Public Compensation for Services of General Economic Interest: An Analysis of the 2011 European Commission Framework

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I. Introduction

For a long time, the legal regime applicable to State compensation for Services of General Economic Interest ("SGEIs") was a source of uncertainty under State aid law. It is only in its Altmark judgment that the Court of Justice of the EU ("CJEU") brought clarity on the matter by setting out the conditions under which SGEI compensation escapes State aid scrutiny.¹ Drawing on the clarifications brought by the Altmark judgment, the European Commission ("Commission") adopted in 2005 a so-called "SGEI Package".² It consisted of two documents, a Decision and a Framework, which detailed the conditions under which SGEI compensation would constitute compatible State aid. The 2005 SGEI Package, which has been applied extensively by the Commission, expired in November 2011. To anticipate this, the Commission engaged in a wide consultation process on the revision of the Package. As a result, a draft Package was published in September 2011 and after additional comments were made by various stakeholders, the Commission adopted the final version of the Package in December 2011.³ The new Package includes three documents, a Communication,⁴ a Decision⁵ and a Framework.⁶ The Communication clarifies the Altmark conditions. When the SGEI compensation meets these conditions, it does not constitute State aid and does not need to be notified to the Commission. When the SGEI compensation does not meet the Altmark conditions, the analysis turns to the Decision and the Framework. In the Decision, the Commission describes certain types of SGEI compensation that are regarded as compatible

¹ Case C-280/00 Altmark Trans GmbH [2003] ECR I-7747.
⁴ 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 ("Communication") [2012] OJ C8/4.
⁵ Commission Decision of 20 December 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 [2012] OJ L7/3.

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with Article 106(2) TFEU and exempt from the requirement of prior notification. If the conditions set in the Decision are not met, the State aid measure is subject to the prior notification requirement, but it can still be declared compatible with the internal market if it meets the criteria spelled out in a third document: the EU Framework.

The Framework is perhaps the most contentious document in the Package. It has received both praise and criticism from stakeholders. Among the conditions that the Framework introduces for the compatibility of SGEI compensation with the internal market, some are not of a strictly economic nature as they relate to the existence of a genuine SGEI and the act by which it has been entrusted. For the sake of convenience, these are thus referred to as the “procedural” conditions. However, the most important condition, to which the largest part of the Framework is dedicated, is economic in nature in that it provides a methodology to determine whether the amount of compensation paid by the State exceeds what is necessary to cover the net cost of discharging the SGEI (including a reasonable profit). In this regard, the context of the financial crisis in which this Framework was developed is important. As Commissioner Almunia put it in one of his speeches, the Commission has to respond to the challenges created by the depleted state of “public coffers almost everywhere in Europe” and the “deep cuts into public services and the welfare state” by ensuring that public money earmarked for such services is spent wisely and efficiently. Finally, the Framework foresees that an SGEI entrustment can sometimes generate serious distortions of competition, in which case the Commission can impose additional requirements to declare it compatible with the internal market.

Against this background, this paper is structured as follows. Section II reviews the procedural conditions and places particular emphasis on the problems of linking State aid with the application of public procurement rules. Section III discusses in detail the economic condition that the SGEI provider should not be overcompensated. Section IV explores the additional requirements imposed when the SGEI entrustment seriously distorts competition. Section V concludes.

It is submitted that the 2011’s SGEI Framework is in many ways a remarkable document for which the Commission should be commended. A number of provisions contained in the Framework give, however, rise to uncertainty in particular regarding the application of the “net avoided cost” methodology to assess the absence of overcompensation for SGEIs. In addition, linking public procurement with State aid control can lead to important practical difficulties, which will be discussed below. On the other hand, the emphasis placed by the Framework on efficiency is particularly welcome, especially at a time where public money is scarce given the imperative of fiscal discipline. As every new set of rules, the Framework should be applied with flexibility so as not to penalize SGEI providers. These undertakings

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should neither be advantaged nor penalized as if Member States expect them to deliver quality public services they must be viable in the long-run.

II. **Procedural conditions for compatibility of SGEI compensation**

The procedural conditions that an SGEI entrustment must satisfy in order to be declared compatible with Article 106(2) TFEU are laid out at paragraphs 12-20 of the Framework. The most important of these conditions are the existence of a genuine SGEI (sub-section A), the entrustment of the SGEI to one or several providers through a public “act” outlining the content of the SGEI and the compensation calculation mechanism (sub-section B), and the compliance with public procurement rules (sub-section C).

A. **Genuine SGEI**

The Member States possess wide discretion to define what an SGEI is on the basis of their specific social needs and their cultural and political traditions.\(^8\) This has been reaffirmed in the Treaty of Lisbon, for example, in Article 1 of the Protocol 26 to the TFEU.\(^9\) Notwithstanding this wide discretion, the Framework states that:

> “…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, by undertakings operating under normal market conditions”.

