

Services of General Economic Interest

Opinion Prepared by the State Aid Group of EAGCP

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Introduction

Services of General Economic Interest (SGEI) are defined in EU competition law as economic activities that public authorities identify as being of particular importance to citizens and that would not be supplied (or would be supplied under different conditions) if there were no public intervention. In this Opinion we discuss some basic economic principles governing the treatment of SGEI.

The rules that should constrain the way in which national, regional and local Governments deal with their SGEI constitute a special case of “State Aid policy”. It is therefore useful to start from a brief discussion of the proper role of State Aid policy in general in a market economy, even if a thorough discussion of this topic goes beyond this opinion.

State Aid policy in general

Economic analysis suggests that three general principles should guide EU State Aid policy:

1. The first principle is that there are many instances where State Aids are legitimate responses to market failure. The most frequent causes of market failure are externalities (e.g. with respect to innovation¹ or the environment) and public goods.. In addition State Aids may be a legitimate response to concerns about equity or wider social and political objectives that are not reflected in individual consumer choice. This may be relevant for the the provision of public services in rural areas, or in underdeveloped neighborhoods or regions..
2. The second principle is however that State Aids should not lead to undue market distortions: The realization of the first principle should be incompatible neither with *competition in the market* nor with *competition for the market* when cost or other conditions prevent the achievement of competition in the market. It is therefore the mission of competition policy in the area of State Aids to focus on preventing obstacles to competition in and for the market in the EU, to ensure a smooth functioning of the Internal Market. Indeed, by doing so, it is simply striving for a cost-effective way of delivering on the first principle.
3. The third principle is a very general one, which concerns the relative costs and benefits of regulation: Intervention is warranted only if its expected benefit, in terms of improving market outcomes, outweighs the expected cost of intervention. As a consequence, state aid should only be used as a remedy for market failures if it is the best feasible remedy. While this is uncontroversial as a matter of general principle, its application in concrete cases may not be straightforward.

In this document, we first define the concept of Services of General Economic Interest and the related concept of Universal Service Obligations. We stress that the EU should typically not constrain the desire of national, regional or local Governments to define what are to count as instances of SGEI. We focus on the second principle, that is, the EU’s mission to ensure competition in and for the market. Our third principle leads us to express caution against EU regulation of competition in the market, beyond the elimination of excessive subsidies. Pushing for open tenders whenever possible is on the other hand a good way to favor competition for the market, even if it also has its limitations. We emphasize that EU intervention is only warranted in the presence of foreign competitors for the market (i.e. potential bidders from abroad). We conclude with a discussion of the Altmark judgment and the Community Framework for State aid in the form of public service compensation in the light of these principles.

¹ State aid to innovation has been the subject of a Commission consultation launched in September 2005 and will be the subject of a forthcoming note from the EAGCP.

Services of General Economic Interest: Definition and Appropriate Treatment by the EU

What are Services of General Economic Interest?

In economic terms, the concept of SGEI as defined above is closely related to that of “Universal Service Obligations” (USO), that is obligations imposed on one or more firms of a given industry to supply given products or services to all citizens, often though not always on a non-discriminatory basis. For instance, a regional bus service as in Altmark can be thought out as an obligation to serve a particular segment of bus users. Indeed, SGEI typically concern citizens within a certain relevant category (such as the sick in the case of certain medical services, or those living in vulnerable areas in the case of measures of protection against natural disasters)². Examples of industries where such USO are often imposed are: telecommunications, broadcasting, water supply, electricity, gas, railways, postal services. USOs are typically imposed to ensure that all citizens have access to such products or services. In other words, it is thought that if market forces alone operated, some deserving sub-groups of citizens would not be able to buy those products and services at an affordable price. Public intervention – in the form of the imposition of USO – is then imposed so as to guarantee that even such groups will be able to enjoy those products and services.

