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Applying the Private Investor Test (PIT) in practice

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Agenda

Concept of PIT within the State aid framework

When do I need a PIT?

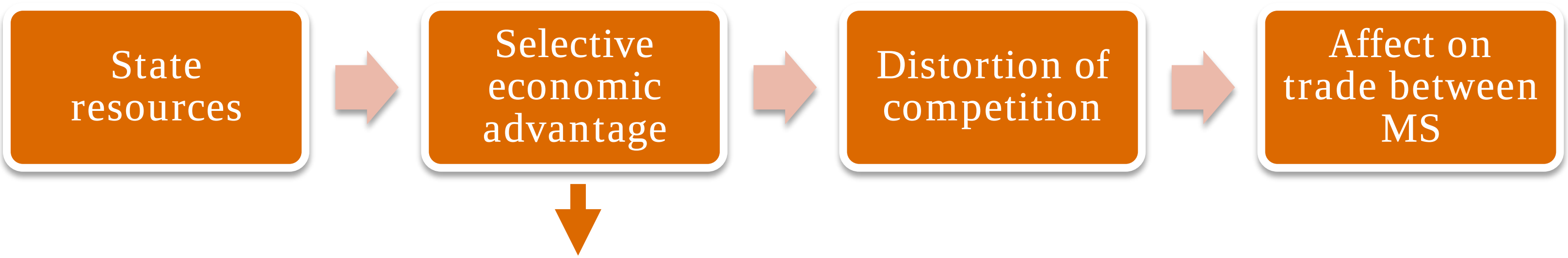
How to carry out the PIT? PIT's economic parameters

Overview leading Court cases and Commission decisions

Concept of PIT within the State aid framework

Legal basis

The PIT is an interpretation of Article 107 (1) TFEU and more specifically of its second criterion determining whether government funding constitutes an economic advantage.



PIT principle tests whether a public measure **confers an economic advantage** to an undertaking that would not otherwise have been achieved.

Any measure that **satisfies the PIT is not considered** State aid.

Notification to the EU Commission is then not required.

Concept of PIT within the State aid framework

Concept – profitability analysis

The principle assesses whether a particular **financial assistance** by **a State** or State-owned/controlled firm/institution **to an undertaking** would have also been acceptable to a private investor.

Is it a profitable investment and do the public resources generate a usual market return?

Would a private investor undertake the same investment?

PIT uses established financial economic tools and measures if the investment is profitable.

Put simply, a public investment is profitable if the expected return from the investment outweighs its costs.

PIT principle applies to both **private and public undertakings** – neutrality as to property ownership (Article 345 TFEU).

When do I need a PIT?

The PIT as standard for material appraisal of State aid

- ECJ in EDF judgment: PIT as a rule & PIT ex officio
  - PIT is not an exception to State aid control which applies only if a Member State so requests.
  - If the PIT is applicable, the Commission should apply it when analysing the presence (or lack of presence) of State aid.

- Implications: PIT as a material standard for State aid assessment
  - The judgment seems to require the use of the PIT as the general standard for the material appraisal of State aid measures.
  - The same standard should apply to similar tests, such as the private creditor test.

When do I need a PIT?

Examples of application

- Injection of capital in a company by the State
- Discount in long-term contracts
- Selling assets (land, buildings), services, goods without a tender procedure
- Granting a loan to an undertaking
- Public guarantees

➢ Market Economy Investor Test, Private Creditor Test, Private Vendor Test

When do I need a PIT?
Limitations of application

- PIT may not apply to acts of public power , e.g.
  - subsidies,
  - social insurance contribution,
  - certain infrastructure measures like security.
  - tax exemptions?
- PIT may be applicable even where the State has at its disposal means which are not available to the private investor (such as fiscal means), if those means are used to pursue an economic activity (EDF judgment).
- Effect and purpose of the measure (economic or non-economic) should matter – not the form of the measure (EDF and ING judgment vs. Bank Burgenland judgment).

When do I need a PIT?