\(^{10}\)

Unless it is interpreted flexibly, this condition could arguably be seen as excessively limiting the Member States’ discretion to define what constitutes an SGEI on the basis of their particular situation and general interest needs. For instance, in the TV2 case, the applicants claimed that TV2 could not be recognised as a public service channel to the extent that there was nothing to distinguish its programming from that of commercial channels. The General Court (“GC”) considered that:

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\(^{9}\) Some authors interpreted the Treaty of Lisbon as reflecting an ongoing trend towards a more socially oriented Europe and a wider discretion of Member States to define what is an SGEI (S. Wernicke, ‘Taking Stock: The EU Institutions and Services of General Economic Interest’, in M. Krajewski/ U. Neergaard/ J. Van De Gronden (eds), *The Changing Legal Framework for Services of General Interest in Europe: Between Competition and Solidarity*, The Hague: TMC Asser, 2009, p. 79). Others, however, support the opposite position, i.e., that “the wording of the changes does not suggest in any way… a significant modification of the approach to SGEI under European law” (N. Fiedziuk, ‘Services of general economic interest and the Treaty of Lisbon: opening doors to a whole new approach or maintaining the status quo?’, *ELRev* 2011. 226-242, 242).

\(^{10}\) See Framework, para 13 (emphasis added).
“[t]o accept that argument and thereby to make the definition of the [...] SGEI dependent [...] on the range of programming offered by the commercial broadcasters would have the effect of depriving the Member States of their power to define the public service. In fact, the definition of the SGEI would depend, in the final analysis, on commercial operators and their decisions as to whether or not to broadcast certain programmes.”

It should be noted, however, that the control of the Commission will be “limited to checking whether the Member State’s definition is vitiated by a manifest error, unless provisions of Union law provide a stricter standard.”

B. **Entrustment Act specifying public service obligations and the compensation calculation mechanism**

Responsibility for the provision of an SGEI must be entrusted to an undertaking by way of one or more “entrustment acts”. The form of the entrustment act is determined freely by each Member State. Therefore, the type of entrustment act chosen and the procedure to adopt it do not (and should not) play a fundamental role in the assessment of compatibility of the SGEI entrustment.

What is more important than the *form* of the entrustment act is its *content*. Pursuant to the Framework, the act must at least specify (a) the content and duration of the public service obligations; (b) the undertaking and, where applicable, the territory concerned; (c) the nature of any exclusive or special rights assigned to the undertaking by the granting authority; (d) the description of the compensation mechanism and the parameters for calculating, monitoring and reviewing the compensation; and (e) the arrangements for avoiding and recovering any overcompensation. The Framework also provides that the duration of entrustment should not exceed the period required for the depreciation of the most significant assets required to provide the SGEI.

Although the form that an entrustment act is taking is left to the discretion of the Member State, the content of the entrustment act should be carefully reviewed by the public authorities providing compensation for SGEIs and the beneficiaries of that compensation. Failure to comply with the content requirements set out in the Framework could render

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13 For instance, an entrustment act can take one of the following forms: a concession contract or tender document; a ministerial programme contract; a ministerial instruction; a Law or Act; a yearly or multiannual performance contract; or a Legislative Decree and any kind of regulatory Decision. See Commission Staff Working Document, Guide to the application of the European Union rules on state aid, public procurement and the internal market to services of general economic interest, and in particular to social services of general interest, 07.12.2010, pp. 38-39.
14 See Framework, para 16 and Communication, para 52.
15 See Framework, para 17.
otherwise justified compensation (corresponding to the net cost of providing the SGEI) illegal, and thus require recovery.

C. Compliance with EU public procurement rules

Pursuant to paragraph 19 of the new Framework,

“aid will be considered compatible with the internal market on the basis of Article 106(2) of the Treaty only where the responsible authority, when entrusting the provision of the service to the undertaking in question, has complied or commits to comply with the applicable Union rules in the area of public procurement”.\(^{16}\)

This is one of the most radical changes that the new Framework brings in relation to previously applicable rules. Through this provision, compliance with public procurement procedures seems to have become a condition *sine qua non* for the clearance of SGEI compensation.\(^{17}\) This provision came as a relative surprise to those who followed the consultation process for the new SGEI Framework.

The economic literature has indeed identified a number of reasons why public procurement procedures are not always the optimal solution for the entrustment of public services.\(^{18}\)

*First*, public procurement does not necessarily lead to the most efficient outcome due to information asymmetries, especially in SGEIs related to network industries. For instance, when the potential cost of supplying an SGEI in a given area is difficult to estimate, tenderers cannot participate in the tendering process with informed and realistic bids. In this case, there is a risk that the tender will be won by the tenderer with the most optimistic expectations

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\(^{16}\) Emphasis added.