Two forms of USO that may be imposed on a firm (often simultaneously) are *universal coverage* and *uniform pricing* requirements: universal coverage entails the obligation to provide the product or service at an ‘affordable price’, while uniform pricing obliges the firm to offer a given product or service at the same price to all consumers, regardless of any variations in the cost of supplying different groups.

For instance, in the telecommunications sector, a fixed telecom network firm may be obliged to provide access to the network to users located in isolated rural areas, and under the same conditions as to users who are located in a city area. The cost of linking an additional residential user to the network may be large in the former case, and very low in the latter. Without USO or other public interventions (such as direct subsidies to the users involved), users in isolated areas would probably not be served at all.

Note also that USO (or SGEI) are by definition services which are provided at a loss by firms, otherwise there would be no need to impose the USO. Therefore firms often need be compensated for the provision of such services. There are several ways in which a government or public authority could devise such compensation. In most of the sectors which are usually characterized by USO, there used to be national monopolies: on these monopolies USO were imposed, and losses implied by universal coverage and uniform pricing were often covered through cross-subsidization: the loss made in serving groups of citizens which would not have been served without USO were covered by the profits made on other groups. These monopolies were often state owned enterprises with few incentives to strive for efficiency. With the advent of deregulation and privatization of utilities, such an approach could not work any longer, and required a more explicit definition of USO and of their compensation. For instance, a former incumbent monopolist could now face competition in the higher valuation segments of demand, and could not be expected to cover losses deriving from USO with the same ease. (Furthermore, under competition it is not clear why one firm should be imposed to serve unprofitable segments of demand, while others are not.) Hence, USO should be clearly defined and properly compensated. This raises a number of further issues: which firms should have USO? How should they be selected? How should subsidies be devised? Before turning to these central issues, though, let us briefly deal with the reasons why USO exist at all.

Why do SGEI exist?

There may be several reasons why a government (or more generally a public authority) would like to impose USO which guarantee access to all citizens. The most common explanations relate to social and political objectives, such as equity, participation, cohesion, solidarity. However, in some particular instances USO may also reflect economic efficiency considerations. For instance, in the case of telecommunications and postal services, there may exist network externalities: the utility of each user increases with the number of other users. Therefore, an extra user or subscriber of the service will exert

² Of course, there are also some SGEI, like cultural activities or health services, that concern the entire population. This is further discussed below..

a positive externality on all other users and subscribers. Since the private benefit is lower than the social benefit, there may be scope for subsidising into the network citizens who would not otherwise have subscribed the service.

Although in principle economic efficiency considerations might exist, in practice justifications for USO are in the vast majority of cases related to non-efficiency objectives such as the desire to prevent social exclusion. Since social and political priorities, and demand and technological conditions, vary greatly across member states, it is impossible to determine at a supra-national level which sectors should have which USO. The current approach, correctly in our view, acknowledges this, and allows each member state to have a wide margin of discretion in setting USO – or as they are called in EU law, SGEI. The role of the European Commission (EC) should be only to check that there exist no manifest errors and no abuses in exercising such discretion. To this end, each member state is rightly required to clearly and explicitly indicate services that are classified as SGEI. At present member states are not required to state the objectives that their SGEI are intended to fulfill, though such a requirement might enhance transparency.

The first general principle stated in the Introduction thus applies here: It is not for the EC to set uniform criteria for the identification of SGEI. But the second principle means that the EC, and more generally EU competition law, should guarantee that no undue distortions of the Internal Market take place because of SGEI.

A first indication of whether the provision of SGEI involves a distortion of competition might therefore be found by seeing whether the services in question are provided by unsubsidized as well as by subsidized firms. If so, it seems likely that the subsidies are enabling the continued operation of inefficient firms. However it will be important to check that the services provided by the two types of firm are fully comparable: it might be that the subsidized firms provide a different level of quality or a somewhat different range of services.

More generally, we have already mentioned that in the current (partially or completely) deregulated markets USO should have a counterpart: for the firms providing them, USO imply losses that should be covered by a subsidy or compensation. Such a subsidy or compensation might not be ‘competitively-neutral’ - it could distort competition in the internal market. It is then crucial to understand under what conditions such a distortion of competition would take place.