PIT for infrastructure development

- For a long time, the construction or enlargement of infrastructure projects was considered a general measure of economic policy which could not be controlled by the Commission under the Treaty rules on State aid.
- Aéroports de Paris (1998-2002): Infrastructure management can be considered an economic activity.
- Leipzig/Halle (2008-2012): The financing of functions falling within the public policy remit or of infrastructure directly related to these functions does not constitute State aid; the financing of economic activities or infrastructure directly related to these activities falls under the scope of State aid control.
- Commission practice (Uppsala, Copenhagen, Nürburgring, etc): The financing of infrastructure that is later commercially exploited is State aid relevant and a PIT is therefore needed.

How to carry out the PIT? PIT's economic parameters Overview

Step 1
- Identification of a baseline scenario

Step 2
- Identification of counterfactual scenario

Step 3
- Comparison and assessment

Case Example - For the purpose of PIT's assessment lets assume that a Member State gave a capital injection to a private company.

How to carry out the PIT? PIT's economic parameters Step 1 – Baseline scenario

- Baseline scenario **with public capital injection** and respective cash/dividend flows

Relevant documents for the PIT assessment (not exhaustive list):

- Business plan
- Annual financial statement
- Integrated business planning (incl. forecast, profit plan, income statement, balance sheets, cash flow statement)
- Investment plan

How to carry out the PIT? PIT's economic parameters Step 2 –Counterfactual scenario

- Counterfactual scenario **with hypothetical investor**

- **Constraints and parameters**

1. Selection of a comparable investor
2. Deter-mination of period under consider-ation
3. Ring-fencing of the commercial activity
4. Identi-fying expected returns
5. Identi-fication of the correct discount rate
6. Expected cash flows and incremen-tal cash flow

How to carry out the PIT? PIT's economic parameters Selection of a comparable investor

- The **size** of the public institution injecting the capital measure in a certain **sector** determines the size, expectations and sector of the hypothetical investor.
- Leaving aside all social, regional and sectoral policy considerations.
- The type of relationship between the investor and the borrower has to be taken into account (i.e. relationship between parent and subsidiary company; long/short term goals; already involved or not, losses may be acceptable for other purposes).
- The investor is well informed (documentation requirements).
- Unlimited State resources?

Special case - If a real investor invests under similar conditions and in the same time, the hypothetical is not needed anymore – PIT is then met.

How to carry out the PIT? PIT's economic parameters Determination of period under consideration

- The assessment should be made in a **forward-looking manner**, taking into account only the **information** that could reasonably have been foreseen **at the time** the public body decided **to make the investment – ex ante point of view**. (GC Stardust Marine Judgment from 16. 5.2002 C-482/99)
- The factor of investor's **expectation** plays a crucial role. If the investor, based on the objective grounds, could reasonably expect a positive return, no State aid is involved.

Practical tips - Challenge is to picture the ex-ante-view, especially a compliance of required documentation in ex-ante assessment is difficult, the subsequent findings do not play a role.
The documentation should be presented in writing.
Wrong decisions by the State?

How to carry out the PIT? PIT's economic parameters Ring-fencing the commercial activity

- PIT assessment concerns the entire economic activity to be examined, which corresponds to EU definition of an undertaking.
- In case of acts of power it is impossible to make a comparison, or find a comparable power that a private investor could use (EDF Judgment from 15.09.2009).

The role of the State as a **public authority** needs to be distinguished from its role as **a shareholder/investor**.

PIT does not apply to **acts of public power** exercised by public authorities - an act which a private investor is unable to do and which does not have an economic character (examples: customs control; airport security).

How to carry out the PIT? PIT's economic parameters Identifying expected returns

- All costs and returns need to be identified and valued (examples: dividends on shares, capital increase, extra voting rights, tax effects).
- **Expected profitability** needs to be considered, depends on a long or short term investment focus/prospective.
- Assessing this, it is important to determine how much time would the private investor give to achieve the return.

The relevant benchmark for the profitability assessment is the specific transaction in question and not other investment possibilities.

All associated risks, capital costs, future expectations and other relevant information need to be taken into account.

How to carry out the PIT? PIT's economic parameters Identification of the correct discount rate

- Compares the expected profitability of the public investment with the expectations of a private company.
- Returns of the investment should be discounted using the same rate that private investor would have used.
- Correct discount rate depends on the **financial risk associated** with the investment – consider expectation of cost and revenues.
- The cost of capital is **the minimum return** that investors expect for providing capital to the company. Calculation of Weighted Cost of Capital is therefore necessary.