\(^{17}\) Commissioner Almunia had provided several hints about linking State aid assessment with the public procurement requirement. However, at least in relation to tendering, he was always careful to highlight that it should be applied only when appropriate as it might not be suitable for all categories of SGEI entrustments. E.g., see SPEECH/11/901, Reform of the State aid rules for SGEI and decisions on WestLB, Bank of Ireland and France Telecom, 20.12.2011 (“Whenever possible, the SGEI should be entrusted through an open and transparent public tender”, emphasis added), SPEECH/11/385, An integrated approach to State aid, 26.05.2011 (“another idea would be mandating the use of tenders *in cases they don’t obstruct the performance of the service*”, emphasis added), SPEECH/11/328, Reform of EU State aid rules on the SGEIs, 12.05.2011 (“I also know that tendering can be a burden for public authorities and that *it would not work in all cases*. We need to look for a *balanced solution*…”, emphasis added) or SPEECH/11/300, Reforming EU State aid rules on public services: The way forward, 02.05.2011 (“Could we make compulsory a tender procedure… *when they do not obstruct the performance of the service?*”, emphasis added). It is not clear whether Commissioner Almunia’s caveated approach is fully reflected in paragraph 19.

regarding the likely costs, a problem known as the “winner’s curse”. Unless the public authority is willing to renegotiate (and thus pay more than initially agreed on), this problem may lead to financial difficulties for the SGEI provider combined with a drop in quality.

Second, public procurement processes might not necessarily result in the provision of SGEIs at the least cost to the community. In a tender, an efficient outcome will only materialise when each of the bidders perceive a real risk of losing the SGEI should they fail to bid at (or very near) their true expected valuation. However, if the likely costs of SGEI provision are significantly higher for new entrants (when, for instance, the sector is characterised by economies of scale or scope), the incumbent may use this opportunity to bid up the price of the entrustment and thus the costs of the provision of the SGEIs to the public authority.

Third, public procurement will not lead to the most efficient outcome when some or all the candidate SGEI providers are able (and willing) to engage in collusive conduct. Such practice effectively minimizes the competitive threat and leads the contracting authority to pay a higher amount of compensation. The risk of collusion is higher where there are few candidates, as is often the case in network industries, or where the design of the public procurement process enables participants to learn about the proposals of their competitors.

Unless paragraph 19 is interpreted flexibly, the all-encompassing requirement for application of public procurement procedures may lead to sub-optimal outcomes in some circumstances. From a legal point of view, it may also be argued that this paragraph is incompatible with the case law of the EU Courts (sub-section 1) and leads to a misuse of the enforcement procedures foreseen in the Treaty (sub-section 2).

1. Inconsistency with EU Courts case law

The Framework aims to better explain the “SGEI exception” contained in Article 106(2) TFEU, by elaborating how State aid rules apply to SGEI compensation. This logically means that the provisions of the former have to be fully aligned with the meaning of the latter as interpreted by the EU Courts. However, paragraph 19 appears to be inconsistent with the GC’s interpretation of Article 106(2), according to which this provision does not require compliance with public procurement rules as a condition for the compatibility of SGEI compensation with State aid law. In Olsen, the GC found that “it is not apparent either from the wording of Article [106(2) TFEU] or from the case law on that provision that an SGEI

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22 See Framework, para 7.
may be entrusted to an operator only as a result of a tendering procedure."\(^{23}\) This statement was subsequently repeated in the \textit{SIC} case, where the GC added that “absence of competitive tendering cannot […] have the result that State funding of the SGEI holder’s public service obligations must, even though the requirements concerning the definition of the SGEI, the remit and proportionality are fulfilled, be considered to be State aid incompatible with the common market.”\(^{24}\) Therefore, by linking State aid clearance with compliance with public procurement rules in every single SGEI entrustment, paragraph 19 of the Framework seems to be inconsistent with what is stipulated in the case law of the GC.

2. \textit{Misuse of the enforcement procedures foreseen in the Treaties}

An additional problem is that by requiring authorities to comply with the public procurement rules, the Commission is effectively enforcing public procurement rules via Article 108 TFEU (which provides for the enforcement of State aid rules). This is probably the case because Article 108 provides a much faster means to enforce public procurement rules than by taking action against Member States for failure to fulfill their obligations (Article 258 TFEU). Clearly, Article 108 confers extensive powers to the Commission and is a strong enforcement instrument in its hands. However, as pointed out by an observer, “using such powers as a ‘lever’ to enforce other [EU law] provisions of a different nature might perhaps be perceived as an abuse of power” and even “…raise delicate institutional issues”.\(^{25}\)

III. \textit{Economic condition for compatibility of SGEI compensation}

In addition to imposing a series of procedural conditions, the Framework then turns to its core economic principle, whereby the amount of compensation granted for a given SGEI “must not exceed what is necessary to cover the net cost of discharging the public service obligations, including a reasonable profit.”\(^{26}\)


