LUND UNIVERSITY

Spring 2010

School of Economics and Management
Department of Business Law
HARM02 Master of Business Law
Master thesis 30 ECST

On the right track towards a competition neutral compensation?

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State Aid Control

Preface

Foremost I would like to thank to Professor JD Christopher H. Bovis at University of Hull, UK for his sincere support and insightful advice. My second expression of gratitude goes to my supervisor, Professor JD Boel Flodgren for her precious guidance and help in shaping my thinking and improving my reach. I am also grateful to the officials of the National Competition Councils, especially to Mrs Izabela Nedelcu in Bucharest and Mr Jesper Halvorsen in Copenhagen for enabling me to keep in touch with authority practice. I would like to express my profound gratitude to Mrs Eva Molnar, from European Commission for her supportive contribution. Eventually, I cannot fail to thank to the dedicated management of the Department of Business Law for their salutary initiative to provide an interdisciplinary form of education in law and management at Lund University.

Emanuela Andersson
Thursday, 10 June 2010 Ängelholm

Abstract

Passenger transport services constitute public utilities, exactly like all the other similar public networks e.g. energy & water distribution, TV broadcasting or postal services. The Member States in the EU have a keen interest in the development of passenger transport and therefore the financing of public transport is such an important economic, political and social issue. In its ideal form, the financing of public transport should be handled by the transport operators and the use of State money would be restricted to exceptional cases. However, due to the existent failures in the public transport markets, the quality and intensity of these services depend on the public intervention. Therefore, the existence of State aid in this sector is still necessary and the compatibility of such an aid is often motivated by the protection of public interest. On the other hand, according to the EU law rules, the State intervention should be kept under control in order to ensure that the competition between Member States is not distorted in a disproportional manner. There is a presumption that all the financial aids granted by the State to certain service providers have a distortive influence and even smaller aids in the transport sector can have a negative effect on competition between Member States. In this context, the stand-still clause has been stipulated in the Treaty, in order to make sure that the presumptive negative effects are held under control and the principles of proportionality, transparency and non-discrimination are respected, as well. The scope of the prohibition rule in Article 107(1) TFEU has nevertheless been reduced in court practice and according to this amended definition of State aid for public service interest, the focus falls on the existence of a real advantage granted by the public authorities instead of the distortive effect of the financial measure under review. The existence of a real advantage has to be disclosed by applying a simple formula that inputs the necessary costs, the reasonable profit and the possible extra-revenues incurred in fulfilling public service obligations. May this formula be too simple in order to ensure an effective control of State aid or ought the legal approach adopted by the case-law to be tuned to the effect doctrine expressed by the Treaty rules? These are the main questions that the present study endeavours to answer.

Keywords: *State aid control, Stand-still clause, Compensation for PSO, Reasonable Profit, Quality Requirements*

Sammanfattning

Kollektivtrafiken hör till allmänna nyttigheter, precis som alla andra nätverktjänster till ex vatten- och energidistribution, TV-sändning eller posttjänster. Medlemstaterna i EU visar ett stort intresse för kollektivtrafikens utveckling och därför utgör dess finansiering en mycket viktig ekonomisk, politisk och social fråga. Idealiskt sett borde transportoperatörerna ta hand om finansieringsfrågan och offentliga medel skulle utnyttjas bara undantagsvis. På grund av karaktäristiska marknadsfel är dock kvaliteten och frekvensen av dessa tjänster beroende av offentliga medel. Därför är statligt stöd fortfarande nödvändigt inom denna sektor och dess kompatibilitet med den interna marknaden grundas ofta på skyddet för det allmänna intresset. I enlighet med EU- rätten skall emellertid statens ingripande hållas under kontroll för att försäkra sig att konkurrensen mellan medlemstaterna inte snedvrids på ett oproportionellt sätt. Det finns en presumtion att alla finansiella stöd som beviljas av staten till vissa transportoperatörer har ett snedvridande inflytande och att även mindre stöd har negativa effekter på konkurrensen mellan medlemstaterna. I detta sammanhang har stillaståendeklausulen stipulerats i fördraget för att försäkra att de presumtivt negativa effekterna hålls under kontroll och proportionalitets-, transparens- och icke-diskrimineringsprincipen också respekteras. Trots allt detta har omfånget av förbudsregeln i artikel 107(1) FUEG reducerats i rättspraxisen och enligt denna modifierade definition av statligt stöd för allmänt intresse hamnar existensen av en reell förmån i fokus istället för effekten som en sådan finansiell åtgärd kan medföra. Existensen av en reell förmån skall yppas genom att tillämpa en kalkylformel som inmatar nödvändiga kostnader, en rimlig vinst och eventuella extrainkomster som uppstår som resultat av dessa allmänna tjänstplikter. Må denna kalkylformel vara för enkel för att kunna försäkra en effektiv kontroll av statliga stöd eller bör det rättsliga synsättet som adopterades av rättspraxis ställas in på samma frekvens med effektdoktrinen som kommer till sitt uttryck i fördraget? Det är dessa huvudfrågor som den här studien strävar efter att besvara.

Ämnesord: *Statligt stöd, Stillastående klausulen, Ersättning av allmän trafik, Rimlig vinst, Kvalitetsmålen*

Abbreviations

BUPA- British Union Provident Association

CIE- Córas Iompair Éireann

CJ- Court of Justice

DB- Deutsche Bahn

DSB- Danske Statsbaner

EU- European Union

EVA- Estimated Value Added

FUEG- Fördrag om Upprättandet av Europeiska Gemenskaperna

GC- General Court

LCR- London & Continental Railways Ltd

PMI- Private Medical Insurance

PSO- Public Service Obligations

RATP- Régie Autonome des Transports Parisiens

RES- Risk Equalisation Scheme

SJ- Sveriges järnvägar

SNCB- Société Nationale des Chemins de fer Belge

SNCF- Société Nationale des Chemins de fer Français

SGEI- Services of General Economic Interest

TFEU- Treaty on the functioning of the European Union

VHI- Ireland Health Insurer

VVT- Verkehrsverbund Tyrol

Glossary

Term	Definition
candidate	means one who has sought an invitation to take part in a restricted or negotiated procedure
commercial traffic	public transport market where there is no need for State intervention in order to guarantee a certain level of quality of service
competent authority	any public authority or group of public authorities of a Member State or Member States which has the power to intervene in public passenger transport in a given geographical area or anybody vested with such authority
competent local authority	any competent authority whose geographical area of competence is not national
contracting authorities	State, regional or local authorities, bodies governed by public law, associations formed by one or several such authorities or one or several of such bodies governed by public law
cross-subsidisation	an incorrect allocation of joint costs between the competitive and the non-competitive sector
direct award	the award of a public service contract to a given public service operator without any prior competitive tendering procedure
economic operator	contractor, supplier or service provider
exclusive right	a right entitling a public service operator to operate certain public passenger transport services on a particular route or network or in a particular area, to the exclusion of any other such operator;
general rule	a measure which applies without discrimination to all public passenger transport services of the same type in a given geographical area for which a competent authority is responsible
integrated public passenger transport services	interconnected transport services within a determined geographical area with a single information service, ticketing scheme and timetable
internal operator	a legally distinct entity over which a competent local authority, or in the case of a group of authorities at least one competent local authority, exercises control similar to that exercised over its own departments
market failure	inefficient allocation of resources in a free market
public passenger	passenger transport services of general economic interest provided to the public on a

transport	non-discriminatory and continuous basis
public service compensation	any benefit, particularly financial, granted directly or indirectly by a competent authority from public funds during the period of implementation of a public service obligation or in connection with that period
public service contract	one or more legally binding acts confirming the agreement between a competent authority and a public service operator to entrust to that public service operator the management and operation of public passenger transport services subject to public service obligations
public service obligation	a requirement defined or determined by a competent authority in order to ensure public passenger transport services in the general interest that an operator, if it were considering its own commercial interests, would not assume or would not assume to the same extent or under the same conditions without reward;
public undertaking	any undertaking over which the contracting authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it
public service operator	any public or private undertaking or group of such undertakings which operates public passenger transport services or any public body which provides public passenger transport services
service concession	a contract of the same type as a service contract except for the fact that the consideration for the provision of services consists either solely in the right to exploit the service or in that right together with payment to the competent authority in question
services of general economic interest	This term refers to market services which the Member States subject to specific public service obligations by virtue of a general interest criterion; it covers transport networks.
service provider	a natural or a legal person, or a contracting entity or a group of such persons and/or entities which offers services on the market
supply, works and service contracts	contracts for pecuniary interest concluded in writing between one or more of the contracting entities and one or more contractors, suppliers, or service providers
tendered traffic	public transport market where State intervention is necessary in order to guarantee a certain level of quality of service
tenderer	a transport operator who submits a tender
value	the value of a service, a route, a public service contract, or a compensation scheme for public passenger transport corresponding to the total remuneration, before VAT, of the public service operator or operators, including compensation of whatever kind paid by the public authorities and revenue from the sale of tickets which is not repaid

