

# Agenda

## Advancing economics in business

### Who's over-compensated and who's not? Implementing state aid regulation in practice

Compensation for providing socially necessary public services (or services of general economic interest) has been the subject of much legal debate. While the landmark *Altmark* judgment from the General Court in Luxembourg emphasises the need for providers of public services to be efficient, there is ambiguity as regards the definition of efficiency. How can performance assessment measures be applied to resolve compensation debates?

When socially desirable services are not commercially viable, reliance on the private sector often results in under-provision. The private sector may not provide bus services or broadband access to remote areas if profitability is compromised. In such situations, government bodies may intervene by creating public service obligations (PSOs). Historically, these services have been provided by public operators, but there is an increasing trend towards putting contracts out to tender to private providers. In the context of such public service contracts (PSCs), there is regulatory pressure for greater transparency with regard to information on exclusive rights granted and parameters for financial compensation.<sup>1</sup>

Legal disputes regarding state aid for the provision of services of general economic interest (SGEIs) and PSOs have arisen in several sectors ranging from transport to the provision of healthcare services. Compensation for SGEIs may or may not be state aid under EU law. The 2003 *Altmark* judgment (a case involving subsidies to local bus services in Magdeburg, Germany) sets out the conditions under which compensation for SGEIs would not be classified as state aid under Article 107(1) TFEU.<sup>2</sup> While it is clear that the *Altmark* conditions state that funding for SGEIs should not lead to over-compensation, there is a degree of ambiguity in some of the other areas of the judgment—specifically the efficiency criterion.

As the number of cases of state aid challenged in courts increases, there is a need for a better understanding of the conditions governing compensation for public services. In the public transport sector, with the coming into force of EU Regulation 1370/2007 on public passenger transport services by rail and road, introduced in 2007 and implemented in December 2009, authorities and

operators will need to ensure that no over-compensation is granted for the operation of PSO services. While case law regarding public transport contracting can provide insightful precedents, at a practical level, regulatory practice and performance assessment in other sectors can provide guidance on how to comply with the EU rules.

#### Public funding regulations

Article 107(1) sets out a general prohibition of state aid (including aid for PSOs). The *Altmark* judgment states that compensation for transport PSOs, and PSOs in general, will not be considered state aid if four criteria are met.

1. The recipient undertaking is actually required to discharge PSOs and those obligations have been clearly defined.
2. The parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner.

#### The main features of Regulation 1370/2007

- PSCs will be either competitively tendered, provided, or directly awarded by relevant government authorities.
- Over-compensation should be avoided irrespective of the procedure chosen to award PSCs.
- Compensation is based on the costs incurred, revenues earned, other financial effects and a 'reasonable profit'.
- Contract limits (ten years for bus and 15 years for track-based modes, except in special circumstances) are set to mitigate the risk of market foreclosure over time.
- Accounting separation is required where the PSO provider undertakes other activities.

3. The compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the PSOs, taking into account the relevant receipts and a reasonable profit for discharging those obligations.
4. Where the undertaking which is to discharge PSOs is not chosen in a public procurement procedure, the level of compensation has been determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

The *Altmark* criteria attempt to resolve uncertainty regarding compensation for PSOs and encourage efficient utilisation of resources. The first two conditions stress the importance of transparency and clarity by requiring service providers to define their operations and funding needs at the outset. The third and fourth conditions focus on efficient utilisation of funding by ensuring that there is no over-compensation, and awarding compensation to an efficient service provider.

For those measures that fail to meet the *Altmark* criteria and are classified as state aid, it is possible that the aid is nevertheless permitted under Article 106(2) (or Article 93 for transport):

Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.

As regards aid to the public transport sector, Regulation 1370/2007 sets out requirements for granting compensation to PSO providers, covering national and international public passenger transport services by light and heavy rail and by road. The key conditions of Regulation 1370/2007 are similar to the *Altmark* criteria regarding over-compensation and transparency. While the Regulation aims to reduce regulatory risk through transparency in the award disbursement process, it is imprecise as regards the 'reasonable profit' to be included in the compensation over and above the costs incurred. Therefore, to avoid the problem of over-compensation in the public transport sector, there is a need for a framework to define reasonable profits and efficient cost levels.

