

BROADBAND PROJECTS: STATE AID ISSUES

Headline Points

- State aid issues can arise when the public sector provides support for broadband roll-out.
- There are no quick fixes. Consider state aid issues early when designing an intervention.
- Running an open tender competition or procurement exercise does not guarantee that an intervention is free of state aid.
- The European Commission is willing to approve public sector support for broadband roll-out but will consider the position of potentially affected third-parties.
- Allow sufficient time for Commission approval procedures.
- Schemes which closely follow existing approvals are likely to be authorised more quickly. Greater complexity or novelty will entail delay.
- Take care with aggregation. Excessively long contracts that remove demand from markets for long periods may give rise to concerns. Be careful with contracts which link aggregation and the creation of new networks.
- If new infrastructure is established by a network operator to facilitate the provision of a public service contract consider whether there is residual value in the assets at the end of the contract.
- If making an investment in publicly owned infrastructure consider whether the rate of return is one which would be accepted by a market investor.
- Consider mechanisms which ensure that suppliers do not make excess profits.
- Offering broadband services to third-parties outside the public sector is an economic activity and also gives rise to potential state aid issues.

Introduction

1. This paper considers the state aid issues surrounding funding broadband projects. The advice represents the DTI State Aid Policy Branch's assessment as at April 2004 reflecting the European Court of Justice's decision in the Altmark case and the Commission's approval of Project Access¹. Other UK Broadband cases are currently before the Commission and further policy developments from the Commission on SGEI are in progress². The European Court of Justice also continues to make new decision in this field. **It is important therefore when considering a broadband project you that you check with DTI State Aid Policy Branch for the latest guidance (contact details are in paragraph 47).**

¹ http://europa.eu.int/comm/secretariat_general/sgb/state_aids/comp-2003/n282-03.pdf

² See Commission Press Notice IP/04/235 18 February 2004 at <http://europa.eu.int/rapid/start/cgi/guesten.ksh>. Also a draft decision and directive on the "Operation of services of general economic interest" at http://www.europa.eu.int/comm/competition/state_aid/others/

2. The guidance³ issued by the UK Broadband Task Force has made clear from the outset that state aid issues can arise where the public sector intervenes in the market to support the provision of broadband. The competition provisions of the EC Treaty control the provision of state aid. Article 87(1) makes all state aid unlawful unless it is paid in accordance with a block exemption or a Commission approval. The state aid assessment needs to be done in the light of the circumstances of the specific case. As regions are free to design their interventions themselves (within the constraints imposed by the state aid controls) it is unlikely that the specifics of one case, or indeed Commission decision, will exactly match those of another. Precedents both favourable and otherwise therefore need to be treated with caution.

3. In some cases it will be clear whether or not state aid is present. In others, where matters are less clear cut, various factors, as outlined in this paper, will need to be weighed in coming to an assessment. Where the position is uncertain the appropriate course will be to notify, particularly if the likelihood of challenge, either through the Courts or from the Commission seems probable. If however there are reasonable grounds for believing a scheme does not involve aid, and the risk of challenge seems low, notification is unlikely to be necessary. It is always best to consider state aid early when designing a project.

4. When assessing state aid in Broadband projects it is necessary to consider whether aid exists to the service provider and to end-users. Aid can potentially arise at either or both levels even where a measure is targeted solely at one tier. If other intermediaries are involved in delivery then their position also needs to be assessed. Potentially there may be separate entities acting as dark-fibre owners, telecommunications supplies, internet service providers and end users. There are considerable advantages in keeping scheme structures as simple as possible. Increased complexity will make the position less clear-cut and protract the assessment if the scheme is considered by the Commission.

5. If aid appears to be present it is essential to ensure state aid cover is secured either through notification, through an existing approved aid scheme or under a Block Exemption. The remainder of this paper looks at factors indicating the existence of aid, or otherwise, and the avenues for ensuring legality.

What is a State Aid?