When Can SGEI Distort Competition in the Market?

Consider first the case where one or several firms have already been selected to fulfill a USO. What are the competitive consequences of this fact? We shall discuss separately the direct impact of the USO on the behavior of the firm *on other markets*, and its indirect or financial impact, through the *level of compensation* offered in return for carrying the USO, which may give the firm resources enabling it to behave in a predatory or otherwise anti-competitive way. In addition, an excessive level of compensation, even if it does not facilitate anti-competitive conduct, might be a *symptom* of anti-competitive procedures used for the award of the USO itself.

The impact of USO on other markets

The economic literature has stressed that USOs are generally not competitively-neutral. Suppose for instance that in a given country there exist two groups of citizens, urban and rural, and that the cost of linking the latter to the network is so high that not even under monopoly would a firm supply the rural market (whereas the cost of supplying the urban market is low relative to the valuation for the good of the urban citizens). Consider a USO which requires a firm to serve both markets (universal coverage) and to provide the good at the same price as in the urban market (uniform pricing). Suppose then that the urban market is served by firm A and firm B, and that firm A is also chosen (or obliged) to provide the rural market under the USO. It can be easily shown that the constraint of having the same price on both markets changes the behaviour of firm A in the urban market: indeed, in order to limit the losses on the unprofitable rural market, firm A would have an incentive to raise prices there; in turn, given the uniform pricing obligation, it will also price less aggressively in the urban market, where prices will be

higher than if no USO was imposed on the rural market (or if the firm which is serving the rural market under USO is not present in the urban market).³

Beyond the simple example, the point is that in general USO will have an impact – in more or less subtle ways – on other markets in which the holder of the obligation is also operating. Other ways in which this could happen are through economies of scope (when production for the unprofitable market may lower production costs in another market), externalities on demand (if the low valuation users may later increase their demand of more lucrative services), or instead through *diseconomies* of scope (for instance if serving the unprofitable market entails use of a scarce resource which is also used for production in another market). *The overall impact of these influences is difficult to predict as a general rule*: in some circumstances, having to provide the USO may confer a strategic advantage over the firm, in others, it may entail a strategic disadvantage.

Another issue which is crucial is whether the market distortions are national or international. Since we are considering here the impact of SGEI on EU competition law, we have to ask whether there is scope for national or supra-national intervention. In order to justify intervention of a supranational competition agency (and of the European judges), there must be cross-country externalities; otherwise the only effects are within a country's borders, and the authorities of that country are the best placed to determine the appropriate response. The most obvious source of strategic impact of SGEI, through the uniform pricing requirement, ceases to act beyond the national borders: indeed, the USO will oblige the firm to set the same prices only across the different national consumers, being silent on prices across countries. This means that in the international markets the pricing policy of the firm holding the USO is not directly constrained, and direct strategic effects through uniform pricing are absent. Still, more subtle strategic effects could still take place: if different national markets are not independent, due to either demand or cost linkages, then the USO will end up having an impact on the equilibria of all markets where the firm subject to the USO is operating.

From the discussion above it follows that SGEI have a potential strategic impact on the nature of competition on markets other than the national one where the USO are imposed. However, these strategic effects can take place through subtle mechanisms, and it is not clear as a general rule whether they would help or hurt the firms which are providing the USO.

The third general principle stressed in the introduction applies here: using the EU's scarce resources to analyse in a systematic way these strategic effects of SGEI on domestic and international competition – which are bound to be small and uncertain – would make no sense. Particular SGEI should be investigated only if there are serious grounds of concern.

Finally, it is important to stress that even when a firm benefits from a USO in one market by improving its ability to compete on a different market, this is not necessarily in itself a distortion of competition. If it represents a genuine economy of scope, this is an efficiency gain that can be expected to result in improved benefits for consumers. Pricing at a level that is difficult for competitors to match is not anti-competitive if it reflects lower costs than those of competitors. Of course, even if the strategic impact of USOs will often be small and uncertain, there may still be some circumstances where the USO will have a direct and predictable effect on competitors or allow the beneficiary firm to act, or threaten to act, in an anti-competitive way.