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1. Introduction

1.1. Background

This paper is about the financial support granted by the award of public service contracts to track-based transport operators in the EU and the undue distortion of competition in relation with this financial support. The public service contracts are procurement agreements between a public authority as purchaser and a track-based operator as service provider. Most of these contracts are awarded via competitive tenders according to the EU competition rules. There is a responsibility for the Member States to award public service contracts by transparent awarding procedures. However, the direct award of public service contracts is not illegal in the EU.

In order to support the European model of market economy with strong social responsibility, the national, regional and local authorities enjoy a wide discretion in providing, commissioning and organising public transport as closely as possible to the needs of the passengers. These authorities shall promote a high level of quality, safety and affordability, equal treatment and the promotion of universal access and of passengers' rights.

Probably the most harmful way to distort trade is by grant of State aid. The legal definition of State aid is stipulated in Article 107(1) TFEU. A State aid measure is a financial support granted by the State to certain undertakings. This support implies an advantage for the beneficiary and has a distortive impact on the internal market. All financial measures that satisfy the cumulative conditions in the Article 107(1) TFEU are illegal, unless notified by the government to the Commission and approved by it. The rule imposing the obligation of notification is known as the stand-still clause.

During the period of implementation of a public service contract, the public authorities may grant financial benefits to the track-based operator in order to guarantee high quality passenger transport. These benefits can either constitute State aid or can be treated as representing a remuneration paid by the State to the track-based operators entrusted with public service obligations. In this context, a correct definition of the financial measure is absolutely essential in order to insure that no undue distortion of competition will incur as a result of an unnecessary or disproportional large reward. The contracts should be awarded by tender only where there is no interest from the free competition sector.

1.2. Topic

During the last decades, the State intervention in the economy has been continuously reduced, though the state continues to play a crucial role in the regard of public interest. However, the competition in the railway sector concerns foremost the tendered traffic, while the commercial one is still reserved to the traditional railway companies.

Well-functioning passenger transport links are vital for both European undertakings and citizens. The transport policies affect everyone in Europe and no Member State is capable to deal by its own with the challenges of sustainable mobility in the EU. The funding & pricing is one of the most important components of transport policy, which can only be successful by enforcing an effective control of the compensatory benefits granted to public transport operators in the EU. The key issue is to find a balance between the tendered and commercial traffic, making sure that the society needs are met and the market offers all the right conditions to minimize the need for State intervention.

The Commission is invested with the duty of preventing distortion of competition in the EU and the provision of public services is subject to the competition law and the Treaty rules on State aid apply to undertakings entrusted with public service obligations. According to case-law, the necessary reward or so-called, compensation for public service obligation is not regarded as State aid measure, unless the private operator is granted a gratuitous benefit from the State. The compensatory elements have to be clearly defined and classified in order to ensure that the stand-still clause is respected.

According to the pursuit of less and better targeted State aid[1], the national authorities shall promote the maintenance or development of an efficient management by public service operators, which can be the subject of an objective assessment, and the provision of passenger transport services of a sufficiently high standard. The same consideration for management efficiency has been previously expressed by the CJ in the *Altmark* judgment C-280/00[2], where four cumulative criteria have been formulated in order to determine the existence of an advantage obtained by a transport operator entrusted with public service obligations.

Achieving a high level of efficiency is a central issue, which means to create prerequisites for lower prices, better quality and a broader range of travel services above and beyond the regular public transport. The main challenge is to achieve all these objectives in a way that minimize the State intervention.

[1] Commission staff working paper - Annex to the : State aid action plan - Less and better targeted state aid: a roadmap for state aid reform 2005–2009 (Consultation document) Impact assessment {COM(2005) 107 final}, SEC/2005/0795 final

[2] ECR 2003 Page I-07747

1.3. Purpose

In this paper, I will focus on the award of public contracts for tendered traffic and aim to establish the State aid control rules that apply on financing of track-based passenger transport. More exactly, I have pursued to investigate whether the efficiency assessment is necessary and why and, what approach is the most effective and legally certain in order to prevent the undue distortion of competition. The paper analyzes also the importance of the quality requirements as a mean to attain a competition neutral compensation.

In order to deliver an appropriate answer to the issues announced above, the study will pursue to answer a series of supporting questions: What is the relation between the Article 107(1) TFEU and *Altmark* criteria? What is the relation between Articles 93 and 106(2) TFEU? What is the relation between Articles 107(1) and 93 TFEU as implemented by the *Regulation on PSO*? What is the relation between State aid control and procurement rules? What is reasonable profit? What is a typical undertaking well run and adequately equipped? What is over-compensation? Should there be a judgment on efficiency? When is it necessary to notify a State aid in the form of public service compensation to the Commission? What are the legal consequences if the compensation is indeed a State aid covered by the stand-still clause and non-notified?

1.4. Delimitations

The perspective adopted in this paper is the one of the public transport authorities, since they are responsible both for ensuring a satisfactory standard of public transport as close as possible to the needs of the passengers and for avoiding the undue distortion of competition between the Member States. It is almost presupposed that the main accent falls on the tendered traffic, while the commercial traffic is only digressively treated. The particular case of public-private-partnerships is not treated in this paper. I will neither dedicate closer attention to compatibility grounds that fall outside the scope of the *Regulation on PSO*, such as transport coordination, allocation of infrastructure costs or R & D promotion.

1.5. Method and Material

This paper applies the legal scientific method[3] in order to analyze the legal rules that govern the public funding of passenger transport in the EU. The efficiency appraisal related to decisions on the issue of discharging PSO is made on a case-by-case basis since an exhaustive legislation could not be established in this field of law. The legislation provides nevertheless some rules of thumb, based on the general principles

[3] Sandgren (2007) p 39

of law, in particular the transparency and proportionality principles. Subsequently, I have pursued to analyze case-by-case the Court and Commission decisions which interpret the efficiency criterion. The central Court cases discussed in this paper are: *FFSA* T-106/95[4], *Ferring* C-53/00[5], *Altmark* C-280/00[6], *Chronopost* C-83/01, C-93/01P and C-94/01P[7] and *BUPA* T-289/03[8]. Furthermore, the thesis examines a series of Commission-cases: *Poste Italiane* C-49/2006[9], *Postbus* C-16/2007[10], *DB Regio* C-47/2007, *Emsländische Eisenbahn* C-54/2007, *Southern Moravia* C-3/2008[11], *Danske Statsbaner* C-41/2008 and *Anhalt-Bitterfeld* C-6777/2009[12]. The paper contains also a brief presentation of the last strategic acquisitions occurred on the public transport arena and some reference examples related to the recently proposed legislation on public passenger transport in Sweden.

1.6. Outline

This paper proceeds as follows. Chapter 2 analyzes the economic justifications to grant public service compensation and the legal framework that has been enforced in order to prevent the possible negative effects on competition and trade. This framework comprises the *Utilities Directive*, the *Regulation on PSO* and the applicable treaty rules. In chapter 3, I introduce the general applicable regulation on State aid control. In the first part, I analyze the four cumulative criteria composing the legal definition of State aid. I focus in particular on the advantage criterion, which represents a central issue in this paper. Further on I give an account of the relevant compatibility rules and emphasize the role of the Commission in safeguarding competition in the internal market. Chapter 4 is concerned with the case-law in the field of discharging public service obligations. Firstly I give a general account of the legal approaches and later on I focus on the *Altmark*-approach and follow its application in the post-*Altmark* case-law. Chapter 5 analyzes the post-*Altmark* case-law in order to underline the legal significance of the efficiency and quality criteria in the assessment of compensation for public service obligations. Chapter 6 concludes and offers hopefully new insights concerning the financing of public service interest.

