At A Glance

State Aid

Overview

Economic analysis plays an increasingly important role in European State aid law and practice. For many years, the market economy investor principle (MEIP) has been the guiding principle in identifying and quantifying State aid. In 2014, the European Commission (EC) established the balancing test as the basis for determining State aid as part of its State aid modernisation (SAM) initiative. By establishing the MEIP as the guiding principle, the EC placed economic reasoning and analysis at the heart of all horizontal State aid guidelines, be it for regional aid, rescue and restructuring aid, R&D&I aid, risk finance aid, or aid for environmental protection and energy. Applicants must also weigh positive and potential distortive effects of aid for some sector-specific types of aid. Economic analysis is therefore central in identifying and quantifying the effects of State aid, for assessing its likely impact on welfare, and in justifying beneficial aid before the EC. NERA has substantial expertise in advising private, public, and government initiatives in State aid matters.

NERA's Experience

NERA has extensive experience in advising governments and private and public undertakings in State aid matters for many years. Our work has involved the application of the MEIP, the definition of relevant markets for State aid purposes, and the assessment of the competitive effects and benefits of aid in the airport, airline, energy, financial, paperboard, media, medical, and transport sectors. We have carried out compatibility studies for undertakings and authorities. NERA's work has been submitted as evidence in proceedings before the EC and the General Court. Recent engagements include:

- The UK Department of Energy & Climate Change (DECC) commissioned a NERA team to assist with the design of the UK's Renewable Heat Incentive (RHI). Supported by NERA's detailed analysis, the UK government scheme obtained State aid approval from the EC.

- The city of Munich commissioned NERA to conduct a private investor test (PIT) to assess the planned equity infusion for the renovation of the Munich Municipal Hospital.

NERA has applied rigorous economic analysis to different aspects of State aid cases. Drawing on the broad expertise of experts and academics from across our practices, we offer offers gold standard economic advice for our clients.

Economic Analysis in State Aid Cases

Does a measure constitute State aid?

Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU) defines State aid as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods (…) in so far as it affects trade between Member States." Such State aid is considered incompatible with the internal market.

Insight in Economics™

From an economic point of view the decisive element of this definition is that of "favouring", i.e., the provision of an "advantage." Whether or not a certain measure confers an advantage upon the recipient can be determined by applying the MEIP, which asks whether a private investor would be willing to carry out the same investment under the same terms and conditions as the State. If the terms and conditions of the measure in question would be acceptable to a private (market economy) investor, no advantage is conferred upon the recipient of the State funds and thus the measure does not constitute State aid.

NERA's experts assist clients in determining the net present value (NPV) of each investment to analyse whether the terms and conditions are acceptable to a private investor. This method involves a prediction of the cash flows associated with the measure (cash in- and outflows) and discounting these cash flows using the appropriate cost of capital. If the NPV is positive, an investment is profitable. If the NPV is negative, the investment is not considered profitable and it can qualify as State aid.

While the principle of NPV calculation in the context of the MEIP is simple, its application can be complex. First, in many cases it is not obvious which cash flows are associated with a potential aid measure as most aid measures change the behaviour of the economic actors affected. For example, a State-owned airport granting a rebate on airport charges to a certain airline will attract more traffic and thus passengers. When assessing the cash flows associated with the measure in question, in this instance the rebates on airport charges, also the cash flows from additional passengers at the airport must be taken into consideration. More generally, identifying the cash flows attributable to a measure requires a rigorous comparison of the situation with the measure and the situation without, a so-called counterfactual analysis. Second, in addition to direct capital injections or simple loans, there are various other instruments for injecting State funds into an undertaking, e.g., tax exemptions, soft loans, guarantees, repayable advances, or several hybrid instruments. Financial tools and techniques of varying degrees of sophistication are required for assessing these non-standard instruments. Third, in many cases the appropriate cost of capital to discount the cash flows in the calculation of the NPV is not obvious. In such instances, an economic analysis may be required to determine the appropriate cost of capital. Finally, all of the previous potential complications are also affected by the question of how to determine an equivalent private investor. For example, if an undertaking is entirely State-owned, would one have to consider a private investor with an equivalent 100% ownership of the undertaking in question? If the State holds a portfolio of undertakings with potentially offsetting risk profiles, would one have to consider a private investor holding a similar portfolio of undertakings? All analyses required to address the aspects mentioned must occur on an *ex ante* basis, i.e. they must take into account the market conditions and expectations at the time the respective measure was introduced.

The Balancing Test

If a measure must be classified as State aid, it may still be compatible with EU State aid law, if it passes the so-called balancing test. The balancing test assesses whether (1) the aid is aimed at a well-defined objective of common interest, e.g., growth, employment, research & development, protection of the environment, or the correction of a market failure, (2) whether the measure is a well-designed instrument to deliver the identified objective and has an incentive effect, and (3) whether the positive effects of achieving the objective of common interest outweigh the potential negative effects of the aid in terms of distortion of competition.

Economic analysis is critical at each stage of this three-stage test. NERA economists help clients demonstrate how certain types of State aid, such as R&D or environmental protection, can correct a market failure, and why certain activities cannot be provided without State aid. We also work with clients to establish an incentive effect, and to assess whether State aid may distort competition.

When it comes to balancing the positive and negative effects of a particular measure, NERA's experts can provide a robust conceptual framework that can illustrate the potential negative impact if State aid is refused.

If it can be established that the aid will have a positive effect, quantifying that effect in terms of consumer benefits is the next step. Economics can help to put a price on non-price benefits such as enhancement of choice or quality and increased security of energy supply. Consumer surveys and market research can provide useful insights and conjoint analysis can be used to determine consumers' willingness to pay for specific "priceless" attributes.

NERA experts have significant experience in effects-based assessments to evaluate the potential distortions of competition and the effects an aid measure would have on trade. We have conducted a range of cost benefit analyses and assessed the socio-economic effects of aid measures. We can offer valuable advice and assistance to illustrate how the benefits of the aid in question outweigh its cost.

Practice Synergies

Advising aid beneficiaries, governments, and affected parties on State aid matters requires a detailed conceptual knowledge of economics, finance, statistics, and econometrics. Depending on the measure in question, it might also require detailed industry expertise. A specific advantage of NERA is that it systematically draws not only on its profound experience in competition and State aid consulting services but also on both the particular sector expertise stemming from regulatory work (e.g., in the energy or telecommunications sector) and the wider methodological expertise from other focus areas such as NERA's Finance Practice.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real-world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

Contact

For more information or to contact our experts, please visit **https://www.nera.com/at-stateaid.html**.