## Evidence from selected case law

The *Altmark* criteria have been employed across sectors to determine compliance of SGEI providers with European law, including healthcare, water, telecoms, transport and postal services. It is worth considering the European Commission's interpretation of important aspects of contracts for providing SGEIs. The following cases illustrate recent approaches to the quantification of over-compensation.

- A number of state aid cases brought before the EU courts fail the first two *Altmark* conditions. For example, in the Cumbrian broadband access decision, the Commission ruled that the process by which the terms of the contract were specified did not satisfy *Altmark*.<sup>3</sup>
- In the healthcare sector, the Irish government introduced a system of levies and tax relief in order to promote 'intergenerational solidarity' by generating net payments from companies with younger customers to those with older customers. The government presented the case to the Commission in advance of implementation. The Commission judged the first two *Altmark* criteria to be satisfied, and the third criterion on over-compensation was met subject to an undertaking provided by the government to evaluate the profitability of the net beneficiary on an ex post basis.<sup>4</sup> The fourth *Altmark* criterion was not satisfied, however, as the Commission considered that no evidence had been presented to prove that the net beneficiary's costs were those of an efficient undertaking. It accepted that the net beneficiary had an incentive to be efficient, but judged this insufficient to *prove* efficiency.
- With regard to the transport sector, the Commission employed the *Altmark* judgement in its 2008 decision concerning alleged state aid granted in 2002 by the Tyrolean public transport authority to its publicly owned business, Postbus AG.<sup>5</sup> The Commission concluded that the first two criteria were met as the service constituted a PSO, and remuneration was paid on a fixed price/km basis as well as for a fixed number of kilometres driven.<sup>6</sup> It also concluded that the compensation paid was 'fair and adequate given the average costs in the sector' and thus did not amount to over-compensation (the third *Altmark* criterion).<sup>7</sup> However, determining compliance with the fourth criterion was more complex. While the Commission accepted that Postbus's costs were those of an average Austrian undertaking, it considered that this was not sufficient to demonstrate that the costs were those of a 'well-managed undertaking'. It therefore decided that the fourth criterion was not met.<sup>8</sup>

## How to ensure compliance?

To become compliant with the *Altmark* criteria, compensation needs to be assessed in light of economic and financial analysis. In the above-mentioned cases, among others, PSOs have been contracted without open procurement. The fourth *Altmark* criterion outlines that, in the absence of open procurement, the cost of a well-run third party should be taken as a benchmark when determining compensation. The following principles provide some guidance on how to establish such a benchmark.

### Principle 1

The costs associated with the provision of SGEIs must be clearly identified. For public transport state aid PSOs, Regulation 1370/2007 requires a separation of accounts for SGEI and non-SGEI services, and that accounts should be prepared such that they are open to third-party audit. Separate accounting for SGEI costs is a prerequisite for the estimation of reasonable levels of profit and subsequent performance assessment.

### Principle 2

To comply with the fourth *Altmark* criterion, performance needs to be compared with efficient undertakings. Finding a comparator group for SGEIs can be a difficult task, especially if the structure of the sector is such that few firms operate.<sup>9</sup> Evidence from regulatory practice illustrates several approaches to benchmarking that could be employed.

- When only part of the business is engaged in the provision of SGEIs, internal comparisons between SGEI and non-SGEI operations could provide a plausible approach to assessing the efficiency of the SGEI operations. Case law concerning *Postbus*, and other studies of performance assessment, suggest that internal benchmarking across parts of the business is acceptable practice.<sup>10</sup>
- Functional or process benchmarking—using bottom-up activity-based approaches—against companies outside the sector with similar processes could be another feasible technique.<sup>11</sup>
- Comparison with similar firms may be possible either within the sector itself in a particular country or region—if the structure of the sector is such that it provides comparators—or with similar firms in other countries.
- Comparison with firms which have won a series of competitive tenders in the sector. For example, in the Commission's decision regarding state aid granted by

Austria to *Postbus*, it considered the average cost of firms with a history of successful tenders to be reasonable benchmarks.<sup>12</sup>

### Principle 3

The literature on performance assessment reveals a long list of performance measurement techniques that can be employed to determine efficient cost levels.<sup>13</sup> Rates of performance change, both historical and planned, may also provide a useful source of information on efficiency.<sup>14</sup>