6. State aid is funding from any level of Government or a public body, including Regional Development Agencies and Regional Aggregation Bodies, which meets all four of the following tests:

by with or from state resources

favouring a particular undertaking or the production of certain goods

distorting or threatening to distort competition

affecting intra-community trade.

7. Before considering these tests it is also necessary to assess whether the beneficiary is an “undertaking”. Undertakings are taken to be entities which are engaged in an economic activity. Typically this would not include private citizens, schools, police authorities, GP surgeries and local authorities (except where they are offering commercial services). Conversely most SMEs and large firms will clearly constitute “undertakings”. The position of charities and other non-profit making corporations has to be assessed on their individual circumstances. The mere fact that a body is non profit making does not necessarily mean that it will not be an undertaking

³ http://www.broadband.gov.uk/html/ukbroadband_task_force/Final%20Guidance.pdf

for the purposes of the State aid rules. RDAs and Broadband Regional Aggregation Bodies are not undertakings except to the extent that they offer commercial services (e.g. acting as landlords or sellers of broadband services) in which case that part of their activities will constitute those of an undertaking.

8. Court juris-prudence and Commission practice establish that the four tests in paragraph 6 are easily satisfied. State resources include any public sector moneys and also includes private sector moneys, the dispersal of which is within the control (either complete or partial) of publicly appointed persons. Measures which target particular geographic areas (eg. county, parish or region), industrial sector, or category of undertaking (eg. solely SMEs) are regarded as being “selective” and as fulfilling the second criterion. The third and fourth criteria are deemed to be met in almost all instances as the vast majority of goods and services are tradable and therefore competition is deemed to be either affected or potentially affected. Telecommunications is obviously a sector in which international trade occurs.

9. In general the state aid rules facilitate the provision of aid more easily to SME end users than to large firms. The more difficult issue of the handling aid to large firms is therefore considered first.

The Position of Broadband Service Providers and Network Operators

10. In considering whether or not there is state aid to a service provider or contracting party various factors need to be considered to identify whether state aid exists, and if so whether it can be eliminated. Factors to be considered include issues surrounding procurement, publicly funded infrastructure, regional aid, and whether a scheme might qualify as a “service of general economic interest”. There are also issues arising in the context of public sector demand aggregation.

Commission Approach

11. In assessing whether public sector support for the establishment of a broadband network represents state aid the Commission follows a several step analysis. The first issue it considers is whether a project represents publicly owned infrastructure which is open to all. The creation of such infrastructure does not give rise to state aid issues because it is a common facility, such as a road or a bridge, which is not for the specific benefit of certain undertakings.

12. Although the European Treaty and the Commission maintain neutrality over issues of ownership broadband projects where the assets remain in public ownership are less likely to arouse state aid suspicions than those involving privately owned assets. This is because in the latter case privately owned assets are at the disposal of a commercial undertaking and may be applied elsewhere. Whilst an undertaking is capable of receiving state aid even if it is in public ownership the material issue is whether it engages in economic activity. It may in some instances, for example through provisions in the Articles of Association of the undertaking, it may be possible to so constrain the functions of the publicly owned undertaking for its activities not to amount to economic activities.

13. The funding, in whole or in part by the public sector, of the capital assets of a private sector entity clearly raises potential state aid issues. In these circumstances the Commission will move to the next stage of its analysis and consider whether the public sector support can be regarded as not amounting to state aid on grounds that it represents a market economy investment. Under the “market economy investor principle” it is possible for the public sector to make investments, such as capital injections, in private sector undertakings, without them amounting to state aid, on the basis that a rational market investor would make such an investment on the same terms. The risks and benefits to the public sector body making the investment should be exactly proportionate, relative to other investors, for there to be no aid. Thus an arrangement where the public sector

invests 30% of the capital but gets only 20% of any return would not be MEIP compliant. Additionally the Commission is very unlikely to accept 100% public sector funding as being MEIP compliant. The MEIP approach can usually only be sustained where there is private sector co-investment which represents a substantial proportion of the project.