\(^{25}\) J. L. Buendia Sierra, ‘Finding the Right Balance: State Aid and Services of General Economic Interest’ in \textit{EC State aid Law: Liber Amicorum in Honour Francisco Santaolalla}, Alphen aan den Rijn: Kluwerlaw, 2008, p. 191, 213. Note, however, that according to some precedents, the Commission cannot declare as compatible with the internal market, State aid whose application is indissociably linked with an infringement of a fundamental rule of EU law (Case 74/76, \textit{Ianelli} [1977] ECR 557, paras 9-14 and in the same vein, Case T-359/04, \textit{British Aggregates and Others v Commission} [2010] nyr, paras 90-91). Based on this, one might argue that SGEI compensation is indissociably linked with the procedure of selection of the SGEI provider. It is submitted, however, that the compatibility of SGEI compensation and the procedure of selection of the SGEI provider are two different matters and hence are not indissociably linked. While the former adopts a functional/substantive approach, emphasizing the existence of a selective advantage, the latter simply addresses the need to follow specific procedures (see C. Giolito, ‘La procédure de contrôle des aides d’Etat peut-elle être utilisée pour contrôler la bonne application d’autre dispositions de droit communautaire?’ in \textit{EC State aid Law: Liber Amicorum in Honour Francisco Santaolalla}, Alphen aan den Rijn: Kluwerlaw, 2008, p. 145, 159). Another such procedural requirement is prior notification under Article 108(3).

\(^{26}\) Para. 21.
The Framework provides guidance on the determination of the net cost (sub-section A) and the calculation of the reasonable profit (sub-section B). One of the fundamental objectives of the new Framework being to encourage the efficient provision of SGEI, the Framework allows the provider to capture part of the efficiency gains it realizes, by including them in the amount of compensation (sub-section C). The guidance of the Framework, albeit useful overall, is sometimes unclear and needs to be further qualified. Proposals in this direction are made below.

A. Determination of the net cost necessary to discharge SGEIs

1. Methodologies for net cost calculation

At paragraph 24, the Framework provides that

“the net cost necessary, or expected to be necessary, to discharge the public service obligations should be calculated where possible using the net avoided cost methodology, notably in sectors where this is requested by EU or national legislation.”

The net avoided cost methodology (“NAC”) calculates the net cost of an SGEI by comparing the net cost of the provider operating with the SGEI with a hypothetical (“counterfactual”) scenario, whereby the same provider operates without this obligation. While this methodology finds support in the economic literature, its practical implementation (given the Commission’s limited decisional practice and the absence of case law) raises a number of issues, which are discussed hereafter.

First, the definition of a realistic counterfactual scenario is not necessarily an easy task as it requires some complex determinations, regarding, for instance, the costs that are likely to be saved and the revenues that are likely to be lost should the operator no longer have to provide the SGEI. The complexity of such determinations depends on the circumstances of each case. In some instances, when a product or service is simply discontinued, the determination of cost savings and revenues losses may be relatively straightforward (although some complex evaluations will remain in the presence of common costs with other activities). In some other instances, such as, for instance, when the scale of the operator’s network is optimized

28 Note that the definition of NAC used in the Framework is not fully in line with the terminology used in economic literature. According to the latter, this methodology corresponds more to profitability cost rather than NAC (see C. Jaag/ M. Koller/ U. Trinkner, ‘Calculating the cost of the Universal Service Obligation: the need for a global approach’ in M. Crew/ P. Kleindöfer (eds), Progress in the Competitive Agenda in the Postal and Delivery Sector, Cheltenham/ Northampton: Edward Elgar, 2009, p. 113, 115).
(because an SGEI imposing territorial constraints are removed), such determinations may be quite complex.

Second, implementation of the NAC methodology raises important definitional issues. Paragraph 25, for instance, states that “[t]he net cost calculation should assess the benefits, including intangible benefits as far as possible, to the SGEI provider.” The terms “benefits” and “intangible benefits” remain, however, undefined. The Framework refers the reader to electronic communications and postal secondary legislation for further guidance on the net avoided cost methodology. But these instruments do not offer much additional clarity and do not even appear fully consistent with each other, for example, when it comes to the benefits that need to be taken into account in the net cost calculation. While Annex IV of the Electronic Communications Directive, refers to “benefits, including intangible benefits”, Annex I of the Postal Directive refers to “any intangible and market benefits which accrue to a postal service provider designated to provide universal service”.30

The notion of benefits could be either interpreted broadly (including all benefits enjoyed by the SGEI provider including those resulting from the exclusive rights it enjoyed in the past or the dominant position it retains) or strictly (including benefits enjoyed by the SGEI provider as a direct result of the provision of the specific SGEI). The latter definition is certainly to be preferred as it is in line with Guidelines issued by the Commission to National Regulatory Authorities (“NRAs”) in other sectors.31 It is also sustained in a recent study commissioned by the ARCEP (French Communications NRA), which states that: “… the intangible benefits deriving from the [SGEI] should also be distinguished from other benefits that the incumbent might enjoy, but which do not have as source the [SGEI] itself (for instance, the benefits related to the fact that [the SGEI provider] is the strongest player in the market…).”32

Third, the Framework states at paragraph 25 that:

“Although the Commission regards the net avoided cost methodology as the most accurate method for determining the cost of a public service obligation, there may be

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31 Communication COM (1996) 608, Assessment criteria for National Schemas for Costing and Financing of Universal Service in Telecommunications and Guidelines for Member States on Operation of such Schemas, 27.11.1996, p. 11: “When calculating net cost a quantification of the intangible benefits of being a universal service provider should be added on the benefit side”.
cases where the use of that methodology is not feasible or appropriate. In such cases, where duly justified, the Commission can accept alternative methods for calculating the net cost necessary to discharge the public service obligations, such as the methodology based on cost allocation.”