### Principle 4

Finally, it is worth noting that the language of the fourth criterion is open to interpretation, as it refers to both 'typical' and 'well-run' undertakings—this could imply either the industry average or the lowest-cost firm. While the average firm may characterise the 'typical' firm, it is not representative of the 'efficient' firm. Existing case law can provide guidance on defining benchmarks. The *Postbus* decision states that achieving the costs of an average undertaking cannot be considered the same as achieving those of a well-run undertaking, at least in the Austrian context, since contracts had been awarded without tenders for a long time. However, there is little precedent regarding the appropriate treatment of companies operating less efficiently than the average undertaking. In such cases, it is unclear whether the PSC should necessarily be competitively tendered in order to comply with the *Altmark* criteria, or whether it is sufficient to set targets such that, during the life of the PSC, the operator has to improve its efficiency up to the level of the average operator. This latter approach would seem to be consistent with Recital 27 of Regulation 1370/2007, which states that 'the amount of compensation needs to reflect a desire for efficiency and quality of service.'

## Conclusion

With increasing precedent being set following the *Altmark* judgment, and the recent coming into force of Regulation 1370/2007 (albeit with a gradual transition period), several changes are expected in the way PSCs achieve compliance with the EU state aid rules. Evidence from case law and standard regulatory practice can provide valuable insights to service providers and institutions drafting contracts when seeking compliance with state aid guidelines. In addition, service providers and Member States need to ensure transparency in cost allocation to SGEIs and choose performance assessment techniques which are most appropriate in light of the available cost data and the industry structure.

<sup>1</sup> See Oxera (2008), 'Funding Public Transport Services: In Need of Standard Regulation Tools?', *Agenda*, June. Available at [www.oxera.com](http://www.oxera.com).

<sup>2</sup> *Altmark*, case C-280/00, judgment of 24 July 2003.

<sup>3</sup> European Commission (2003), 'Cumbria Broadband: Project Access—Advancing Communication for Cumbria and Enabling Sustainable Services', Decision N282/2003, 10.12.2003 C(2003) 4480fin.

<sup>4</sup> See European Commission (2009), 'Ireland Health Insurance Intergenerational Solidarity Relief', N 582/2008, paras 41–42 and 69.

<sup>5</sup> European Commission Decision of 26 November 2008 on State Aid Granted by Austria to the Company Postbus in the Lienz District C 16/07 (ex NN 55/06), 2009/845/EC.

<sup>6</sup> *Ibid.*, paras 71 and 76.

<sup>7</sup> *Ibid.*, para 81.

<sup>8</sup> *Ibid.*, para 88.

<sup>9</sup> For a detailed discussion of the complexities of setting appropriate benchmarks, see Oxera (2008), 'Dealing with Doping: A Question of the Benchmark', *Agenda*, July. Available at [www.oxera.com](http://www.oxera.com).

<sup>10</sup> For an application of internal benchmarking, see Horncastle, A., Jevons, D., Dudley, P. and Thanassoulis, E. (2006), 'Efficiency Analysis of Delivery Offices in the Postal Sector Using Stochastic Frontier and Data Envelopment Analyses', chapter 5 of M. Crew and P. Kleindorfer (eds), *Liberalization of the Postal and Delivery Sector*, Edward Elgar Publishing.

<sup>11</sup> For example, in the absence of direct comparators, Oxera employed approaches and estimates derived by other regulators in network industries to define efficiency enhancement targets for Network Rail in the UK. See Oxera (2008), 'What is Network Rail's Likely Scope for Frontier Shift Enhancement Expenditure over CP4?', March.

<sup>12</sup> See European Commission Decision of 26 November 2008 on State Aid Granted by Austria to the Company Postbus in the Lienz District C 16/07 (ex NN 55/06), 2009/845/EC, para 86.

<sup>13</sup> Comparison of key performance indicators (KPIs) is the simplest approach to performance assessment. Its main advantage is ease of implementation and data collection, although it does not account for differences in operating environments so may not be appropriate. Other methods like (corrected) ordinary least squares, stochastic frontier analysis and data envelopment analysis establish more comparable benchmarks and have been extensively employed in the performance assessment of regulated utilities.

<sup>14</sup> Analysis of real unit operating expenditure (RUOE) of comparable firms can provide insight into firms' cost efficiency. RUOE is commonly used for efficiency assessments in the regulated sector. In the absence of data regarding comparator unit costs, economy-wide productivity estimates have also been used to define benchmarks.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email [g\\_niels@oxera.com](mailto:g_niels@oxera.com)

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