[4] ECR 1997 Page II-00229
[5] ECR 2001 Page I-09067
[6] ECR 2003 Page I-07747
[7] ECR 2003 Page I-06993
[8] ECR 2008 Page II-00081
[9] OJ L 189, 21.7.2009, p. 3–37
[10] OJ L 306, 20.11.2009, p. 26–38
[11] OJ L 97, 16.4.2009, p. 14–25
[12] http://ec.europa.eu/community_law/state_aids/transports-2009/n206-09.pdf

2. Public Passenger Transport Service

2.1. Public Service Obligations

A requirement defined or determined by a competent authority in order to ensure public passenger transport services in the general interest that an operator would not assume without a reward, represents a public service obligation (hereinafter "*PSO*"). Another characteristic of the PSOs in the field of transport is the market dispersion as a consequence of entry barriers such as: low profitability, high set-up costs and oscillating volume. Due to these entry barriers, the public transport market is dispersed to such an extent that often there is no comparable value of the relevant service, because the commercial market is not interested in assuming the business risk related to PSO.

The term *Service of General Economic Interest* is used in Article 106 TFEU and refers to market services, which the Member States subject to specific PSOs by virtue of a general interest criterion.[13] The definition of *Service of General Economic Interest* covers transport networks. The PSOs must be fulfilled efficiently, at a reasonable price and be sustainable and socially just.[14] In order to promote the social and territorial cohesion, the Union recognises and respects access to services of general economic interest as provided for in national laws and practices, in accordance with the Treaties.[15]

Article 14 TFEU provides that achieving the *Services of General Economic Interest* mission shall be done by complying with the Articles 93 and 107 TFEU:

> *Without prejudice to Article 4 of the Treaty on European Union or to Articles 93, 106 and 107 of this Treaty, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Union and the Member States, each within their respective powers and within the scope of application of the Treaties, shall take care that such services operate on the basis of principles and conditions, particularly economic and financial conditions, which enable them to fulfil their missions.*

According to the principle of proportionality, public service providers shall not engage in activities which would result in disproportionate distortions of competition that are not necessary for fulfilling the public service mission.

[13] Report to the Laeken European Council - Services of General Interest /* COM/2001/0598 final */
[14] Faull & Nikpay 2007, p 1747
[15] Article 36, Charter of Fundamental Rights of the European Union

2.2. Public Service Contract- an instrument to enforce Public Service Obligations

A public service contract is a legally binding agreement between a competent authority and a public service operator to entrust to that public service operator the management and operation of public passenger transport services subject to PSOs. The concept of public service contract reinforces the universal treatment of the PSOs in the EU and attempts to bring it under the wider concept of Services of General Economic Interest with the intention to exonerate PSOs from the remit of state aid rules.

Until the eighties, public utilities networks such as railway, tramway, trolleybus and bus services have been considered to constitute the exclusive competence of the National State. The changes imposed by the liberalization of public services have brought a new perspective on the public utilities networks and enlightened the differences between them. In the EU, the service contracts for PSO on public passenger transport, by track-based can be awarded to:

1. joint stock companies, such as *Veolia Transport*[16] (F) and *Arriva*[17] (UK) selected by means of public procurement procedures;
2. companies with mixed public and private ownership, in which the private partner is selected by means of public and open tendering procedures that have ensured compliance with domestic and Union legislation on competition in accordance with guidelines issued by the competent authorities in specific regulations or circulars;[18]
3. companies belonging entirely to the public sector on condition that the public authority or authorities, such as *Deutsche Bahn*[19] (D), *DSB*[20] (DK) or *SNCF*[21] (F) holding the share capital exercise over the company control comparable to that exercised over their own departments and that the company carries out the essential part of its activities with the controlling public authority or authorities.

Most of the Member States which have opened up their markets for public passenger transport have developed the so-called "*regulated competition*" system; this means that a competent authority grants an exclusive right for a specific period following an open and transparent invitation to tender, which often contains selection criteria referring to the service level, quality standards and/or tariffs.[22]

[16] Formerly Connex, is the international transport services division of the French-based multinational company Veolia Environnement

[17] One of the leading transport services organisations in Europe with bus and train operations in the UK, Denmark, Germany, the Netherlands and Sweden. In addition Arriva has bus operations in Czech Republic, Hungary, Italy, Portugal, Slovakia and Spain, and operates rail services in Poland.

[18] Skånetrafiken (SE), for instance, operates through a number of PPP, in this system of mixed ownership.

[19] National Rail Operator in Germany

[20] National Rail Operator in Denmark

[21] National Rail Operator in France

[22] Revised proposal for a Regulation of the European Parliament and of the Council on public passenger transport services by rail and by road, COM/2005/0319 final - COD 2000/0212

The third alternative renders the public tendering inapplicable, because of the existence of the dependency links between the operator and the State or its organs, so-called contracting entities. *Regulation on PSO* has introduced the notion of "*internal operator*", which means a legally distinct entity over which a competent local authority, or in the case of a group of authorities at least one competent local authority, exercises control similar to that exercised over its own departments. An "*internal operator*" is not allowed to participate in competitive tenders outside the area for which the public service contract has been granted.[23]

The current financial crisis has affected the private owned transport operators and the major state owned transport operators, *DB* and *SNCF* have been lately involved in a battle to achieve control over the European railway market. *DB* controls for instance the *English Welsh & Scottish Railway Holdings*[24], *Transfesa*- the largest private operator in Spain[25], and more recently the British operator, *Arriva Plc*[26]. *DB Regio* UK won a local tender for the operation of *Tyne & Wear Metro* in Newcastle[27] and *DB Regio Sverige* will take over commuter train routes in the Swedish province of *Östergötland* starting in December 2010.

SNCF, *Eurostar*[28] Ltd and *SNCB*[29] have proceeded to restructure their contractual cooperative joint venture to a full-function joint venture to be jointly controlled by *LCR* and *SNCF*.[30] Moreover, *SNCF* owns a 44, 5% stake in *Keolis*[31], a French transport company operating in regional railway passenger networks in both UK and Germany.[32] *SNCF* controls also *Veolia Cargo*, formerly division of *Veolia Transport*.
A strategic move on the railway market was made by *DSB*, the Danish state-owned operator, who entered the German market by taking over 50% of the local company *VIAS* GmbH[33], which is headquartered in Frankfurt am Main. *DSB* is present on the Swedish market as well.[34]

These strategic transactions suggest the beginning of a new trend in the railway sector, where two giants, *SNCF* and *DB* compete for market supremacy. Both of them are State-owned undertakings. One of the most significant private transport operators on the European market, *Arriva Plc* (UK) could not manage the

[23] Regulation on PSO, art 2(j) and art 5(2) b
[24] OJ C 125, 22.5.2008, p. 6–6
[25] OJ C 137, 4.6.2008, p. 6–6
[26] On the 22nd of April 2010 DB has bought Arriva Plc for £ 1, 59 x 10^9 (€ 1, 9 x 10^9). Arriva operates transport in 12 European countries.
[27] http://deutschebahn.de/site/ir/ir__dbag/en/news__presentations/archive/db__regio__uk__tyne__and__wear.html 2010-05-13 13:51
[28] A subsidiary of London and Continental Railways (LCR)
[29] Belgian Rail Operator
[30] Notified OJ C 112, 1.5.2010, p. 6–6
[31] Keolis is the largest public transport operator in France. Read more at http://www.keolis.com/en.html 2010-05-13 13:10; For the prior notification of the concentration see OJ C 227, 22.9.2009, p. 30–30
[32] http://www.sncf.com/en_EN/html/page/GROUP 2010-05-13 13:15
[33] http://www.dsb.dk/Om-DSB/In-English/Company-Profile/UK-press-releases-/DSB-acquires-fifty-per-cent-of-German-train-operator/ 2010-05-13 13:20
[34] http://www.dsb.dk/Om-DSB/In-English/Company-Profile/UK-press-releases-/DSB-wins-fourth-rail-contract-in-Sweden/ 2010-05-13 14:22

financial crisis as well as its State-owned competitors. On 22nd of April 2010, *Arriva Plc* has joined the *DB Group*. The acquisition has been concluded after a bidding war between *SNCF* and *DB*.[35]

2.3. The legal framework on PSO in the field of land transport

The European transport by track-based is an integral part of the Union policies and internal actions under Articles 90-100 TFEU. Special provisions on State aid under Article 93 TFEU have been adopted at EU level. This article provides:

> *Aids shall be compatible with the Treaties if they meet the needs of coordination of transport or if they represent reimbursement for the discharge of certain obligations inherent in the concept of a public service.*

Article 100(1) TFEU stipulates that Articles 90-100 TFEU only apply to transport by rail, road and inland waterway.

