

# Agenda

## Advancing economics in business

### Unreasonable profit? A new framework for services of general economic interest

The European Commission has powers to control the compensation granted for the provision of services of general economic interest (SGEI), where Member States intervene in markets to deliver social objectives such as universal service. From 2012 the Commission will implement reforms of the state aid rules used to carry out this control. A new, stricter set of principles is proposed for large-scale commercial activities in SGEI. How will these principles, such as the concept of 'reasonable profit', operate in practice?

In September 2011, the European Commission published a draft Communication on a new framework for compensation of services of general economic interest (SGEI).<sup>1</sup> SGEIs 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 SGEIs 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 Communication is to clarify the conditions under which state aid for such services can be found to be compatible with Article 106(2) of the Treaty on the Functioning of the European Union (TFEU). In some of the relevant sectors, such as transport, telecoms, energy supply and post, SGEI compensation is also addressed in separate sector-specific rules.<sup>2</sup> The main focus of the proposed revised 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 efficiency incentives. In addition, the Vice President of the EU, Joaquin Almunia, commented recently:

we have decided to ease our control on the services that do not have a significant impact on the internal market and to focus on the commercial operations that have a real potential to distort competition. For instance, a new de minimis rule will exclude from our control compensations made by small local authorities under certain thresholds. On the other hand, new guidelines are devoted to large-scale commercial services – such as

the post, environmental services and energy supply. If the package is approved, you can expect a stricter scrutiny of these operations with a clear impact on the internal market.<sup>3</sup>

The form of compensation to be adopted by the Commission in this instance (as with other mechanisms in state aid, such as Regulation 1370/2007, which provides similar rules in the public transport sector) will require considerable economic analysis, including:

- determining the costs and revenues of the undertaking with and without the obligation to provide the service (the difference being the required compensation);
- 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 article describes the approach that the Commission is proposing in its framework Communication, and discusses some alternative options. It concludes with a review of policy implications arising from the Communication, which are worth considering as the new framework is being finalised.

#### What are the potential problems with SGEIs?

Governments require SGEIs to be provided in order to fulfil certain policy objectives. The need for governments to define SGEIs can arise when there is

a gap in market provision—first, where a well-functioning market does not provide such services, since the cost of provision exceeds the revenues; and second, where the market does not provide such services at a socially acceptable (eg, uniform) price (for example, a universal postal service whereby a letter has the same price regardless of the distance it travels). Other examples include public service broadcasting, health insurance provision for the chronically sick, and ferry and air routes to remote islands. A ‘reverse definition’ is given by the Commission in its framework Communication:

services that are already provided or can be provided satisfactorily and under conditions, such as price and access to the service, consistent with the public interest, as defined by the State, by undertakings operating in accordance with the rules of the market cannot be defined as services of general economic interest. (paragraph 13)

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—itsself, or a private sector party. Furthermore, 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. In circumstances where a government chooses to provide the services itself, it will need to be transparent about the money required for provision—to ensure that it is not overpaying for the self-provision.

Essentially, the Commission appears to wish that the ‘competent authority’ that makes the entrustment be indifferent between self-provision and tendering out the service in a competitive environment. In addition, the SGEI framework is seeking to ‘mimic’ a competitive outcome, by ensuring that the service provider is earning a reasonable profit (but is not overcompensated), and has strong incentives to deliver efficiency and innovation.

In summary, there are two rationales for controlling SGEI compensation. The first is avoiding cross-subsidisation of commercial activities, which could distort competition in adjacent markets; the second is avoiding overcompensation of the SGEI activity, which could waste taxpayers’ money and implicitly is not the outcome expected under competitive conditions for the provision of SGEIs.

## Costs and revenues

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 life of the contract between the state and the provider.

The methodology envisaged is drawn from 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 this obligation’ (paragraph 25). This involves envisaging the business operating purely in a competitive market with neither government requirements on service or price levels, nor access to government support, and comparing that business plan with the actual one 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 framework would require the government to compare the ‘summer only’ business plan with the ‘year round’ business plan. The net avoided cost is the difference between net costs in the two business plans.

Applying this logic will require an element of judgement—while the Commission may reasonably expect that a business will understand which parts of its activities make what 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; this might occur if a government, faced with an entrustment period ending, required the SGEI provider to increase the level of service provision under a new entrustment.

The Communication suggests that the net cost calculation should include a valuation of intangible benefits. The valuation of intangibles in the provision of universal service obligations can be uncertain. It may therefore be helpful for the Commission to develop guidance on the circumstances in which significant intangibles valuations might be expected, in order to avoid uncertainty going forward around this issue.

An alternative approach to the net avoided cost methodology suggested by the Commission is what it calls the ‘cost allocation methodology’. Under this approach, the direct costs necessary for discharging public service obligations are assessed, together with ‘an appropriate contribution’ to the indirect costs common to both the SGEI and other activities of the entity being entrusted. In addition, where an undertaking is providing activities other than those required simply to deliver the SGEI, its accounts should show costs and revenues arising from the SGEI separately from those relating to the other activities.

## Reasonable profit

When establishing whether an entrustment is going to lead to overcompensation, two main issues need to be addressed: how to measure profitability; and how to assess the benchmark against which to compare profitability. The Commission's preference (see footnote 17 and paragraph 32 of the Communication) is to measure profitability using the internal rate of return (IRR) approach, in which the IRR is calculated over the life of the entrustment. This is consistent with the appropriate methods to assess economic profitability in competition cases more generally.<sup>4</sup> Only if 'duly justified' (paragraph 32) should alternative measures such as return on equity (ROE), return on capital employed (ROCE), return on assets (ROA) or return on sales be used to measure profitability.