The former case may include the provision of services (like medical services) at prices well below cost for the entire population. Subsidized providers of these services will then compete with private providers charging unconstrained prices. Such cases are unlikely to be a matter of concern to the extent that cross-border effects are unlikely (as one not expect a member state to provide free medical services to citizens of other member states) but may warrant particular attention⁴.

³ One could also conceive cases where USO makes the holder of the service more aggressive rather than less aggressive. The point we want to stress here is that there exist strategic interactions which take place because of USO.

⁴ Cross-border effects may occur if patients can move across countries. If these effects are significant, it may imply that state aids for SGEI are dominated by alternative instruments for providing free services. For instance, vouchers for healthcare services that can be used with any provider may involve less distortion.

The latter case involves the circumstances for which European competition law already provides redress in the form of actions under Article 82. For instance, if the firm subject to the USO were to tie other competitively supplied products to the supply of the monopolistic good (such as tying the sale of telephone equipment to the supply of telephone services to customers in rural areas), there would be prima facie grounds for an action under Article 82. Sometimes, it is true, the standards of proof required for establishing abuse under Article 82 are more stringent than seems reasonable in the presence of state aid⁵: arguably there should be a somewhat lower burden of proof for establishing abuse when the firm concerned benefits from a USO. Nevertheless, it seems reasonable to say that concerns about distortions of competition in the market should follow the broad economic logic of Article 82 even when they cannot be left entirely to the legal machinery of Article 82.

We now turn to the issue of excessive compensation and competition for the market.

The financial impact of USO

Given the potential cost and/or demand cross-market linkages, identifying the actual net compensation which should be assigned to a firm which holds a USO is far from a simple affair. Indeed, the 'right' compensation for USO should in principle take into account not just the additional costs incurred by the firm in serving the 'unprofitable' group of consumers, but also all the modifications in costs and revenues which are caused by the USO.

This issue is important because the level of compensation awarded for fulfilling the USO could have an impact on competition elsewhere at least if *capital markets are imperfect*. Suppose that a firm which is holding a USO is overcompensated for it. Then, it may have a strategic advantage due to the larger availability of funds: this may allow it to invest more than rivals in new projects, R&D, or innovation. Whether capital market can be presumed to be inefficient to such an extent that small or moderate overcompensation will be an issue is hard to tell. However, such inefficiencies may offer some scope for strategic behavior by government; if the compensation is deliberately devised in such a way as to give the firm an incentive to over-invest or to alter its behaviour in international markets, there might be a direct and significant distortive effect on competition.

In contrast with the discussion on the impact of USO on other markets, the direction of this effect here is unambiguous, which means that ensuring that a firm holding USO is not overcompensated is a worthwhile objective of State Aids policy towards SGEI. Asking firms to provide accounts specific to the USO activities is the natural step towards an assessment of the absence of overcompensation (below, we discuss the Altmark judgment, which is devoted to this assessment). Ensuring competition for the market through open tenders will also help, as discussed below, to avoid overcompensation. However, EU intervention is only warranted if competition for the market is distorted across countries, i.e. if there are some competitors for the market from abroad.

To summarize, when it comes to competition in the market, if there is no over-compensation, one could reasonably presume that the SGEI will have no serious distortive impact over international competition, unless there are independent grounds for action under Article 82 of the Treaty. If there is over-compensation, then there may be grounds for an in-depth investigation of SGEI, and it may prove necessary to ask the national government to justify its SGEI policy, at least when competition for the market involves foreign firms.