This paragraph raises two questions. The first relates to the circumstances where the Commission will be willing to consider that the use of the NAC methodology “is not feasible or appropriate” and thus where reliance on “alternative methods” may be “duly justified”. It is submitted that paragraph 25 should be interpreted flexibly, especially at a time when the Commission does not yet have much experience on the application of this methodology. In this respect, it is interesting to note that the Commission recently commissioned a study “on the principles used to calculate the net costs of the postal universal service obligation.”

According to its terms of references, this study should aim to:

“assess the important empirical and theoretical approaches that have been conducted to date on the calculation of the net cost of the universal service provision in the postal sector. The resulting analysis should shed light on the critical assumptions those approaches rest upon, as well as on the trade-offs they involve. The study will also elaborate on the data requirements of each approach and on the relevance of each methodology with respect to Member State specificities, according to criteria that will be set in advance and based on thorough desk research analysis.”

This raises the issue of whether the Commission is ready to apply the NAC methodology at this stage. Clearly, it is important for the Commission to start developing its decisional practice on this methodology, but on the other hand, it would be unfair to treat beneficiaries of SGEI compensation as “guinea pigs” in the (likely) case the Commission is not yet entirely ready to apply this methodology.

The second question relates to what “alternative methods” should be used when recourse to such methods is “duly justified”. The Commission refers to “cost allocation” methodologies as an alternative, whereby “the net cost necessary to discharge the public service obligations can be calculated as the difference between the costs and the revenues for a designated provider of fulfilling the public service obligations, as specified and estimated in the entrustment act.”

Cost allocation methods, such as Fully Distributed Cost (“FDC”), allocate costs down to product and regulatory categories using fact-based drivers, such as volume and time. Hence, their proper application is objective and straightforward. The clarity

33 For instance, DG Internal Market has contracted Frontier Economics to prepare a study on the interpretation of Annex I of the Postal Directive (MARKT/2011/096/E). The study is expected in September 2012. In addition, the European Regulators Group for Postal Services (“ERGP”) has prepared a draft report on the evaluation of the counterfactual scenarios which was open to public consultation (Report (11)(17), on net cost calculation and evaluation of a reference scenario, available at http://ec.europa.eu/internal_market/ergp/docs/documentation/ergp-net-cost-calculator_en.pdf). ERGP operates in close cooperation with DG Internal Market of the Commission.

in the application of FDC methodology makes it also easier to control by the NRA. In addition, cost allocation methods are well tested as they have been the ones traditionally applied to define the costs of SGEIs.

One final observation relates to the “legacy costs” that are often crippling incumbent SGEI providers. Legacy costs, for instance, relate to the statutory personnel that such providers may have inherited from the monopoly period. The conditions of employment of this personnel are usually quite rigid and thus constitute a heavy burden upon incumbents, especially in sectors where labour costs represent the main costs of the SGEI provider. It is not certain that NAC can deal with these costs. The problem is that the “avoided cost” standard at the core of this methodology is stringent. In economic terms, “avoidable costs” essentially consist of variable costs, as it is often only variable costs that can be avoided, while the cost of the statutory personnel is fixed (as this personnel typically cannot be dismissed). As “legacy costs” should be considered by the Commission (because the goal of State aid control is not to penalize the recipient of the public compensation, but create a level playing field), ad hoc solutions may be needed if such costs cannot be taken into account as part of the NAC methodology.

2. **Provisions for SGEI providers that discharge several SGEIs or carry out other activities outside the scope of SGEI**

In a separate section, the Framework deals with the key issue of whether profits achieved by the provider of a given SGEI from activities outside the scope of that SGEI should be allocated in whole or part to the financing of the SGEI in question, pursuant to what can be called an “offsetting” approach.

The “offsetting” approach was much more pronounced in the Draft Framework of September 2011. Examples of this approach could then be found in paragraphs 30, 42, 43 and 51(c).\(^{35}\) Although the Commission must be commended for reducing the instances of “offsetting” in the final text, paragraphs 45 and 46 still refer to this approach, providing the following:

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45. If the undertaking in question holds special or exclusive rights linked to activities, other than the SGEI for which aid is granted, that generate profits in excess of the reasonable profit, or benefits from other advantages granted by the State, these must be taken into consideration […] and added to the undertaking's revenue […].

46. The Member State may decide that the profits accruing from other activities outside the scope of the SGEI, in particular those activities which rely on the
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infrastructure necessary to provide the SGEI, must be allocated in whole or in part to the financing of the SGEI.”

The “offsetting” approach raises both questions of interpretation and of principle, which will be successively addressed below.