In assessing the appropriate benchmark against which to compare observed profitability, the Commission draws on regulatory and financial economics. It notes that benchmark 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' (paragraph 31).

However, it also provides, in paragraph 33, a safe harbour:

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

By providing such a safe harbour, the Commission seems to be aiming to balance the need to get the rate of return 'right' with the (perhaps more important) policy driver that SGEIs should be provided without substantially distorting otherwise competitive markets.

There are some issues, however, even with the simple approach that the Commission suggests in this instance. First, given today's turmoil in the financial markets, it might be necessary to reflect in the 'relevant swap rate' the relative country risk of the particular Member State in which the entrustment is being made. Second, the Commission explains that the premium of 100 basis points is part of the provision 'inter alia to compensate for liquidity risk related to the fact that an SGEI provider that invests capital in an SGEI contract commits that capital for the duration of the entrustment act and will be unable to sell its stake as rapidly and at a low cost as is the case with a widely-held and liquid risk-free asset' (footnote 20). A liquidity premium would seem to be reasonable in the context of current market volatility, and to the extent that SGEI providers might be small and medium-sized enterprises (SMEs). It is

not clear that 100 basis points would be appropriate for every eventuality.

While the above discussion focuses on benchmark measures akin to the weighted average cost of capital (WACC) for the entity providing SGEIs, the benchmark rate of return can also be drawn from evidence on returns achieved by comparator undertakings providing similar services. Ideally, this would be in the same Member State, but international evidence could also be used. For example, if the SGEI provider is the only provider of such services in a Member State, there will be no available comparator in that Member State.

In general, the selection of appropriate comparators for an SGEI undertaking is a difficult exercise, and it may be more transparent and robust to rely on an estimate of the WACC as the competitive benchmark. Where a WACC is selected, its parameters need to be measured over a certain time period, and for a given undertaking. It can be helpful to focus on the WACC of the undertaking, even in the case of a state-owned undertaking where the WACC is an artificial construct.

In paragraphs 34 and 35, 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 life 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' (paragraph 34) with a situation where 'the *ex post* net costs are essentially compensated in full' (paragraph 35). In the former, the Commission clearly expects risk to be higher, and for this risk to be rewarded with a higher return (ie, greater compensation). The choice of compensation mechanism also affects incentives on the SGEI provider during the entrustment, to which we now turn.

## Efficiency incentives

The first compensation option outlined by the Commission—a fixed lump-sum payment—has all the characteristics (and, therefore, incentive properties) of a price cap. Such an arrangement would provide incentives for the SGEI provider to find cheaper ways of delivering the required level of service over the course of the entrustment. The Commission states that efficiency delivered during the entrustment should not come at the expense of quality of service (paragraph 40).

The Commission may wish to ensure that some of the issues that have arisen in regulated sectors in relation to efficiency incentives are 'designed out' of the SGEI framework at this stage. One concern relates to the duration of the entrustment—while the Commission expects that duration should be justified by reference

to 'objective criteria such as the need to amortise non-transferable fixed assets' (paragraph 17), there is some concern that if assets (such as vehicles, which have short asset lives) represent a high proportion of the fixed assets of an SGEI provider there would be a risk that entrustment periods would be too short for substantive efficiency incentives to emerge.

The Commission might also consider the circumstances in which it would be appropriate to 'equalise' the strength of incentives throughout the entrustment period. The risk is 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 (in paragraph 38) of linking compensation more explicitly to the delivery of efficiency targets (if efficiency performance can be measured objectively) might go some way towards this aim.

Finally, the Commission expects that an 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' (paragraph 35).

## Conclusions

The proposed new SGEI framework has the potential to considerably shake up markets that are currently characterised by incumbent or state-owned provision of SGEIs. If approved, the proposed framework will take effect in respect of existing notifications on which the Commission has yet to decide, as well as 'unlawful aid on which it takes a decision after the framework is published in the *Official Journal*, even if the aid was granted prior to such publication' (paragraph 56). Thus, the Commission's proposal is that the new framework will apply retroactively (except the part on efficiencies), requiring considerable efforts from each Member State to ensure compliance.

The proposed framework—expected to be implemented early in 2012—would require competent authorities making entrustments to ensure that SGEI provision is characterised by reasonable profitability, incentives for efficiency, and transparent accounting. Essentially, the Commission is encouraging a 'light touch' form of economic regulation in relation to SGEI provision. Whether the relationship between contracting parties can move quickly to the level of experience required to deliver a light-touch regulatory model remains to be seen. Nonetheless, economic experience elsewhere can inform practice in this area, and this experience would assist with implementing the proposed framework.

<sup>1</sup> European Commission (2011), 'Communication from the Commission: EU Framework for State Aid in the Form of Public Service Compensation', draft, September.

<sup>2</sup> *Ibid.*, p. 9.

<sup>3</sup> Almunia, J. (2011), Speech at BDI Berlin State Aid Round Table, November 11th.

<sup>4</sup> Oxera (2003), 'Assessing Profitability in Competition Policy Analysis', OFT Economic Discussion Paper 6, July.

**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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