Competition for the market

Ensuring competition for the market is a very important objective of competition policy in the case of SGEI, where ex-post competition is very often limited due to very high fixed costs. Competition for the market is valuable for two reasons: first, it helps to ensure that the firm chosen to provide the SGEI is indeed the firm that can most efficiently accomplish this task. Secondly, competition for the market

⁵ For instance, a recoupment test for predatory pricing might be less reasonable when the alleged predator is the beneficiary of a USO.

helps to ensure that the firm is not excessively compensated. The natural way to ensure competition for the market is to have a transparent, open public tender. This would have the advantage of putting pressure on potentially inefficient incumbents. Incumbency advantages may however imply significant asymmetries between firms, so that open tenders are not a panacea. In particular, they may not eliminate the overcompensation phenomenon: it may still be possible for incumbents to win tenders at prices where they enjoy rents over their own costs of providing the USO. In addition, it may be difficult to conduct tenders in a way that ensures the quality of the service provided. Tenders are therefore not a *substitute* but rather a *complement* to an ex-post look at the accounts to check the absence of overcompensation.

SGEI the Altmark judgement and the Community framework

The above discussion has led us to stress that the goal of State Aid policy towards SGEI should be to guarantee competition in and for the market, and that this can be translated into preventing overcompensation and pushing for open tenders in awarding USO.

The Altmark judgement is very relevant for this discussion, and its key provisions have been incorporated into the Community Framework for State Aid in the Form of Public Service Compensation⁶. It establishes that compensation for a SGEI should not be considered as state aid (within the meaning of the Treaty) if four conditions are satisfied:

1. The Universal (or Public) Service Obligation is clearly defined.
2. The parameters for the compensation are objective, transparent, and are established in advance.
3. The compensation should not exceed costs plus a reasonable profit.
4. The compensation is determined either through public procurement (that is, a public tender has taken place and it is the winning firm which is chosen to provide the USO) or, if no public tender has taken place, the firm should be compensated on the basis of the costs of a typical well-run company.

The Community framework also lays down the conditions under which SGEI which constitute state aids (because the conditions above are not fulfilled) may still be compatible with the Treaty. Importantly, the framework indicates that as long as conditions 1-3 are fulfilled and the firm is not overcompensated, the SGEI will be compatible. This implies that firms which are inefficient but not overcompensated will not be sanctioned.

General assessment

The main principle of the Altmark judgment, saying that there is no State Aid if there is no overcompensation relative to the costs that an *efficient* company would have incurred, is perfectly consistent with the economic approach identified above. Absent over-compensation, the presumption is that the SGEI would have effects of minor (indirect) size and of unclear sign, and would therefore not be worth investigating. Hence, we also endorse the general approach of the Altmark judgment which is adopted by the Community Framework

The approach of the Community framework with respect to firms that are not overcompensated but are inefficient (or at least not shown to be efficient), is less defensible. It may entrench the position of inefficient incumbents and may fail to ensure competition for the market in circumstances in which it could be feasible. It may also provide governments with an incentive to try and abuse the SGEI status of the aid in order to prevent the exit of inefficient firms. At the very least, open tenders should be recommended whenever possible.

The effectiveness of open tenders should however not be exaggerated: They may suffer from a lack of actual competition, either in the form of insufficient bidders or of collusion between bidders, and are therefore no guarantee against overcompensation. They may also be difficult to conduct in circumstances where the quality of services is a significant concern. This has two main

⁶ OJ 29/11/05, see http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/c_297/c_29720051129en00040007.pdf

implications. First, the suitability of open tenders should be carefully assessed according to the circumstances of the SGEI in question, as well as to the bidding process it is likely to generate. If the SGEI is beset by significant problems of defining quality of service, it may be more appropriate to negotiate quality standards directly with interested parties rather than engage in a tender that may give excessive incentives for bidders to compete purely on price. If the circumstances of the market mean there is only one likely bidder, it would be better for the government to negotiate the subsidy with the only provider rather than using an auction procedure which would result in large profits for the unique bidder. Secondly, even where open tenders can be conducted, it may be desirable to combine them with ex-post analyses of the costs and profits of USO providers, especially in circumstances where collusion between bidders may be a concern. While the conduct of open tenders for the award of USOs should indeed create a presumption that there has been no overcompensation, this should be a rebuttable presumption, and the authorities should take seriously the circumstances that may make it rebuttable⁷.