2.3.1. Utilities Directive

The procedures for the award of public service contracts in the EU are governed by the so-called public procurement directives: the *Utilities*[36] and respectively the *Traditional Services*[37] *Directive*. Public service contracts are public contracts, other than public works or supply contracts, having as their object the provision of inter alia land transport services.[38]

The State and its contracting entities enjoy nevertheless a wide discretion to award public service contracts under public procurement rules and the price plays often a secondary role.[39] There are two criteria, under which public service contracts can be awarded: the *lowest price* and the *most economically advantageous tender*. Where a public service contract is awarded according to the latter criterion, the market price can be totally different than the price the competent authority wants to pay for the procurement of services satisfying the quality requirements. Furthermore, the public procurement directives provide for an automatic disqualification of an obviously abnormally low offer[40].

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[35] Read more on Financial Times http://www.ft.com/cms/s/0/037ac292-4e4e-11df-b48d-00144feab49a.html 2010-05-14 14:30

[36] Directive 2004/17/EC, OJ L 134, 30.4.2004, p. 1–113

[37] Directive 2004/18/EC, OJ L 134, 30.4.2004, p. 114–240

[38] Directive 2004/18/EC, Annex II and definitions in article 1(2)

[39] Bovis 2008, p 465-466

[40] Utilities Directive, 2004/17/EC, OJ L 134, 30.4.2004, p. 1–113, art 57(1) (e): "*If, for a given contract, tenders appear to be abnormally low in relation to the services, the contracting entity shall, before it may reject those tenders, request in writing details of the constituent elements of the tender which it considers relevant. Those details may relate in particular to (…) the possibility of the tenderer obtaining State aid*."

Public service contracts for tramway fall under the scope of *Utilities Directive* and shall be awarded via public procurement procedure as provided in the article 5(1) of the *Regulation on PSO*.

Public service contracts shall not be subject to the *Utilities Directive*, if the passenger transport activity is directly exposed to competition, in a certain Member State, according to the article 30(1) of this act. The provisions in article 30(1) of the *Utilities Directive* imply that the traffic is no longer tendered and the Treaty rules are directly applicable.

2.3.2. Regulation on PSO

Regulation on PSO shall apply to "*the national and international operation of public passenger transport services by rail and other track-based modes and by road, except for services which are operated mainly for their historical interest or their tourist value*"[41].

The service concessions awarded by the national contracting entities[42] for carrying out public transport services have been left outside the scope of the procurement directives[43]. Service concession is according to the definition in the procurement directives, "*a contract of the same type as a public service contract except for the fact that the consideration for the provision of services consists either solely in the right to exploit the service or in this right together with payment*"[44]. According to proposed Swedish law, the service concession agreement implies that the transport operator takes direct responsibility for passengers in the same way as in commercial services. The public transport authority may not grant exclusive rights for railways in Sweden.[45]

The *Regulation on PSO* is applicable on the award of service concessions, if a reward is absolutely necessary in order to ensure public passenger transport in general interest. In contrast, if the market forces by it selves can provide services of sufficiently high quality, at an affordable price, no reward is involved and the service concessions shall comply directly with the Articles 49-56 TFEU and the principles of transparency and equal treatment of the candidates or potential tenderers.[46]

In order to conclude, the *Regulation on PSO* provides that public service contracts for track-based modes may be awarded via:

[41] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, art 1(2)
[42] According to Swedish Act on County Coordinating Bodies (2002:34), the County and Municipalities in the County are jointly responsible for public transport in Sweden.
[43] Utilities Directive, OJ L 134, 30.4.2004, p. 1–113, art 18
[44] Utilities Directive, 2004/17/EC, OJ L 134, 30.4.2004, p. 1–113, art 1(3) b and Traditional Services Directive, 2004/18/EC, OJ L 134, 30.4.2004, p. 114–240, art 1(4)
[45] SOU 2009:39 p. 25 and Prop. 2009/10:200 "*A new public transport law*"
[46] Regulation on PSO, recital 20

- competitive tendering procedure[47]
- public procurement procedure for tramway[48]
- direct award to internal operators[49]
- direct award to external operators for track-based modes transport except tram and metro under a limited period of time[50].

The rule stipulated by the *Regulation on PSO*, that the direct award of public service contracts shall make subject to greater transparency is essential in order to provide competition neutral solutions in the field of tendered traffic. Transparency guarantees access to information, but in addition to that it is also necessary to use this information that the public transport operators shall have access to the necessary information to be able to appraise the possibilities of running commercial services and the *Public Transport Authority* will have to publish in a way that minimizes the State intervention and facilitates for the transport operators to compete on merits in the tendered traffic market, no matter their ownership structure. The proposed Swedish law requires each county public transport statement and schedule as well as each county comprehensive report on PSO.[51]

The award of public service contracts by the public authorities to the private transport operators may have distortive effects on the competition. The State aid control in the EU pursues to prevent, detect and eliminate these distortions.

[47] Regulation on PSO, art 1(1)-(2), 3(1) and 5(1)
[48] See chapter 2.3.1.
[49] Regulation on PSO, recital 18
[50] Regulation on PSO art 5(6)
[51] Read more SOU 2009:39 pp. 27-28

3. State Aid Control

The pursuit of State aid control is to provide a level playing field in the internal market and to combat market foreclosure and other competition damages that can incur through government favouritism or the act of picking "*winners*".[52]

The State aid control treats a variety of financial measures having a large range of purposes: production aid, environmental aid, investment aid, R & D aid, export aid, agricultural aid, transport support, employment aid, aid for recovery and reconstruction etc. There are three Treaty articles ruling the State aid Control at a general level: 107, 108 and 109 TFEU. Furthermore, the Treaty contains specific rules, such as 93 and 96 TFEU, on land transport and 106(2) TFEU on undertakings entrusted with Services of General Economic Interest.[53] The Article 107 TFEU contains the basic rules on State aid, where Article 107(1) TFEU stipulates a general prohibition and Articles 107(2) and (3) TFEU establish exception rules. The administrative procedures on State aids are treated by the Articles 108 and 109 TFEU.

3.1. Concept of State Aid

A financial measure is State aid if four cumulative conditions are fulfilled:

i. the measure involves State funding- Chapter 3.1.1.;
ii. the measure confers an advantage to the beneficiary- Chapter 3.1.2.
iii. the advantage is selective, in that it is limited to certain undertakings or the production of certain goods- Chapter 3.1.3.;
iv. the measure distorts the competition and affects the internal trade- Chapter 3.1.4.

3.1.1. Aid granted by the State or through State Resources

According to article 107(1) TFEU, "*[s]ave as otherwise provided in the Treaties, 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 shall, in so far as it affects trade between Member States, be incompatible with the internal market*".

[52] Sauter & Schepel (2007)
[53] Commission can authorise a Member State to apply preferential tariffs for the benefit of certain transport undertakings or industries in order to sustain regional policies, according to Article 96 TFEU. However this possibility has seldom been used in the EU.

In order to be qualified as State aid, advantages must be imputable to the State and granted directly or indirectly by means of State resources. The contracting entities operating in the transport sector, as defined in the *Utilities Directive* and the competent authorities as defined in the *Regulation on PSO* are empowered by the State to award public service contracts and subsequently to confer the right to receive compensation for PSO, which constitutes a financial benefit granted indirectly by the State.