Questions of interpretation come up in relation to paragraph 45, which requires that when a provider holds special or exclusive rights or benefits from other advantages, these must be added to the revenue of an SGEI provider. However, the phrase “benefits from other advantages” is entirely open-ended (as the term “advantages” is very broad) and makes operators vulnerable to offsetting. This reference seems also (partly) redundant considering that paragraph 25 provides that the “net cost calculation should assess the benefits… to the SGEI provider.” It is, however, not clear whether the terms “benefit” and “advantage” are used with the same meaning in both provisions, or whether they have a broader scope in paragraph 45.

Questions of principle are even more important. The “offsetting” approach in both paragraphs 45 and 46 raises issues of fairness and non-discrimination. For example, through “offsetting”, the Commission effectively equates (excess) profits gained by users to public compensation, by adding up the two in the context of State aid control. However, should the Commission take a negative decision (estimating that the sum of the compensation plus the profits in question exceeds the cost for the provision of the SGEI), the State would end up recovering amounts which are not directly funded by it. In addition, a broad application of the “offsetting” approach could be discriminatory in that it favours operators which only provide one SGEI against those who are entrusted with the very same SGEI but also provide other SGEIs or have universal service obligations (“USO”). For the same SGEI, the former would receive full compensation, while the latter’s compensation would be subject to offsetting.

The above criticism applies to both paragraphs 45 and 46. However, the “offsetting” described in paragraph 46 appears particularly unreasonable (even if its application is left at the discretion of the Member States). In that context, “offsetting” means forcing an SGEI provider to fund the cost of the SGEI in question through profits made on competitive services. This can hardly be accepted. Once services are open to competition, SGEI providers should not see the profits they achieved “on the merits” being expropriated to fund SGEIs. Moreover, it is difficult to reconcile the “offsetting” principle in paragraph 46 with the emphasis that the Commission places on efficiency. A broad application of the “offsetting” principle would mean that profits achieved through efficient performance would be unfairly taken away and used to subsidize SGEIs. This disincentivizes SGEI providers from introducing efficiency-enhancing mechanisms and realizing productivity improvements since

36 Offsetting related to special or exclusive rights (para 45) seems less unreasonable. Profits and benefits linked to such rights can be considered as monopoly profits.
37 This is emphasis is also clearly pronounced by the Framework, as it will be discussed in Section III.C infra.
the profits they may realize as a result of such efforts may be subsequently confiscated by the State.

B. Calculation of Reasonable Profit

1. Reasonable profit on the basis of the risk level and introduction of safe harbour

In order to decide whether the compensation granted to an undertaking leads to overcompensation, the Commission takes into account not only the net costs of the SGEI provider, but also the “reasonable profit” to which it is entitled. In order to reduce uncertainty, the Framework introduced a safe harbour, below which the profit of an SGEI provider is always reasonable. This is the case, when the profit margin does not exceed the relevant swap rate plus a premium of 100 basis points (1%).

This margin can be increased, in view of risks borne by the SGEI provider. Three broad categories of risks are distinguished in the Framework: sector-specific; service-related; and compensation-mechanism-related risks. It is then left to the Commission’s and the Member States’ discretion to further detail these types of risk, in the context of each case. A table with examples of indicative risks that an SGEI provider might face is included below.

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<thead>
<tr>
<th>Risk Type (Framework)</th>
<th>Examples</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td><strong>Sector-specific Risks</strong></td>
<td>Volume Risk</td>
<td>Some SGEI providers may be active in sectors which face structural decline, leading to significant volume decreases (e.g., postal sector, certain types of transport services, etc.)</td>
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<td></td>
<td>Pricing Risk</td>
<td>Some SGEI providers are subject to tariff regulations (e.g., price caps), which prevent them from fully passing-through input cost increases (e.g., oil price, salary inflation)</td>
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<td></td>
<td>Regulatory Risk</td>
<td>SGEI providers may face uncertainty as regards their long-term profitability, because legislators at EU or national level could review the existing regulations and/or regulators (NRA) could adapt their policies or implementation strategies.</td>
</tr>
<tr>
<td><strong>Service-related Risks</strong></td>
<td>Operational Risk</td>
<td>SGEI providers may be subject to strict performance standards and quality penalties, which creates significant operational risks.</td>
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<tr>
<td></td>
<td>Investment Risk</td>
<td>SGEI providers will often need to continuously implement major restructuring</td>
</tr>
</tbody>
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38 *See* Framework, para 37.
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<th>Risk Type (Framework)</th>
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<tr>
<td>Compensation</td>
<td>Fixed Lump Sum Risk</td>
<td>Some SGEI providers bear the risk of cost overruns and/or revenue shortfalls, when the compensation for SGEIs takes the form of a fixed lump sum payment covering expected net cost without <em>ex post</em> correction.</td>
</tr>
<tr>
<td></td>
<td>Limited Duration Risk</td>
<td>SGEI providers typically face the risk that the entrustment might not be renewed at the end of the entrustment period. If so, they would suffer from winding down costs (e.g., redundancies) or be left with assets not being fully depreciated (e.g., new investment in infrastructure with long payback period).</td>
</tr>
<tr>
<td></td>
<td>Counter-party Risk</td>
<td>Some SGEI providers receive funding (compensation or other revenue) by counter-parties (e.g., State, suppliers, customers) who could potentially default on their obligations.</td>
</tr>
</tbody>
</table>

