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State aid in response to COVID-19 and implications for competition

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With the adoption of the initial Temporary Framework on 19 March, the European Commission ("EC") enabled Member States to take swift action to mitigate the economic fallout, by applying State aid rules flexibly and approving notified aid measures at record speed. The EC has so far approved more than €2.5 trillion across around 200 national aid schemes, mainly under the Temporary Framework, which since its adoption has been amended three times. In setting up the Temporary Framework and widely approving the notified aid measures, the EC has made extensive use of the room for manoeuvre that the rules afford it in the specific context of the COVID-19 crisis.

As State aid linked to COVID-19 becomes more targeted, what will be the most controversial issues of debate?

The 2020 State aid Temporary Framework is more generous when compared with that which was adopted during the 2008/2009 financial crisis, mainly because it allows for significantly larger amounts of compatible aid. The initial framework, which allowed Member States to adopt general support measures, applicable across economic sectors, included guarantees and subsidies on loans, direct grants, tax advantages, repayable advances and short-term export credit insurance. The Temporary Framework has been amended three times to date.

The first amendment of 3 April supplements the initial framework by widening the scope of general aid to tax (including VAT) and social security deferrals, wage subsidies as well as support of R&D activities and production of goods and services directly related to the mitigation of the pandemic. General support measures have accounted for about 95 percent of the volumes of State aid granted so far, with only the remaining 5 percent going to single-firm beneficiaries.

The second amendment to the Temporary Framework enables Member States to provide aid in the form of recapitalisations and subordinated debt to companies with urgent liquidity needs. These kinds of support measures are generally considered to pose a greater threat to competition and, although safeguards have been put in place to try to protect the level playing field, some measures have already attracted intense controversy. The most prominent example so far is the Lufthansa bailout approved by the EC, which signalled a shift toward sizeable interventions targeted more specifically at individual, predominantly large companies. These support measures, and the conditionality attached to them to avoid undue distortions of competition, will undoubtedly continue to be the focus of debate. Ryanair has already lodged five appeals before the EU General Court against EC decisions approving State aid granted to various carriers.

The recently introduced third amendment softens the conditions associated with recapitalisation measures to encourage private capital injections and company participations in order to limit the need for State aid and the risk of competition distortions. It also allows for support of certain small enterprises, including start-ups that were already in difficulty before the end of 2019. The EC argues that these companies have been particularly affected by the liquidity shortage, exacerbating their existing difficulties to access financing compared to larger enterprises.

Whilst the EC should be commended for taking swift and decisive action, there is nevertheless a risk that the wide reach of the State aid measures taken contributes to the entrenchment of companies with longstanding structural problems unrelated to the current crisis. All EU economies have some "zombie firms" (e.g., firms that are unable to repay their loans but are kept alive by weak banks concerned about their own financial stability). Zombie firms are not only inefficient and unable to grow, they also crowd out more efficient companies, denying them the opportunity to grow and to diffuse technological innovation. Instead of allowing for a quicker regeneration of the European economy, State aid without requirements for adequate restructuring may slow down aggregate productivity and growth.

Read more in a paper authored by Jorge Padilla (Compass Lexecon) and Nicholas Petit (European University Institute) on the implications of COVID-19 for competition policy and economic growth.

[1] The views expressed in this report are those of the authors Urs Haegler, Senior Vice President at Compass Lexecon and Georges Siotis, Consultant of Compass Lexecon and Associate Professor at the Universidad Carlos III de Madrid.

What role does conditionality play?

The generosity of some of the schemes created by certain Member States has raised questions related to conditionality. The EC is constrained in the extent to which it can attach conditions. For example, Article 107(2)(b) TFEU allows for compensation of damages caused by a natural disaster or an exceptional occurrence as an exemption to the prohibition of State aid. Compatibility with the treaty is given, without the need for the EC to assess, provided the Member state can show evidence of exceptionality. This route lends itself well to compensate for damages suffered by certain sectors that have been particularly hard hit and some Member States have made use of it. Examples include the Swedish and Danish governments' financial support for SAS and a €550 million state guaranteed loan adopted by the German government to the benefit of the charter airline Condor.

Although, in principle, the 107(2)(b) TFEU route appears particularly appropriate for the compensation of damages suffered by sectors that have been particularly hard hit, there have so far only been 18 cases of this type. One of the main reasons is likely that a member state must still demonstrate that the aid it grants does not overcompensate, which in practice can be burdensome, not least due to data requirements. Moreover, outright compensation of damages also has more severe budgetary implications for the countries that provide it.

Member States, on the other hand, can impose conditions more freely with a view to creating incentives to pursue wider public-policy objectives, particularly in relation to digitalisation and future technologies (e.g., in Germany's economic recovery programme) as well as environmental sustainability.

For example, the Air France aid package designed to provide €7 billion in urgent liquidity (in line with the provisions of the Temporary Framework as amended 3 April) was granted on condition that Air France becomes "the most environmentally friendly airline in Europe". The French government's Air France package imposes a range of target on the carrier, including carbon dioxide reductions and a shift towards more sustainable fuel sources, although the extent to which those targets are binding is not clear.