14. Another factor to be considered when considering whether an investment which might be argued as being MEIP compliant is whether the rate of return on the investment would be acceptable to a market investor. A low rate of return that might be accepted by the public sector may not be acceptable to a private sector investor. Where the publicly infrastructure is being established, in possible competition with privately financed infrastructure, the Commission is unlikely to accept that the investment is MEIP compliant where a commercial rate of return is not being achieved. There are no hard and fast figures on acceptable rates. In comparable utility type investments, perhaps involving asset lives of 20 years, it is thought the Commission might regard 8% as an acceptable rate of return.

15. In the event that a project represents neither infrastructure nor an MEIP investment then the Commission will move to assess whether the proposed measure represents aid which is approvable on the basis that it does not adversely affect trading conditions to an extent contrary to the common interest. In assessing whether this is the case the Commission will consider a number of factors such as the use of procurement procedures and, if there are competing privately owned assets, whether such asset owners are given an opportunity to participate.

Procurement

16. The UK's view is that a contract for services between a state body and the private sector at a normal commercial rate should not be regarded as involving aid. Where the normal procurement processes have been followed, and where the best value for money (or "most economically advantageous") tender has been accepted there should be no aid. The contractor supplies the goods or services for a market price and no question of over-remuneration should arise.

17. This approach is supported by the case law in the European Court of Justice (ECJ), e.g. ADBHU (Case C-240/83). The absence of state aid is clear where, for example, the state tenders for cleaning services for its offices. The Commission does not however always share this view. In the past, it has advanced the argument that a distinction should be drawn between the purchase of services for the private use of the state and the purchase of services for the public. More recently the ECJ in the Altmark case (Case C-280/00 described in paragraph 35 below) set out four tests which establish the circumstances where a public service contract does not amount to aid because no benefit is conferred. Instances where a public service obligation exists, but the four tests are not fulfilled, may contain aid and therefore need to be notified to the Commission.

18. It is very important to distinguish between a contract for goods or services and a competition for subsidy. In the former case the public sector will require the provision of the goods or services. In the latter the public sector is providing assistance to an operator. The concept of a "competition for subsidy" is not a Commission term of art but is used here to describe a situation where a public authority seeks to get bids to take a development project forward where the winner is the undertaking offering to do the most and represents the best value for money. Where a procurement or tendering process has been followed in the former instance there should be no aid but in the latter aid will be present, but will be demonstrably the minimum necessary to secure the project. Cases involving competition for subsidy are likely to require Commission approval.

19. It is not always easy to distinguish between a procurement and a competition for subsidy. In the case of the public sector requiring, say the supply of paper cups, if the contractor winning the tender buys a new cup making machine, at the end of the contract it is the UK's view that no state aid would be conferred, even though the cup manufacturer remains free to use the equipment in

subsequent contracts. On the other hand the Commission, in the Access case, which involved the competitive procurement of a broadband network in Cumbria observed that the infrastructure necessary to deliver the service would remain in the ownership of the service provider upon termination and that the service provider would be able to exploit it subsequently. It concluded that the Access project, combined with the fact that it involved public sector demand aggregation (see paragraph 25 onwards), could confer an “advantage” to the service provider. The Commission may have come to this conclusion in the Access case because, although a service was being procured, a substantial amount of infrastructure, which could be exploited subsequently, was being created. Another factor may have been that the nature of the procurement in this instance was to create a new market in an area where there was no existing market.

20. It is worth noting however that Commission’s decision on the Access case did not categorically state that aid was conferred to the service provider, only that an advantage could be conferred by the project.

21. The UK’s view is that an advantage does not necessarily equate to an aid. Furthermore the Access decision concerned a case which combined both the requirement to establish a public network and public sector demand aggregation. It is not clear whether the Commission, if it had considered these aspects individually would have concluded that there was a potential for aid to arise. **The Commission’s overall finding in the Access case with regard to the service provider was only that “the Commission cannot exclude the existence of aid at the level of the service provider.” This contrasts with their firm finding of aid to end users considered in paragraphs 43 and 44 below.**

22. In order to separate contracts for services from competition for subsidy, public authorities should ensure that procurement notices in the *Official Journal* are carefully framed. It is also important to ensure that the invitation is couched in form capable of appealing to a sufficiently broad field of suppliers.