The reasonable profit rate that results from the above assessment should then be compared with the rate of return that is achieved on similar types of SGEI entrustments awarded under competitive conditions (for example, contracts awarded under a tender).\(^{39}\) Where it is not possible to calculate the risks or benchmark against similar types of entrustment, other methods can be used, such as benchmarking against the weighted average cost of capital (“WACC”) of the SGEI provider in relation to the SGEI or with the average return for the sector in recent years.\(^{40}\)

2. *Reasonable Profit Level Indicators*

A positive aspect of the Framework is that it acknowledges that various categories of “rates of return” can be taken into account for reasonable profit. While it considers the rate of return on Capital (ROC) as the “default” indicator for the calculation of reasonable profit, Member States are also enabled to apply other indicators, such as return on Sales (ROS), average return on Equity (ROE), return on Assets (ROA), etc. Regrettably, the safe harbour and benchmarking rules mentioned above only apply when the ROC indicator is used, while there

\(^{39}\) *Ibid.*

\(^{40}\) *Ibid.*, p. 19, fn. 3. In the latter case, it should be taken into account whether historical data can be appropriate for forward-looking purposes.
is no such provision in relation to the other indicators. This omission effectively discriminates against non-capital intensive sectors where the ROC indicator is not commonly used.

C. Efficiency and Quality and their impact on Compensation Calculation

Under the 2005 Framework, compensation to an SGEI provider could cover all the costs incurred for the provision of the services in question plus a reasonable profit, regardless how efficient the provider was. Some of the costs compensated by Member States to SGEI providers could thus be resulting from the provider’s inefficiency, which leads to considerable waste of public money.

To address this issue, the draft Framework placed a strong emphasis on efficiency. This approach was heavily criticized by some Member States, such as France, which argued that the Commission cannot “[set] itself up as judge of the efficiency of public spending.”\(^{41}\) France held that the insertion of efficiency as one of the criteria in the Framework is contrary to the case law of EU Courts.\(^{42}\) Moreover, Germany pointed out that efficiency is the object of the 4th Altmark criterion, and added that by inserting efficiency criteria in the Framework, the Commission was effectively transforming a condition to determine whether compensation amounted to State aid into a compatibility condition.\(^{43}\)

Notwithstanding these reactions, the final version of the SGEI Framework still emphasizes the importance for Member States to promote efficiency in devising SGEI compensation mechanisms. Paragraph 39 states that:

“In devising the 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.”

I. Designation of Efficiency Incentives


\(^{42}\) See Joined Cases T-568, 573/08, M6 and TF1 v. Commission [2010] nyr, paras 139-141, where the GC found that “in the absence – as in the present case – of harmonised Community regulations on the matter, the Commission is not authorised to rule on the scope of public service tasks incumbent upon the public operator – namely […] the economic efficiency of the public operator […]. In any event, economic efficiency is of no relevance in assessing the compatibility of the financial endowment with the common market under the terms of Article [106] paragraph 2 [TFEU]”. Appeal against this judgment was rejected by an Order of the Court (Case C-451/10, M6 and TF1 v. Commission [2011], nyr).

Pursuant to paragraph 40, efficiency incentives can be designed in different ways to best suit the specificity of each case or sector. The Framework indicates two possible mechanisms that can be put in place to boost efficiency and provide incentives to SGEI providers. First, Member States can define upfront a fixed compensation level which anticipates and incorporates the efficiency gains that the undertaking is expected to make over the lifetime of the entrustment act. Second, Member States can define efficiency targets in the entrustment act and make the level of compensation dependent upon the extent to which the targets have been met. If the undertaking does not meet these objectives, the compensation should be reduced. By contrast, if the undertaking exceeds the objectives, the compensation should be increased.

Irrespective of which mechanism is applied by the Member State in each case, the following basic principles should also be taken into account when granting efficiency incentives:

- All mechanisms for incentivising efficiency improvements must be based on objective and measurable criteria set out in the entrustment act and be subject to a transparent ex post assessment carried out by an entity independent from the SGEI provider.\(^4^4\)

- Rewards linked to 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. “Balanced” sharing of efficiency gains can take various forms, as shown in the Table below. All the mechanisms described in the Table are acceptable under the Framework but each offers efficiency incentives of different intensity to the SGEI provider.

<table>
<thead>
<tr>
<th>Efficiency Incentives</th>
<th>Sharing Mechanism</th>
<th>Description</th>
</tr>
</thead>
</table>
| **High** High         | ‘Floor’ Mechanism | - Efficiency gains above the pre-defined threshold are captured by the SGEI provider.  
- The incentive to attain and exceed the threshold is, hence, very high. |

\(^{44}\) *Ibid.*, paras 42. The effect of exogenous factors on which the SGEI provider has little or no influence should be neutralized. For instance, when calculating efficiency gains, the Member State should not take into account the effect of inflation or volume variations. More generally, variations in the volume of any product offered by the SGEI provider should be excluded, because they influence the allocation of common fixed costs and indirect costs shared by the SGEI and the other products.

