantage in not being assessed to the tax on direct sales of medicines exceeds the additional costs that they bear in discharging the public service obligations imposed on them by national law.”

The Court further held that, to the extent that the advantage enjoyed by the wholesalers exceeded the costs of the public service obligations that they bore, such advantage would constitute state aid that would not benefit from the exception under article 86(2) since such aid by definition would not be necessary to enable the wholesalers to discharge their public obligations.

In his first opinion in the *Altmark* case, Advocate General Léger severely criticised the judgment in *Ferring* and suggested that the Court should reverse it. He took the view that the Court in *Ferring* had confused the characterisation of measures as state aid and the justification for a measure once it has been characterised as state aid. Mr Léger felt that the judgment deprived article 86(2) of its effect, while the conditions for the application of this article were stricter than the conditions set by the Court in *Ferring* for the definition of state aid.

In other words, measures that in the past would have been considered as state aid and would not have met the conditions to benefit from article 86(2) would now escape all scrutiny. Advocate General Léger also feared that the *Ferring* test would effectively remove state measures for the financing of public services from the Commission’s control of state aid. He thus proposed that the Court should rule that subsidies granted to offset the costs of a public service obligation were liable to constitute state aid.

In an opinion given a few months later, Advocate General Jacobs adopted a compromise position, suggesting that a distinction should be made between state measures showing a direct and manifest link between the financing granted and the public service obligations imposed, where these obligations are clearly defined, and measures “where it is not clear from the outset that the state funding is intended as a *quid pro quo* for clearly defined general interest obligations.”

Mr Jacobs conceded that his proposed distinction might not always be easy to draw. In his view, however, this solution may give member states “an incentive to grant compensation for the provision of general interest services on the basis of unequivocal and transparent arrangements, and perhaps even on the basis of public service contracts awarded after open,

transparent and non-discriminatory public procurement procedures.”

In yet another case, Advocate General Stix-Hackl agreed with the opinion of Advocate General Jacobs.

The Court’s judgment in *Altmark*

In view of these divergent opinions, the *Altmark* case was entrusted to the full Court of Justice. It was decided to re-open the procedure to afford all parties the opportunity to comment on *Ferring* and the ensuing discussions in the different opinions of the Court’s own Advocates General.

In the event, six member states intervened and, as it happens, split evenly with three suggesting that the Court should confirm the *Ferring* solution and three arguing that it should adopt the compromise solution put forward by Advocate General Jacobs.

As for Advocate General Léger, in a second opinion in the *Altmark* case given on 14 January 2003, he persisted in his first opinion that the Court should simply reverse *Ferring*.

In its judgment on 24 July, the full Court adopted a solution clearly inspired by Advocate General Jacobs’s opinion. First of all, the Court did confirm *Ferring* in holding that a state measure to finance public obligations is not state aid within the meaning of article 87(1) where it “must be regarded as compensation for the services provided by the recipient undertakings in order to discharge public service obligations, so that those undertakings do not enjoy a real financial advantage and the measure thus does not have the effect of putting them in a more favourable competitive position than the undertakings competing with them” (*para 87*).

However, the Court showed sensitivity to the arguments that had been put to it that, without more, the *Ferring* formula may make it tempting for member states to advantage some undertakings unduly, since it enables them to refrain from notifying their intended measures of financial support to the Commission, while not having to worry about the consequences in the national court.

For this reason, the Court subjected the *Ferring* solution to a number of relatively stringent conditions meant to ensure that it would only be applied in the most clear-cut cases:

- the public service obligations being compensated must be clearly defined in national law
- the compensation for such obligations must be based on parameters that have been determined in advance, in an objective and transparent manner
- the compensation cannot exceed the costs of the public service obligations, but the Court does concede that these “costs” may include “a reasonable profit” (*para 92*)
- the Court encourages member states to select the public service providers through a public procurement procedure, in the absence of which the compensation will have to be based, not on the actual costs of the undertaking entrusted with the public service obligations, but on the costs of a “typical undertaking, well run and adequately provided with the means [of performing the services]” – meaning, presumably, a normally efficient and economically viable company. Again, the Court allows for the fact that the typical service provider used as a basis for the costs to be compensated is entitled to “a reasonable profit” (*para 93*)

Consequences of the judgment

The *Altmark* solution illustrates the way that the Court is able to enact quasi-regulatory requirements that member states will have to take into account if they wish to avail themselves of the favourable regime heralded by the *Ferring* judgment.