23. Potential means of distinguishing a procurement of services from a competition for subsidy might be to provide that if the contractor establishes capital assets as a result of winning the contract, which have a productive life after the contract has ceased, that the contract price should duly net off their worth at the end of the contract. This would, for example, distinguish a project from the Access case which did not so provide.

24. The Access case also gives rise to some points concerning the “negotiated procedure” which are detailed in paragraph 38 below.

Aggregation

25. **The UK is of the view that where the public sector seeks to aggregate its demand for a particular good or service, which it wishes to procure, such action cannot of itself confer state aid on the winning tenderer, provided normal procurement processes are followed and the best value tender is selected.** Indeed it would be odd if demand aggregation led to greater likelihood of aid, not least as overall payment to an operator for aggregated service may be lower than the sum of a series of contracts let piecemeal. In any event, the size of the requirement per se is not a determinant of the existence of aid.

26. As indicated above however, in the Access decision the Commission observed that, combined with the infrastructure remaining in the ownership of the service provider on termination, an “advantage” could be conferred through aggregation because a certain level of demand for broadband services would be confined to the service provider. A number of points therefore need to be watched to avoid aggregation amounting to aid within the meaning of Article 87(1).

27. Aggregation can potentially give rise to competition issues but these may not necessarily amount to state aid issues. First, for example, if a contract was abnormally large or long it may lock other players out of the market. Consideration therefore needs to be given to the scale of the project and the duration of service delivery. Clearly however any Government (or private) contract removes some demand from the market for a given length of time. Secondly, consideration should be given to the potential growth of the public service requirement during the contract and whether other service providers might be denied the opportunity to tender. The UK's view is that this is not a state aid matter, particularly where the supplier is not guaranteed a particular level of demand. The situation may be analogous to a framework contract (which could involve a single supplier) where the public sector can vary its demands during the lifetime of the agreement. However care needs to be taken to ensure competition in the market is not ossified, particularly in the case of long-term contracts.

28. Provided due care is taken demand aggregation projects should not confer state aid. It is also important to note that aggregation of demand need not mean aggregation of supply. It is for the public purchaser to take an informed and holistic view of the best approach depending on the requirement and the characteristics of the market concerned.

Avoidance of Excess Profits

29. A further step which can be taken to reduce the likelihood of aid being present is the incorporation of mechanisms providing for a reduction in the cost of service to the public sector where the winning tenderer succeeds in securing higher than expected sales to third parties.

Regional Aid

30. Where a project involving a large firm is located in an assisted area⁴ the Commission may consider the provision of capital subsidies approvable under the Regional Aid Guidelines. It should be noted however that the Assisted Areas map is not coterminous with the Structural Funds map and that regional aid must respect the relevant aid ceilings and eligible costs set out in the Guidelines and UK Assisted Areas Map approval. Structural funds, where used for business support, must also be spent in accordance with the state aid rules. Regional aid must be notified to and approved by the Commission unless awarded under an already approved scheme such as Regional Selective Assistance. If however a scheme involves solely structural funds, and is in an Assisted Area and meets the requirements of the *Guidelines on National Regional Aid*, then further Commission approval is usually unnecessary. A project involving capital investment by a SME is eligible for investment support regardless of location under the SME Block Exemption Regulation (70/2001/EC). Rates permissible vary from 7½% of eligible costs to 50%. For these purposes you must follow the European definition of an SME contained in Annex I of the regulation.⁵

31. The Commission issued a communication on the use of structural funds for electronic communications on 29 July 2003.⁶

32. Outside assisted areas it may still be possible to progress a broadband project in variety of manners. This might involve its definition either as a “service of general economic interest” or, as with Project Access, notifying and securing direct approval on the face of the Treaty.