\(^{45}\) The graphs refer to a 5-year entrustment period. Coloured in black is the part of efficiency gains captured by the SGEI provider, while in coloured in grey is the part captured by the Member State.
<table>
<thead>
<tr>
<th>Efficiency Incentives</th>
<th>Sharing Mechanism</th>
<th>Description</th>
<th>Graphical Representation</th>
</tr>
</thead>
</table>
| High                  | Percentage Sharing Mechanism | • Efficiency gains are shared between the SGEI provider and the Member State following a pre-defined allocation key.  
• Sharing does not need to be in equal parts (50%) to be “balanced”. What is more important is that the efficiency gains captured by the SGEI provider represent a considerable percentage of its EBIT, otherwise, the mechanism will not provide real incentives. | ![Graphical Representation](image1) |
| Low                   | ‘Cap’ Mechanism    | • Efficiency gains captured by the SGEI provider are capped so that the total profit (reasonable profit entitlement + efficiency gains) does not exceed a certain pre-defined threshold. Profits above that threshold are captured by the Member State.  
• A similar mechanism has been accepted in the Commission’s decisional practice. | ![Graphical Representation](image2) |

2. **Quality**

In the course of the public consultation, some Member States, such as Belgium, pointed out that an excessive focus on efficiency could potentially harm the quality of SGEI offered. In relation to this, the Framework explicitly mentions that “Member States must introduce incentives for the efficient provision of SGEI of a high standard” and that “efficiency should be achieved without prejudice to the quality of the service provided and should meet the standards laid down in Union legislation.”

### III. Additional requirements for SGEI entrustments that create serious distortions

Fulfilling the procedural and economic conditions described above is generally sufficient to ensure that the SGEI entrustment and compensation, even if it constitutes State aid, does not distort competition and can be thus cleared by the Commission. However, the Framework provides that there might be exceptional circumstances in which the compensation can

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46 Earnings Before Interest and Taxes.  
49 See Framework, paras 39, 43.
generate “more serious competition distortions in the internal market.” To mitigate such distortions, the Commission is enabled to impose additional conditions or commitments for the compatibility of the aid.\footnote{Framework, paras 51-53.}

The part of the Framework dealing with “serious distortions” used to be very problematic in the draft Framework published in September 2011. It then included two long “checklists”: one with categories of serious distortions of competition and one with possible commitments, from which the Commission could freely mix and match. Responding to criticisms received in the public consultation process, the Commission reduced the length and the scope of this section and structured it in a different fashion. The Framework now identifies categories of serious distortions and matches them with specific types of commitments that the Commission can require. Although the final version of this section is better than the September version, it still contains certain problems, which are highlighted below.

\textit{First}, some categories of serious distortions seem to be already covered in other provisions of the Framework. For instance, the Framework finds that competition can be seriously distorted “when the entrustment… has a duration which cannot be justified by reference to objective criteria, such as the need to amortise non-transferable fixed assets”\footnote{Ibid., para 55.} or where the entrustment concerns an SGEI “in a non-reserved market where very similar services are already being provided or can be expected to be provided”.\footnote{Ibid., para 56.} None of this language seems strictly necessary. Paragraph 17 already clarifies that the entrustment duration should be objectively justified (even making reference to amortisation), while paragraph 13 mentions that a State cannot entrust as SGEIs services that are already provided or can be provided under normal market conditions.

\textit{Second}, there are also categories of serious distortions that are extremely broad and open-ended. For example, “the aid [which] allows the undertaking to finance the creation or use of infrastructure that is not replicable” can qualify as a serious distortion of competition. This wording is so overbroad that it can literally catch any SGEI entrustment in a network industry, given that the “use of infrastructure” is inextricably linked to the provision of an SGEI in these industries. Moreover, it is not clear that this language adds much to what can already be achieved under Article 102 TFEU through the “essential facilities” doctrine,\footnote{Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, [2009] OJ C45/7-20, paras 83-84, with references to the EU Courts. Several references to case law on the matter are included therein} although the Commission may use the need for the Member State to obtain clearance under State aid rules to force an access obligation.
IV. Conclusions

The Commission Framework for State aid in the form of public service compensation is in many ways a remarkable document for which the Commission should be commended. A number of provisions contained in the Framework give, however, rise to uncertainty in particular regarding the application of the “net avoided cost” methodology, which should now normally be used to assess the absence of overcompensation for SGEIs. In addition, linking public procurement with State aid control can lead to important practical difficulties. On the other hand, the emphasis placed by the Framework on efficiency is particularly welcome, especially at a time where public money is scarce given the imperative of fiscal discipline. Member States should thus ensure that SGEIs are effectively delivered and that they get value for their money. As every new set of rules, the Framework should be applied with flexibility. These undertakings should neither advantaged not penalized as if Member States expect them to deliver quality public services they must be viable in the long-run.