While the Court maintains the *Ferring* solution, it surrounds it with significant constraints on the ability of member states to organise the provision of public services as they see fit. In particular, with the fourth condition attached to its judgment, the Court is clearly pushing member states towards a policy of systematic allocation of public service contracts through open bid procedures.

This requirement appears to be justified from a legal point of view since it can be argued that state financing that would reward providers of public services for their inefficiency would constitute an advantage, and hence state aid, to these providers. A public bid procedure is the best way to make sure that public services will be discharged in the most efficient manner. While these constraints may perhaps create a significant burden, in particular for local authorities, the transparency and efficiency thus promoted by the Court can only be positive for the provision of public services.

The *Altmark* judgment has brought significant clarification to the treatment of the financing of public services in the European Union. However, there are still important issues that will require further clarification through case law in order for their scope to be clearly defined, such as what constitutes reasonable profit. This notion has proved to be quite elusive in other areas of EC law, such as the issue of what constitutes abusively high pricing under article 82 or the regulation of interconnection and access issues in the telecoms field.

Also unresolved is the question of the role that article 86(2) may play for all cases of state financing of public services that will not benefit from the *Altmark* rule. Indeed, while article 86(2) does not enable state aid to public services providers to escape from the notification and standstill obligations, it may be argued that allowing a national court to draw all consequences from the illegality of such aid granted in violation of these obligations may at least hamper the provision of public services in certain circumstances.

Could the beneficiary rely on article 86(2) in such circumstances to set aside the obligation of national courts to take all measures to undo the effects of illegal aid? In view of the divergent views that were expressed by the Advocates General on the proper scope and consequences of article 86(2) in the

field of state aid, it is to be regretted that the Court did not seize the opportunity also to address this issue in its judgment.

This last issue is important. Significant areas of state intervention in favour of public services will not benefit from the *Altmark* judgment. For instance, this will be the case for general exemptions from income and other taxes that, by their nature, do not reflect exactly the costs of provision of public services.

Another frequent type of state intervention in support of public services – the compensation of losses incurred on an *a posteriori*, *ad hoc* basis – will also be considered to be state aid. This will have to be notified to the Commission for approval (which approval could then be granted under the specific exceptions of article 87(2) or (3) or, arguably, under article 86(2)) or, failing a notification, run the risk of national litigation where the beneficiary will have to argue that the measures in question are saved by article 86(2).

In any event, it seems clear from the *Ferring* judgment – as the Court in *Altmark* did not go back on this part of the *Ferring* ruling – that article 86(2) may not be relied on to save state financing that would over-compensate a provider for discharging its public service obligations. State financing that exceeded the costs of provision of these obligations and a reasonable profit for the service provider will indeed be considered unnecessary to allow the public service provider to perform its tasks.

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Commission disputes Council's approval of Belgian tax breaks

The two EU institutions are on a confrontation course over the special tax regime for multinational companies that run their administration and finances from a centre in Belgium.

This regime was found to entail unlawful state aid by the Commission in a decision made on 17 February 2003. The decision let existing arrangements run their course, but not be renewed.

On 16 July, on Belgium's request, the Council authorised the entire regime to continue until 2006, including renewal.

The Commission acknowledges the Council's power to approve state aid, but only before it has itself made a decision. This must be something of an irritant, but it is clearly allowed by article 88(2).

However, what the Council did in this case was to overrule an existing adjudication by the Commission. Accordingly,

the Commission filed a case against the Council at the Court.

This case joins appeals against the Commission's decision that had already been filed by an association of affected companies and by Belgium (*Cases C-217/03 and C-182/03*). On 26 June, the Court suspended the decision's effect on renewals already pending on 17 February.