How to carry out the PIT? PIT's economic parameters Expected cash flows/incremental cash flow

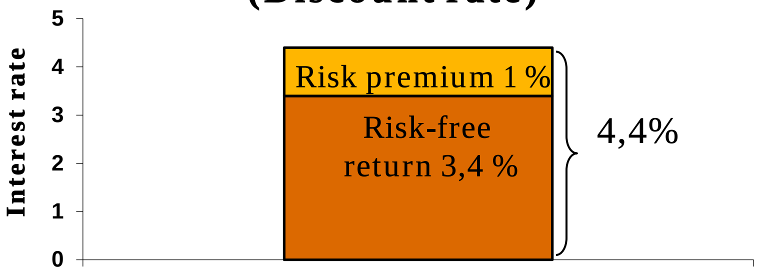
- To determine a project's rate of return, calculate the expected incremental cash flow - the additional operating cash flow after capital injection (for example dividend payout).
- **Cash flow** is the movement of cash into or out of an investment.
- Two ways to calculate the difference between the expected rate of return of a private investor and the actually expected rate of return: calculation of Net Present Value **NPV** or calculation of the Internal Rate of Return **IRR.**

Reminder: The PIT compares the return a (hypothetical) private investor would expect for its investment with the return the public authority achieves with its actual investment in an undertaking.

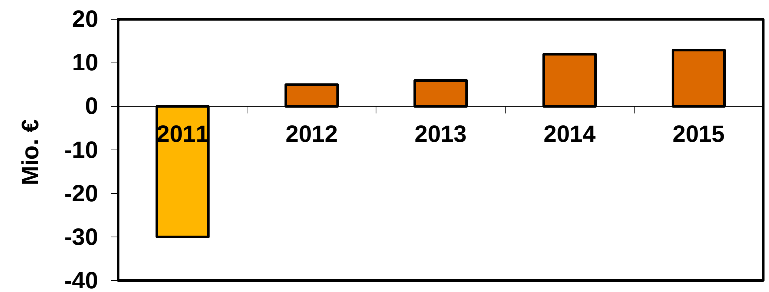
How to carry out the PIT? PIT's economic parameters Step 3 - Comparison and assessment

Example: A public undertaking invests 30 Mio. € in a company in 2011. A positive incremental cash flow between 2012 and 2015 is expected. The risk-free return is 3,4 % per annum, the risk premium is 1 %.

Determination of cost of capital (Discount rate)



Incremental cash flow



Calculation of IRR or NPV through discounting incremental cash flows

Discount rate: **4.4 %,**

NPV 1.78 Mio. € IRR= 6.5 %

IRR 6,5 %>Discount rate 4,4 %

NPV 1,78 Mio. € > 0

The leading cases and recent development

Important Court cases

- ECJ 21.3.1991 - C-303/88 (ENI-Lanerossi), Slg. 1991, I-1433
- ECJ 8.11 2001 - C-143/99 (Adria-Wien Pipeline und Wietersdorfer & Peggauer Zementwerke), Slg. 2001, I-8365
- ECJ 16.5.2002 - C-482/99, (Stardust Marine), Slg. 2002, I-4397
- EGC 6.3.2003- T-228/99 und T-233/99 (Westdeutsche Landesbank/Kommission), Slg. 2003, II-435
- ECJ 22.11.2007 - C-525/04 P (Lenzing), Slg. 2007, I-9947
- **EGC 17.12.2008 - T-196/04 (Ryanair/Commission)**
- **EGC 15.09.2009, T-156/05 (EDF/Commission)**
- **ECJ 5.6.2012 , C-124/10 (EDF/Commission)**
- **EGC 28.2. 2012 T-268/08 (Burgenland/Commission)**
- **EGC 2.3.2012 T-29/10 und T-33/10 (ING/Commission)**