⁴ Article 87(3)(a) or 87(3)(c)

⁵ See OJ L 10, 13.1.2001 as amended by OJ L 63, 28.2.2004.

⁶ http://www.europa.eu.int/comm/regional_policy/sources/docoffic/working/doc/telecom_en.pdf

Services of General Economic Interest

33. An SGEI is not defined in the Treaty and it is for individual Member States to determine what constitutes an SGEI, with the Commission and Courts only having a role in case of manifest error. In general an SGEI is a service which the market does not provide or does not provide to the extent or to the quality which the Government would like. It can be thought of as a service which an entity thinking only of its commercial interest would not undertake. An SGEI must also serve the generality of economic interest and not the interest of one particular group. This works best where broadband is being installed for schools, libraries or health centres. It would be difficult to say that installing broadband for a particular undertaking or for particular group of undertakings was an SGEI. An SGEI can be set by any level of Government (including RDAs and Local Authorities) but it must be clearly defined in advance and it must be entrusted to the undertaking carrying it out by means of a contract, legislation or Ministerial Direction.

34. Broadband in particular areas, remote or heavily rural areas for example, could be seen as an SGEI in that an undertaking thinking only of its commercial advantage would not provide this but the state at some level wishes it to be provided. However as noted above it would be difficult to justify installing broadband solely to help one undertaking or a group of undertakings, for example in a business park, as an SGEI. Care therefore needs to be taken to avoid competing head on with commercial services.

35. The state aid status of funding for SGEI has been clarified recently. Under a decision given in July 2003 (C-280/00 Altmark) the ECJ established that funding will not count as aid if it meets four strict conditions.

- the undertaking must actually have been given a public service obligation (SGEI) to perform and this must have been clearly defined in advance
- the parameters of the basis of which the compensation is calculated must be established in advance in an objective and transparent manner
- the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant receipts and a relevant profit
- where the undertaking is not chosen in a public procurement procedure, the level of compensation must be determined by comparison with an analysis of the costs which a typical undertaking in the same sector would incur.

36. If these very stringent tests are satisfied then there has been no advantage in state aid terms to the company aided and therefore the intervention is not caught by the rules. There is no requirement for prior notification and approval. The Commission has however opined that it expects that 95% of SGEI cases will not meet the Altmark criteria.

37. It is important however that the SGEI is defined in advance (post hoc justification will not suffice) and entrusted to an undertaking. This should be done in a transparent manner and made public – the Commission has in the past requested that a clear description of the SGEI is posted on a website. The actual costs of performing the service must be established in advance – this is why a clear definition of the service is extremely important. There is also the strong presumption that there will have been a tender process to determine the minimum support necessary. **The four Altmark tests are designed to be searching and need to be adhered to closely and you should consult DTI State Aid Branch in case of doubt.**

38. If a given broadband project involves the provision of a public service but does not meet the terms of the Altmark judgment it will need to be notified to and approved by the Commission in

the usual manner. In the Access case the Commission concluded that the use of “negotiated procedure” meant that the second condition of Altmark case was not met. The UK takes issue with this interpretation of the Court’s ruling in Altmark. In the UK’s view the Court’s ruling requires the parameters of the basis on which the compensation is calculated to be established in advance of the letting of the contract for the SGEI, not at the time of publication of the *Official Journal* notice. The negotiated procedure is permitted under the Services (Public Procurement) Directive and the UK’s view is that a properly operated negotiated procedure should not fail the second Altmark test. The ECJ has not examined this issue.

39. Additionally the Commission found in the Access case that “it cannot be excluded that compensation awarded eventually exceeds what is necessary” as the infrastructure would remain in the ownership of the service provider after the termination of the contract. This was not a categorical finding that the Access contract did confer aid, only that the Commission could not rule out that the compensation would not exceed what was necessary to cover all or part of the costs incurred in the discharge of the public service obligations. The UK’s view is that a clearly constructed service agreement, particularly one where the contractor rebated any residual asset value, would fulfil the Altmark criterion so that the intervention did not amount to aid.