3.1.2. Advantage

In order to constitute State aid, a measure must also confer an advantage on recipients. State intervention has two components, the economic and the administrative one or so called the exercise of public power. The *market economy investor* principle[54] aims to establish the borderline between market behaviour and State intervention. Wherever the supply and demand are substitutable and the markets are competitive, *market economy investor* principle is applicable. However, this line of reasoning concerns only the economic component of the State intervention. In contrast, the raison d'être of the administrative component of the State intervention is not related to profitability. The demand and supply in the public utilities markets are not able to adjust to each other in an efficient and natural way. This situation requires administrative corrections for the sake of public interest, which in its turn will demand further State interventions of administrative character. The public procurement legislation is meant to deal with these dysfunctions or so-called market failures. As a rule of thumb, in the absence of competitive award procedures, it will be a presumption that the financial measure confers an advantage.

In the case of track-based transport, a more permissive procurement regime is applicable and under the threshold of € 387 000 per contract the transparency duty shall be met only where certain cross-border interest may exist.[55]

Where the entrustment of PSO confers an exclusive right, in the meaning of article 2 (f) in the *Regulation on PSO*, the operator will often receive compensations in order to ensure a provision of services of sufficiently high quality. The concession's rationale is to grant "*the right of the service provider to exploit for payment his own service and means that he assumes the risk connected with operating the services in question*"[56]. According to the judgment in *BUPA*[57], the commercial risk should be treated distinctly from the PSO-risk. Therefore, the contracting entities are required to define the nature of the missions entrusted to the transport operator and

[54] Expected rational behaviour used as a yardstick in order to determine whether the public authorities' behaviour deviates from the one of a private investor under normal market conditions.
[55] Commission Regulation (EC) No 1177/2009 of 30 November 2009 amending Directives 2004/17/EC, 2004/18/EC and 2009/81/EC of the European Parliament and of the Council in respect of their application thresholds for the procedures for the award of contracts, OJ L 314, 1.12.2009, p. 64–65; It has entered into force on 1 January 2010.
[56] Case C-382/05, Commission v Italy, para 34
[57] Case T-289/03, BUPA, para 179; For further details read the subchapter 4.3.

distinguish basic commercial activities from the PSO-mission. In the case of the service concessions, the risk of the basic commercial activities should be fully assumed by the operator in question, while the risks incurred in discharging the PSO-mission may be compensated by the competent authorities.

In order to conclude the discussion on public procurement as insurance that no advantage has been granted, there are two diametrically opposite situations, where the public services do not have to be tendered. The first one is where the contracting entities provide the public services by themselves or by so-called internal operators. The second situation is where the public services can be viably provided on the basis of market forces alone, with the implication that no compensation for discharging PSO is required. In this case, the State administrative intervention is not necessary and the principle of *market economy investor* is fully applicable. This is the area of commercial traffic[58].

3.1.2.1. *Market Economy Investor Principle* applicable to Commercial Traffic

The identification of a benefit constituting an aid is particularly difficult when services are supplied to recipients who pay less than these services are worth or when the State as recipient pays more than these services are worth. A-G Jacobs in his opinion to the judgment in *Kingdom of Spain v Commission* expressed:

> *Although it is sometimes suggested that financial assistance granted by the State must, in order to qualify as State aid, be gratuitous, the better view is surely that State aid is granted whenever a Member State makes available to an undertaking funds which in the normal course of events would not be provided by a private investor applying ordinary commercial criteria and disregarding other considerations of a social, political or philanthropic nature.*[59]

In the case of economic analysis the course of events is represented by the market conditions. In any financing decision, there are two central variables to be considered: the risk incurred and the corresponding reward to be expected when the investment position is closed. However, the decision making cannot be solely described as objective and rational. Market forces and its operators are not predictable; hence there are no rules to be followed.[60]

[58] Read more about the Swedish interpretation of terms commercial/tendered traffic in SOU 2008:92
[59] Opinion of Mr Advocate General Jacobs delivered on 23 March 1994, Joined cases C-278/92, C-279/92 and C-280/92, ECR 1994 Page I-04103, para 28
[60] Rubini 2009, p 220

3.1.2.2. The *Altmark*[61] *Test* applicable to Tendered Traffic

In 1990, Altmark Trans obtained licences and subsidies for scheduled transport services by bus in the area Stendal for the period 1990-1994. This licence has been renewed in 1994 for the period 1994-1996. The German authorities refused to grant licence to competing companies since according to their understanding, Altmark Trans required the lowest additional financing. In 1996, Altmark's licence has been renewed for the period 1996-2002. A local competitor complained to the German authorities that Altmark was not an economically viable undertaking, since it was unable to survive without public subsidies. The licences granted to it were therefore unlawful. It was also not correct that Altmark Trans needed the least subsidy. Following the legal conflict between Altmark's competitor and public authorities, the German Court asked the CJ inter alia whether such subsidies constitute State aid for the scope of Article 107(1) TFEU.

The CJ established that compensation for discharging PSOs does not represent State aid if:

i. "(…) *First, the recipient undertaking must actually have PSO to discharge and those obligations must be clearly defined (…).*
ii. *(…) Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner (…).*
iii. *(…) Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public services obligation, taking into account the relevant receipts and a reasonable profit (…).*
iv. *(…) Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs, which a typical undertaking, well run and adequately provided within the same sector would incur, taking into account the receipts and a reasonable profit from discharging the obligations*."[62]

The judgment in *Altmark* is consistent with the decision issued by CJ in *Ferring* [63] and the Commission's general approach to public services. The first criterion imposed by *Altmark* judgment requires that the definition of PSO is made clear and specific. Furthermore, the CJ requires that the criteria for the calculation of the compensation must be established ex-ante and made impossible for the national authorities to ignore the calculation parameters and escape examination of compatibility of their State aid. The third criterion prohibits over-compensation in the discharge of PSO.

[61] C-280/00, ECR 2003 Page I-07747
[62] C-280/00, ECR 2003 Page I-07747, paras 87-93
[63] For further details read chapter 4.1

The reference to the element of "*reasonable profit*" in the third and fourth criterion is emphasized for the first time. When is a profit reasonable? What is the comparison base? Is it the national general average or national industry average or European industry average return on investment?[64] All these questions have been left open by the *Altmark* judgment.

The most innovative solution in this case is the rule expressed in the fourth criterion concerning the award of public service contracts. It aims to assure that the award procedure guarantees an optimal allocation of public resources. According to *Intermediación Aérea*[65], the procurement procedure must comply with the criteria of transparency and objectivity and if these criteria are not met then the second part of the fourth *Altmark* condition applies. What is a typical undertaking? When is it well-run and adequately provided with means of transport? All these questions have been left open as well by the *Altmark* judgment. In practical terms, a comparable undertaking may not exist. How can the Commission check that two undertakings are comparable? Who has the burden of proof[66]?

In order to conclude, if the State pays more than necessary for the fulfilment of the PSO, then the transaction contains a gratuitous element and subsequently, it constitutes State aid. The *Altmark* judgment[67] has established also that Article 93 TFEU cannot be applied directly to public passenger transport contracts, but only by virtue of Council Regulations[68].

The real advantage theory holds that the advantages conferred by public authorities have to be judged in relation to the PSO. However, this theory comes in conflict with the fundamental theory of "*effects approach*", which underlines the treaty provisions as it is discussed below in the Chapter 3.1.4. The *Altmar*k maintains the real advantage approach, by not making any reference to the effects of the financial measure under review.[69]

If the Member States do not respect the set of four criteria and if the general criteria for the applicability of article 107(1) TFEU are met, public service compensation constitutes State aid, which must be notified pursuant to article 108(3) TFEU.

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[64] The first useful definition of this term is provided later by the Council Regulation No 1370/2007 (Land Transport Regulation).

[65] Commission Decision of 20 October 2004 concerning the aid scheme implemented by the Kingdom of Spain for the airline Intermediación Aérea SL (notified under document number C(2004) 3938), OJ L 110 , 30/04/2005 P. 0056 - 0077

[66] The Judgment in Laboratoires Boiron, Case C-526/04, ECR 2006 Page I-07529, clarified this legal matter: inverted burden of proof in relation to over-compensation in order to ensure compliance with the principle of effectiveness. (para 57)

[67] paras 77-82

[68] Since the 3rd of December 2009 the Council Regulation 1191/69 has been replaced by the *Regulation on PSO*, OJ L 315, 3.12.2007, p. 1–13.