The leading cases and recent development

Important Commission decisions

- EC 31.1.1996 (IBERIA), OJ L 104/25 from 27.4.1996
- EC 6.9.2004 (Bayern LB), OJ L 307/155 from 7.11.2006
- EC 20.10.2004 (Landesbank Hessen-Thüringen — Girozentrale), OJ L 307/159 from 7.11.2006
- EC 20.10.2004 (WestLB AG), OJ L 307/22 from 7.11.2006
- EU 3.10.2012 (Flughafen München), C(2012) 5047 final

The leading cases and recent development

EGC 17.12.2008 - T-196/04 (Ryanair/Commission)

Background:

- Walloon Region/Charleroi Airport offered Ryanair discounts like reduction in landing and handling charges – long term deal for 15 years
- Cash flows to be used for the NPV calculation:
  - Revenue from serving Ryanair and other airlines (landing/passenger charges)
  - Commercial revenues (retail, catering, transport)
  - Outline activities which have a public power character (ex. Airport's security costs)

Decision 2004/393/EC

- Walloon Region and Charleroi were acting using their public power: ‘Fixing of landing charges fell within legislative competences and is not an economic activity’– PIT does not apply.

Court Judgment annulled the Commission’s decision

- Commission should have applied the PIT to the measures adopted by the Walloon Region since it constituted an ‘economic activity’; the fixed charges could be seen as ‘fees’ rather than ‘tax’.

The leading cases and recent development
EGC 15.09.2009, T 156/05 (EDF/Commission)

Background:

- EDF: public undertaking owned by the French State.
- Writing-off a corporation tax amounting to 889 million €.

Decision 2004/393/EC

- The Commission found this measure incompatible with State aid rules per se and ordered recovery – ‘France has exercised its public power competences – the advantages have been created by means of a tax exemption’.

Court Judgment annulled the Commission’s decision

- Court found that in this case the State was operating as a shareholder and investor, and this measure was not a fiscal measure adopted within the use of public power. The EDF’s capital was strengthened and a private investor would have acted accordingly.

This case rose a big debate over the application of PIT–
before this ruling all State’s fiscal measures were classified as acts of public powers. PIT has so far been seen as excluded in tax measures.

The leading cases and recent development
ECJ 5.6.2012 , C-124/10 (EDF/Commission)

Background:

- Appeal of the EGC judgment before the ECJ

Court Judgment dismissed the appeal and found that:

- PIT should be applied by the Commission as a rule when appraising State aid, and not as an exception when a Member State so requests.
- PIT may be applicable even where the State has at its disposal means which are not available to the private investor (such as fiscal means), if those means are used to pursue an economic activity
- As stated by the EGC, in this case the State was operating as a shareholder and investor, and this measure was not a fiscal measure adopted within the use of public power.

PIT is considered a material standard to be applied as a rule. This includes the application by the Commission ex officio even with regard to fiscal measures.

The leading cases and recent development
EGC 28.2. 2012 T-268/08 Burgenland/Commission)

Background:

- Privatisation of public Bank Burgenland at negative sales price
- Authorities chose second best offer as likelihood whether public guarantee was drawn was smaller

Decision 2004/393/EC

- The Commission found this measure incompatible with State aid rules and ordered recovery – Austria should have sold to the best bidder. PIT not applicable as previous measure (State guarantee) involved State aid

Court Judgment confirmed the Commission's decision

- The Court found that in this case the State was operating as a public authority and not like a private investor, PIT only applicable to measures undertaken under real market conditions (guarantee was not issued at market conditions and therefore cannot be taken into account to valuation of bids).

The leading cases and recent development
EGC 2.3.2012 T-29/10 und T-33/10 (ING/Commission)

Background:

- Recapitalization of ING DIBA through Dutch State
- Change to repayment conditions

Decision 2004/393/EC

- The Commission found the change in the repayment conditions involved State aid of 2 bn € and that per se the PIT cannot be applied.

Court Judgment annulled the Commission’s decision

- The Court found that in this case the Commission was wrong in excluding per se the application of the PIT. PIT is applicable to all measures.

This case together with Burgenland rose a big debate over the application of PIT– whether for a measure the PIT can be applied if the previous measure was involving State aid (spill-over doctrine). Both judgments seem to contradict each other.

Thank you for your attention !

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