If other airlines are not subject to such obligations – either because they are not aid recipients or have received aid without such conditions having been attached by another Member State – this raises the question whether certain conditionalities themselves have potentially anti-competitive effects. If airlines supported by State aid are forced to accept environmental conditions that others do not have to adhere to, that could result in both distortion of competition and less stringent environmental regulation.

What are the parallels with State aid and other government support granted in the wake of the financial crisis? What are the main differences?

The European Commission adopted the initial Temporary Framework on 19 March, only a few days after the introduction of lockdown measures in many EU countries. The Commission was clearly able to leverage the knowledge and experience it had gathered during the financial crisis in 2008 and 2009, when it took almost a month following the collapse of Lehman Brothers for the Commission to issue its first communication on the application of State aid rules to measures taken in relation to the global market turmoil.

The 2009 Temporary Framework ("2009 TF") was adopted in the midst of the financial crisis. It consisted of a relaxation of existing rules involving a number of State aid instruments. The amount of *de minimis* aid was increased (from €100k to €500k), applicable margins on state granted loans and guarantees were lowered, and the rules allowing for State provisions of export credit insurance were loosened. Special provisions were also made for green products and risk capital. Member States made extensive use of the first four instruments.

The 2020 Temporary Framework includes all the instruments of its predecessor, except for specific provisions for risk capital and green products. The main difference is that the level of allowed support is more generous. Grants of €800k are allowed and, more importantly, the applicable margin on guarantees or loans is not conditioned by the recipients' credit rating. In the 2009 TF, the applicable margins were subject to the rules pertaining to the Guarantee Notice. For loans, the Reference Rate Communication applied. In both cases, the 2009 TF allowed for a lowering of the applicable non-aid margin, but the latter continued to be conditioned by the creditworthiness of the recipient. In the 2020 Temporary Framework, applicable margins only depend on maturity firm size, with more generous conditions for SMEs. Overall, the 2020 Temporary Framework allows for significantly larger of amounts of compatible aid. Moreover, the 107(2)(b) exemption was not explicitly considered in the context of the financial crisis.

Unlike the 2020 Temporary Framework, the 2009 TF did not allow for special provisions for equity participation or the purchase of subordinated debt in non-financial entities. It remains to be seen how the Member States will exploit this extra degree of freedom i in the current situation. It may be used to support viable firms that are at risk because of short liquidity problems or exposed to a hostile take-over from state-backed non-EU firms.

The combination of a generous 2020 Temporary Framework with non-selective measures (i.e. considered non-aid under EU rules) implies that Member States can deploy vast amounts of funds to support undertakings.

Do the recent State aid measures undermine the level playing field across Member States?

There have been very large differences in the magnitudes of the State aid measures granted across Member States. Some observers have expressed concern about the potential of significant distortions to the internal market caused by these asymmetric national responses to the COVID-19 outbreak. The fiscal headroom available differs significantly across Member States, potentially allowing some Member States to provide generous support to keep a large swath of their economy afloat, while in other jurisdictions, fiscal constraints only allow for limited use of the flexibility offered by the Temporary Framework. In addition, the possibility of offering non-selective support (e.g., furlough schemes) could exacerbate this tension.

Paradoxically, some European airlines that, prior to the pandemic, were in a significantly better liquidity situation than recipients of bailout packages (such as, e.g. Lufthansa or Air France-KLM) may still end up facing insolvency in the event of a protracted downturn coupled with limited state support.

State aid control (including the current Temporary Framework) is meant to ensure that the level playing field is maintained in the internal market and not distorted by public intervention. Under current circumstances, however, the playing field in the internal market faces a significant risk of distortion stemming from vast differences in the level of public support. The tensions may be alleviated by the current EU negotiations on the creation of a recovery fund and the next EU seven-year budget.

What is the role of economic analysis in evaluating State aid cases?

High-quality economic analysis is essential to reliably assess the cost and benefits of State aid, compliance with State aid rules, and the potential distortionary effects on competition in the marketplace.

Advising aid recipients or government bodies, economists can assess each of the relevant conditions set out in the State aid guidelines for the type of aid at issue and produce quantitative and qualitative analyses that provide robust evidence to advance their case.

Economists will advise on case strategy and prepare economic submissions to authorities and expert reports to assess whether the support is compatible with European Commission State aid rules. This may involve some or all the following steps:

- Perform a Market Economy Operator Principle (MEOP) test to evaluate whether given measures constitute State aid. This involves estimating the rate of return and calculating the net present value of an investment project supported by the measure;
- Compare the net present value of an investment with and without the aid to assess its incentive effect;
- Assess the extent to which a proposed measure may lead to a distortion of competition in favour of the State aid recipient; and
- Where required, assist the recipient of State aid in preparing a restructuring plan, and advise on the implementation of potential behavioural and structural remedies.

Find out how Compass Lexecon has advised clients in State aid cases

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