[69] Bovis, Public Service Obligations in the transport sector, EBLR 2005, 1337-1342

3.1.3. Selectivity

Article 107(1) TFEU prohibits aid which "*favours certain undertakings or the production of certain goods*", that is to say, selective aid. The CJ considers that "*any activity consisting in offering goods and services on a given market is an economic activity*"[70]. In contrast, the construction of the railway infrastructure under the auspices of *CIE*[71] and *Iarnród Éireann*[72] constituted a non-economic activity, because the infrastructure was open to all potential passengers on equal and non-discriminatory terms. Accordingly, the foreseen public guarantee for the financing of the construction of new railway infrastructure in Ireland did not constitute a State aid.[73]

The concept of selectivity exactly like the concept of undertaking relates only to economic activities, i.e. creation of marketable products, in form of goods or services.

3.1.4. Distortion of Competition and Effect on Trade

A measure is defined as State aid by reference to its effects and not to its purpose. Article 107(1) TFEU does not distinguish between the reasons for or the objectives of a measure which reduces the burdens normally imposed on an undertaking, but defines that measure by reference to its effects.[74] The compensation for PSO cannot therefore, merely because of its purpose, escape the application of Article 107(1) TFEU if it confers a competitive advantage on its beneficiaries within the meaning of that provision. The Commission will consider the purpose of a measure only when examining its compatibility with the internal market.

The same considerations apply to effect on trade criterion. It is not necessary to show that the aid measure affects the trade but only the fact that it can affect the internal trade. According to the case-law, strengthening the position of a certain undertaking compared with its competitors within the Union, no matter the specific product affected by the aid is considered to be able to affect the internal trade.[75]

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[70] Judgment of the Court (Fifth Chamber) of 18 June 1998, Case C-35/96, ECR 1998 Page I-03851

[71] Córas Iompair Éireann, as an Irish Statutory Corporation, has no issued share capital or equity invested in the company. Hence, technically speaking, it does not have a shareholder as such. However, as the Irish Government is currently the sole owner of CIÉ, the Government's representatives are the Minister for Transport and his Department.

[72] Irish Rail, contracting entity in the field of rail services

[73] C (2006)2095 final of 07.6.2006 State aid No N 478/2004 – Ireland, State guarantee for capital borrowings by Coràs Iompair Eirann (CIÉ) for infrastructure investment

[74] Case 173/73 *Italy* v *Commission* ECR 1974 709, para 27, and Case C-75/97 *Belgium* v *Commission* ECR 1999 I-3671 (*Maribel bis/ter*), para 25

[75] Case 730/79, para 11; Case 102/87, para 19; Joined Cases 62 and 72/87 para 15 and A-G Lenz Opinion para 20; Case T-55/99, para 86.

Ex hypothesis no actual distortion can exist, where an aid measure is notified to the Commission before its implementation. By contrast, implemented aids without notification distort or threaten to distort competition by the explicit wording in Article 107(1) TFEU.

In order to conclude, a financial measure initiated by the State giving an advantage to certain beneficiaries who are involved in an economic activity and operates in a market in which there is a trade between Member-States, constitutes State aid. It is enough to prove that the aid might limit the potential development of a competing product for which trade already exists. In this connection, two questions arise:

- ✓ The measures do not confer an advantage if the State behaved as a private investor in a market economy.
- ✓ The measures do not confer an advantage, if they serve only to compensate the company for PSO and cumulatively respect the *Altmark* criteria.[76]

It is interesting to notice that a detailed analysis of the relevant market or the competitive relationships between the recipient firm and its competitors is not required in order to prove the existence of State aid.

3.2. Public Transport Service Compatible with the Internal Market

Public service compensation for the operation of public passenger transport services or for complying with tariff obligations established through general rules paid in accordance with *Regulation on PSO* shall be compatible with the internal market. Such compensation shall be exempt from the prior notification requirement laid down in Article 108(3) TFEU. On the other hand, Member States may exclude from the scope of this Regulation general rules on financial compensation for PSO, which establish maximum tariffs for pupils, students, apprentices and persons with reduced mobility. These general rules must be notified to the Commission.[77]

A State aid for track-based transport may be compatible with the internal market, if it satisfies the conditions of Article 93 or 107(3)[78] (a), (c) TFEU. Article 93 TFEU stipulates that State aid for transport coordination and compensation for PSO shall be compatible with the internal market. The *Regulation on*

[76] 2009/973/EC: Commission Decision of 13 July 2009 on the restructuring aid for Combus A/S, OJ L 345, 23.12.2009, p. 28–70, para 279

[77] Art 3(3) in the Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13

[78] Article 107(3) (a) contains rules on investment aid for the purpose of regional development and Article 107(3) (c) contains rules on aid for the objective of broader social interest. The compatibility conditions under Article 107(3) (c) demand well defined and well designed objectives of broader social interest, transparent cost accounting and public tendering procedure in order to reduce the potential competition distortion and effect on trade.

PSO stipulates that compensation for PSO shall be compatible with the internal market, if its purpose is to ensure the fulfilment of PSO or complying with tariff obligations.[79]

According to article 5 of the *Regulation on PSO*, public service contracts must be awarded on the basis of competitive tendering procedure. The only requirements for the competitive tendering procedure are: to be open to all operators; to be fair; and to observe the principles of transparency and non-discrimination. If the tendering procedure observes the principles of equal treatment, transparency and non-discrimination, then the assumption must be that it is also fair.

3.3. Role of the Commission: Safeguard against Distortions of Competition

The EU State aid rules prohibits unjustified distortions of competition, which can arise as a result of over-compensation for or cross-subsidisation of provision of public services, though the Member States define the character of these services within the domestic legal framework. There are three types of competition problems which can occur in the context of public transport:

- Erroneous classification as *Services of General Economic Interest*, i.e. the services concerned are not really in the general interest or the suppliers within the competitive framework already provide them in a satisfactory manner. *Services of General Economic Interest* are defined or determined by a competent authority in order to ensure that an operator, if it were considering its own commercial interests, would not assume or would not assume to the same extent or under the same conditions without reward.[80]

- Over-compensation, i.e. granting advantages to companies entrusted with PSO beyond what is necessary for the service in question. The compensation may not exceed an amount corresponding to the net financial effect equivalent to the total of the effects, positive or negative, of compliance with the public service obligation on the costs and revenue of the public service operator.

In order to calculate the net financial effect, the competent authority shall be guided by the following scheme:

Costs incurred in relation to a public service obligation or a bundle of PSO imposed by the competent authority/authorities, contained in a public service contract and/or in a general rule,

(-) any positive financial effects generated within the network operated under the public service obligation(s) in question,

(-) receipts from tariff or any other revenue generated while fulfilling the public service obligation(s) in question,

[79] Regulation on PSO, art 9
[80] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, art 2 (e)

(+) a reasonable profit[81],

(=) net financial effect

- Compensation for inefficiency, i.e. granting advantages to companies entrusted with PSO which do not promote an effective management and do not provide passenger transport services of a sufficiently high standard.[82]

The State intervention is often motivated by welfare enhancement and consumer protection. In this line of reasoning, it is important to understand that the State intervention even, if well-justified has to define accurately the market failures[83] that it pursues to correct and choose the least harmful solution with consideration on the preservation of competition between the Member States and an efficient allocation of the State resources.

The pursuit of State aid control is to provide a level playing field in the internal market and to combat market foreclosure and other competition damages that can incur through government favouritism or the act of picking "*winners*". According to the treaty definition of State aid, all aids that imply an advantage granted by State to certain beneficiaries and that affect the trade between Member States are incompatible with the internal market. There are several exemption rules provided by the Treaty and by the secondary legislation, which can derogate certain financial measures from the general prohibition in Article 107(1) TFEU. It is the Commission's role to establish the compatibility of State aid measures.