When open tenders are not organized, the comparison with a “typical well-run company”, while desirable in principle, is quite difficult to put into practice. In our view the Altmark judgment and the Community Framework significantly understate these difficulties. There are issues of both principle and practice involved here:

- In principle, while the Framework is right to emphasize the importance of maintaining separate accounts for the SGEI and for other activities in order to make monitoring easier, the costs and revenues attributable to the SGEI include all changes in the firm’s total costs and revenues that result from its performance of the SGEI, *regardless of the market upon which they nominally take place*. For instance, if performing the SGEI lowers the cost to a firm of serving a different market, this is a benefit to the firm of obligation to provide the SGEI and should be set off against the cost⁸.
- A second point of principle concerns the nature of incentives for improvements in productive efficiency over time. As in the basic principles of regulation, an important objective should also be to promote dynamic efficiency, giving the firm an incentive to improve quality and undertake innovations. It would therefore be a mistake to conclude that there is always over-compensation whenever extra-profits are identified. Instead, provided that the compensatory mechanism is transparent and motivated, the government should be given the possibility to devise incentive schemes which promote innovations and improvements (and could be asked to explain how these schemes follow “best practices” of dynamic regulation). Under such schemes, a firm which is able to decrease its costs of the USO over time should also be able to appropriate the profits for its technological improvements. Therefore, to the extent that apparent over-compensation is only the result of an incentive scheme aimed at making the firm more productive over time, it should not be considered as “state aid”. In considering whether there is overcompensation (for a firm that is possibly inefficient), the Framework states at paragraph 14 that a reasonable profit “may include all or some of the productivity gains achieved by the undertakings concerned during an agreed limited period without affecting the quality level of the services laid down by the State”. It would help for the framework to be more explicit that incentives to achieve productivity gains are a desirable feature of compensation schemes (whether compensation is evaluated relative to an efficient firm or not).
- In practice it will often be very difficult to determine the existence or not of excessive compensation in the absence of tender procedures. This is for two reasons. First there may not be clearly comparable “well-run” companies against which a company’s costs can be assessed (for instance, there may exist no domestic companies to be used as comparators, and foreign companies may face too many different conditions of operation to make the

⁷ Of course, when the Altmark criteria are met there is no notification so there may not be the information required to undertake ex-post analyses, but in the case of a challenge, information relating to the costs and profits of a USO provider should certainly be deemed potentially relevant.

⁸ Note that there is no contradiction here with the point made on page 4 that “when a firm benefits from a USO in one market by improving its ability to compete on a different market, this is not necessarily in itself a distortion of competition”. The *existence* of the benefit from the SGEI is not a distortion of competition, but failing to take it into account when calculating the compensation to be offered to the firm could indeed be.

comparison relevant). Secondly, there may be significant uncertainties in the cost data themselves. For both of these reasons we believe it is important to guard against the danger that the Commission becomes a price regulator through the back door. There should be a presumption that the compensation for an SGEI is reasonable unless it can be demonstrated to be otherwise. And after all, even if a given measure fails this test, this does not imply that it will be found to contravene Community competition law. For this reason it would be an unwise use of resources to develop highly complex procedures to establish whether or not a firm has been “overcompensated” according to the Altmark principles. If there is reasonable doubt about this, the measure in question should be considered a State Aid, and the competitive analysis performed at the next stage in line with the general principles governing the impact of state aids on competition.

Overall, therefore, the Community Framework represents a major advance in the incorporation of principles of economic analysis into the assessment of State Aid under Community law. Provided the Commission avoids the risk of becoming bogged down in highly complex calculations of “reasonable costs”, and bears in mind the overall principles of maintaining competition both in and for the market, we are confident that the result will be both a more reasonable economic application of competition policy, and a more transparent and predictable environment for both firms and public authorities.

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