Approval on the face of the Treaty

40. Where an intervention cannot be adapted to amount to “no aid” and is not compatible with the Regional Aid Guidelines or other state aid instrument, it may still be possible to secure approval from the Commission directly on the face of the Treaty. If possible this course should be regarded as a last resort as it will entail the work of preparing a notification and satisfying the Commission that the proposal is approvable. The Commission made a positive decision in the Access case on the basis of Article 87(3)(c) that the aid was proportionate to the objective and did not distort competition to an extent contrary to the common interest. Other cases are currently before the Commission on which the UK expects to secure approval.

41. In the Access case the Commission noted in particular:

- that an open and competitive tender procedure had been followed
- that a mechanism had been implemented to avoid over compensation to the service supplier
- that the service supplier was maintaining separate accounts for the service distinct from other activities so that there was accounting transparency
- the service provider was obliged to admit other operators on a non-discriminatory basis
- post termination of contract open access to the infrastructure would be maintained
- the project was technologically neutral
- that it was time limited to 3 years with a possible extension to 5.

42. These factors have to be regarded as indicative of factors which weighed in favour of Project Access helping establish its approvability directly on the face of the Treaty. It was also a project in a remote area with low population density with negligible existing broadband service provision. The absence or presence of such indicators should not be regarded as confirming whether a scheme is definitely likely to be approved by the Commission. Clearly however the presence of more such factors, or indeed the inclusion of others, increases the likelihood of Commission approval.

Aid to End Users

43. If the end users of a supported broadband project are undertaking any action which reduces costs to them may potentially be aid. In the Access decision the Commission noted that the prices paid by end users were capped at rates equivalent to British Telecom's retail rate in competitive metropolitan areas. **The Commission in the Access case concluded that there was state aid at the level of the end-user enterprises.**

44. It arrived at this assessment on the basis that the cost of service provision to the end-users would, in the absence of the public sector having facilitated the project, in all probability exceeded the rates available in Metropolitan areas. It also considered that the end users were getting an advantage through earlier access to Broadband services than would be the case if the market had been left to itself. The United Kingdom thinks these findings are moot. Furthermore such benefit to the extent that it is quantifiable at all is exceedingly unlikely to amount to more than €100,000 worth of assistance to any particular concern in a three year period. Assuming such a concern was not in receipt of other *de minimis* aid such assistance falls comfortably within the scope of the *de minimis aid* Regulation 69/2001/EC which declares such sums as falling below the amounts caught by Article 87(1). The UK also believes that the issue of aid to end users can also be mitigated by not imposing a price cap and allowing the service provider to determine the rates charged to end users.

Conclusion

45. As indicated in the introduction every case of public sector intervention in the Broadband sector needs to be considered both from a state aid perspective and for compliance with the procurement rules.

46. Advice on procurement be obtained from the Office of Government Commerce www.ogc.gov.uk.

47. Advice on state aid can be obtained from DTI State Aid Branch by e-mail: sapu@dti.gsi.gov.uk or by consulting <http://www.dti.gov.uk/europe/stateaid>. **In accordance with Cabinet Office instructions any public authority who considers that notification may be required must submit details of their scheme to State Aid Branch so that a notification can be prepared and submitted formally on behalf of the UK.**

48. For a case which may or may not involve state aid you need to consider the risk of challenge and the inconvenience and embarrassment if the Commission or domestic courts issue a suspension injunction. Telecommunications remains a highly competitive area and consideration needs to be given to whom the potential challengers might be. In the absence of Commission approval a view also needs to be taken on how likely the Commission might be to approve the intervention retrospectively if they launched an investigation. Finally consideration must be given to the ease of recovery of the aid plus interest from the beneficiaries in the unfortunate event of the Commission concluding that unlawful and unapprovable aid had been provided.

DTI State Aid Branch
April 2004