[81] "Reasonable profit" must be taken to mean a rate of return on capital that is normal for the sector in a given Member State and that takes account of the risk, or absence of risk, incurred by the public service operator by virtue of public authority intervention.
[82] Annex to the Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13
[83] For instance public goods and services, externalities, difficult adjustment to market changes etc

4. Case-Law Approach to Discharge of Compensation for PSO

The compensation for PSO may constitute a remuneration granted by the State in accordance with the market conditions and in this case constitutes no State aid. In contrast, if the compensation contains gratuitous elements, then the compensation constitutes State aid and a compatibility assessment has to be made by the Commission. The Commission should apply principles similar to those laid down in the *Regulation on PSO* or, where appropriate, other legislation in the field of public service.[84]

4.1. The Legal Approach to Compensation for PSO

There are three approaches under which, the Courts and the Commission have examined the financing of PSO: the *State aid* approach, the *compensation* approach and the *compensation plus* approach.

The *State aid approach* provides the most legally certain and clear procedures. Any kind of funding is State aid, which may however be compatible with the internal market under Article 93 TFEU, in the case of track-based transport.

FFSA case deals with an alleged State aid offered to the French Post Office, *La Poste*. An association representing several insurance companies complained that *La Poste* was granted a series of tax reductions in relation with its reorganization. The GC established that *La Poste* has been placed in a more favourable financial position than other taxpayers and the measure in question constitutes State aid. [85] The invocation of a derogation rule, in this case Article 107(3) TFEU, implies that the financial measure is covered by the general prohibition in Article 107(1) TFEU and subsequently, the stand-still clause applies as well.

According to the *compensation approach*, a financial measure constitutes State aid only where the State or its competent authorities buy public transport services and pay a remuneration, which exceeds the market price. However the borderline of market price is not easy to determine even with the presence of public procurement procedures, as it will be discussed later in this paper. In Case C-53/00, *Ferring* SA was a distributor of medicine in France belonging to a multinational group of pharmaceutical companies. It sold directly to pharmacies a medicine produced in Germany by another company in the group. *Ferring* SA held that the tax imposition amounted to a grant of State aid to wholesale distributors and infringed the obligation to give advance notice laid down in Article 108(3) TFEU. According to Court judgment, the tax imposition fell outside the scope of Article 107(1) TFEU because no advantage was granted either directly or indirectly. The legal solution provided by the CJ in *Ferring* expressed the idea that an advantage granted

[84] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, recital 36
[85] FFSA v Commission, T-106/95, ECR 1997 Page II-00229, paras 98-100

outside the PSO is equal to a tax exemption and it cannot be covered by the derogation laid down in Article 106(2) TFEU.[86] The function of Article 106(2) TFEU has been declined by this line of reasoning. It classifies the financial measures granted by a Member States in two exclusive categories:

- Legitimate measures outside the scope of Article 107(1) TFEU;
- Illegitimate measures inside the scope of Article 107(1) TFEU/No derogation rules can apply since the measure is considered to be incompatible with the internal market if the compensation exceeds the additional costs borne in discharging the PSO.

According to A-G Tizzano, "*the requirement of compensating the additional burdens of public service is not limited to the purpose or aim of a measure, but is necessarily reflected in its effects, because it must keep public intervention economically neutral and preclude such intervention distorting competition unjustifiably*".[87] In contrast, "*if there is any over-compensation, the portion of aid in excess of the additional net costs incurred in performing the public service should obviously be declared illegal*"[88] since such portion is not covered by the exemption rules. The exemption rules stipulated by the *Regulation on PSO* are following two:

- The purpose for granting compensation relates to public service obligations;
- Unjustified distortions of competition must be avoided by way of granting a compensation that does not exceed the net costs and a reasonable profit, taking into consideration the revenues generated thereby.[89]

Altmark introduced a third approach, the so-called *Compensation plus* approach, which rules that subsidies for discharging PSO do not constitute State aids under *quid pro quo*[90] terms. This approach has been already examined in the subchapter 3.1.2.2. A-G Léger delivered his opinion on *Altmark* case and proposed that the interpretation in *Ferring* C-53/00 should be set aside for several reasons:

- It should be established whether the beneficiary received an economic advantage which it could not be obtained under normal market conditions (quid pro quo principle);
- Secondly, the *effects* approach is an integral part of the legal definition of State aid and according to it, the subsidies are liable to distort competition in the market of local passenger services[91]
- Thirdly, the subsidies for local and regional transport according to *Tubemeuse*[92]- judgment are prone to affect the trade between Member States, even where the amount of aid is small.

[86] Judgment of the Court (Sixth Chamber) of 22 November 2001, paras 32-22 in *Ferring v ACOSS*, Case C-53/00, ECR 2001 Page I-09067
[87] Opinion of Mr Advocate General Tizzano delivered on 8 May 2001, ECR 2001 Page I-09067, para 61
[88] Supra n 85, para 82
[89] Regulation on PSO, Recital 34
[90] "What for what" indicates an equal exchange, where the remuneration does not exceed the service performance.
[91] Opinion of Mr Advocate General Léger delivered on 19 March 2002, para 103
[92] Case C-142/87 *Belgium* v *Commission* (*Tubemeuse*) [1990] ECR I-959, para 43

Accordingly, A-G Léger proposed that the Court should reply that the subsidies granted by the authorities of a Member State to offset the cost of PSO imposed on an undertaking entrusted with operating a local or regional passenger service by land constitute State aid liable to be caught by the prohibition provided for in Article 107(1) TFEU.

4.2. Criterion of private operator acting under normal market conditions

The CJ has not discussed the relation between *Chronopost* and *Altmark* cases; however following the opinion of Bartosch, the *Chronopost* case represents a *lex specialis* while the *Altmark* case a *lex generalis*.[93] In specific situations where there is no comparable private operator, the structure of costs can be used as efficiency criterion.[94]

French Post Office, *La Poste* operates as a state monopoly in the ordinary mail sector, but also on the express delivery market, which is open to competition. *SFMI* is a private law company indirectly controlled by *La Poste*, which has been entrusted by *La Poste* with the management of express delivery services. *Chronopost* is *SFMI*'s agent and service provider in the handling of international dispatches in France. *UFEX* is a trade association established under French law, grouping together almost all of the companies offering express courier services competing with *Chronopost*. *UFEX* has lodged a complaint with the Commission alleging principally that the logistical and commercial assistance provided by *La Poste* to *Chronopost* constituted State aid within the meaning of Article 107(1) TFEU. They complained that the remuneration paid by *Chronopost* for the assistance provided by *La Poste* was not in accordance with normal market conditions.

The Court has stated that in the absence of any possibility of comparing the situation of *La Poste* with that of a private group of undertakings not operating in a reserved sector, normal market conditions, which are necessarily hypothetical, must be assessed by reference to the objective and verifiable elements, which are available.[95]

The assessments in both *Altmark* and *Chronopost* aim to disclose the range of cases, where the compensation paid for PSO comprises also a selective advantage granted to the service provider. However, the assessment imposed by *Chronopost* is merely technical, based on market benchmark analysis, which pursues to

[93] Bartosch, Clarification or Confusion?, EStAL 3/2003, p 384
[94] Chronopost v UFEX C-83/01 and C-93/01P, para 40
[95] Chronopost SA and La Poste v UFEX and Others (I), C-83/01 and C-93/01P, ECR 2003 Page I-06993, para 38

determine whether the transaction carried out is consistent with normal market conditions. The *Poste Italiane* –case[96] is an application of the *Chronopost* rule and in this specific case the benchmark analysis could support the absence of a selective advantage and subsequently the non-existence of a State aid.

4.3. The Relation between Risk and Efficiency

The *BUPA* judgment raises more questions about what test to apply under Article 107(1) TFEU to public services provided in competition. RES, set up after the liberalization of the private health insurance market in Ireland 1997, is administered by the *Health Insurance Authority* and pursues to compensate those insurers undertaking above average risk work (e.g. in the case of old and chronically sick patients) by providing them with the proceeds of a levy collected from those undertakings below average risk work. *BUPA* as undertaking belonging to the lower risk profile sent a complaint against the RES; the Commission decided that the RES does not constitute a State aid within the meaning of Article 107(1) TFEU or if it were assumed that compensation for extra costs of Services of General Economic Interest constituted state aid within the meaning of Article 107(1) TFEU, these aid elements could be considered compatible with the internal market pursuant to Article 106(2) TFEU.

The main beneficiary of the compensation was the Irish traditional public operator *VHI*. The levels of compensation were also proportionate and, according to the Commission, only covered a limited class of payments made by insurers to their customers[97]. The scheme also took account of the average costs of those eligible for levy payments, with insurers able to keep the benefit of their own efficiencies.[98] The available data suggested that some insurers in the PMI market had been trying to attract younger and presumably healthier subscribers, thereby following a policy of competition based on risk selection rather than quality or efficiency. The RES pursued to prevent competition based on the risk profile of the insured person and encourage competition on profit margin, terms & conditions of the insurance product and administrative costs. The measure imposed by RES aimed to neutralise the difference in the risk profiles.

BUPA brought an action before the GC for the annulment of the Commission's decision. It claimed, amongst other things, that the Commission had been wrong to conclude that the Irish scheme fell within the parameters of the *Ferring* and *Altmark* ruling.[99] The Court asserted that the compensation system in *BUPA*

[96] C49/06 ex NN65/06, on a State aid scheme implemented by Italy to remunerate *Poste Italiane* for distributing postal savings certificates

[97] For instance, it excluded payments for "luxury" medical treatments. See Commission Decision of 13.05.2003 concerning State aid N-46/2003, para 55 and Judgment of 12.02.2008, BUPA v Commission, T-289/03, para 340

[98] Judgment of GC, T-289/03, ECR 2008 Page II-00081, paras 249-250 confirmed the Commission finding in its Decision, C(2003)1322 fin of 13-05-2003, para 56.

[99] BUPA v Commission, T-289/03, ECR 2008 Page II-00081, para 89

is completely different compared with the one in *Altmark*, and the expression "*costs which a typical undertaking (…) would have incurred in discharging those obligations*" in the *Altmark*'s fourth criterion corresponds in *BUPA* with "*neutral [compensation] by reference to any costs associated with inefficiency incurred by [certain undertakings]*".[100]

It was not necessary, in the GC's view, to make a comparative cost analysis between a potential recipient of a compensation payment and an efficient operator. The Commission had expressly found that the scheme took account of the insurers' average claim costs so that insurers were not allowed to keep the benefit of their own inefficiencies. The General Court dismissed *BUPA*'s application.[101]

The *Altmark* ruling appears as a compromise solution allowing compensation for PSO to escape the prohibition rule under *quid pro quo* terms. More precisely, the *Altmark* ruling stipulates that in certain cases the compensation for PSO may constitute State aid and this is true where the compensation includes a gratuitous benefit. The *Compensation* approach treats this kind of compensation as being incompatible per definition and subsequently illegal. The *Altmark* approach opens for the possibility that a gratuitous benefit bearing the label "*compensation*" still can be compatible with the internal market. How is this possible? It can be possible, where public service contracts are awarded without organizing a public procurement procedure and the award decision is not supported by a benchmarking analysis making sure that the "*picked winner*" is an efficient operator or in other words a worthy "*winner*". The contracts shall be anyway awarded via a competitive tendering procedure and only exceptionally via direct award in order to be compatible with the internal market. The difference between *Altmark*-test and compatibility-test is the fact that efficiency is a legally binding duty in the first case and a soft duty in the second case embodied by the wording "*desire for efficiency*". The concept of *reasonable profit* is an integral part of both third and fourth condition in the *Altmark*-test, fact that suggests that there must be an inter-correlation between over-compensation and efficiency.

4.4. The application of the Efficiency Criterion in Commission Cases

In the majority of cases brought before the Commission, the transport service operator was not chosen in a public procurement procedure and the Member States had to prove that the second part of the fourth *Altmark* criterion had been complied with. However, the competent authority failed to provide the necessary information in order to support the conclusion that the compensation has been granted to an efficient operator. Consequently, the hypothesis that the measure at issue conferred an advantage to its

[100] BUPA v Commission, T-289/03, ECR 2008 Page II-00081, see paras 229, 235-238, 241, 246, 249
[101] BUPA v Commission, T-289/03, ECR 2008 Page II-00081, paras 245-258, para 346

beneficiary could not be eliminated.[102] In this case, the Commission pursues to establish whether the financial measure is compatible with the internal market.

4.4.1. C-16/2007- *Postbus* in the Lienz District – Austria

An Austrian bus company filed a complaint with the Commission on the subject of an alleged State aid granted in 2002 by *Verkehrsverbund Tyrol* (hereinafter *VVT)* to the company *Postbus AG* (hereinafter *Postbus*), which operates in the *Lienz* district of *Tyrol*. The *VVT* is a private body responsible for planning and coordinating bus transport in the eastern *Tyrol* region. On 12 July 2002, VVT concluded with the company *Postbus* a public service contract for public passenger transport for bus routes numbered 5002, 5008, 5010, 5012, 5014, 5050 and 5052 in the district of *Lienz* in the province of *Tyrol*. *Postbus* was selected above all because it was the only company with the necessary concession to operate such a transport service in the region of *Lienz*. The contract comprises two pecuniary rewards: *Bestell*- and *Bestands*-remuneration[103].

The contract provides that *Postbus* receives an annual payment of € 0,527 million, plus VAT for 204 807 km, which corresponds to € 2, 57 plus VAT per km, as *Bestell*-remuneration. Moreover, *Postbus* received, as *Bestands*-remuneration, an annual payment of € 1, 69 million for the year 2002 for 952 761 km, i.e. € 1, 77 per km, accounted as follows:

a) compensation for interconnection, the amount of which is fixed each year for each route on the basis of passenger numbers;
b) revenue from ticket sales, net of VAT, returned to *Postbus*;
c) revenue from the compensation granted by the Federal Ministry for Health, Family Affairs and Youth for providing reduced fares for school pupils and apprentices.

The cost paid by *VVT* to *Postbus* for 2002 was therefore € 2 217 000 (including the proceeds returned from ticket sales). In return, *Postbus* was obliged to provide 1 157 568 km of bus services based on the timetables

[102] See for instance State aid — Ireland — State aid C 31/07 (ex NN 17/07) — State aid to *Córas Iompair Éireann Bus Companies* (Dublin Bus and Irish Bus) — Invitation to submit comments pursuant to Article 108(2) TFEU, OJ C 217, 15.9.2007, p. 44–66, paras 83-85; 2009/845/EC: Commission Decision of 26 November 2008 on State aid granted by Austria to the company *Postbus in the Lienz district* C 16/07 (ex NN 55/06), OJ L 306, 20.11.2009, p. 26–38; 2009/325/EC: Commission Decision of 26 November 2008 on State aid C 3/08 (ex NN 102/05) — Czech Republic concerning public service compensations for *Southern Moravia Bus Companies*, OJ L 97, 16.4.2009, p. 14–25; State aid — Germany — State aid C 47/07 (ex NN 22/05) — Public service contract between Deutsche Bahn Regio and the Länder of Berlin and Brandenburg — Invitation to submit comments pursuant to Article 108(2) TFEU, OJ C 35, 8.2.2008, p. 13–29

[103] Bestellleistung and Bestandleistung in German correspond to the fixed and variable remuneration respectively. The first is determined in advance no matter the annual number of passenger or the revenue from the ticket sales. The second remuneration depends on the amount of revenue from ticket sales, total number of passengers and the number of passengers granted reduced fares.

and routes set out in the contract. The average price paid per kilometre was € 1, 92. Austria has proved that the cost in *Postbus* corresponds with the costs in an average Austrian undertaking. Austria has not explained how these parameters also represent the average in a well-managed undertaking. The Commission considers that Austria could have taken as a basis the average costs in undertakings which have won a significant number of tenders in the sector in the last few years. It must be concluded that Austria has not demonstrated that the price paid by *VVT* to *Postbus* corresponds to the cost in a well-managed undertaking. The fourth *Altmark* criterion is therefore not met.

4.4.2. C-47/2007 DB Regio and the Länder of Berlin & Brandenburg

The private operator *Connex Regiobahn*, nowadays part of *Veolia gro*up claimed to the Commission that *DB Regio* had received illegal State aid from the Länder of Berlin and Brandenburg. The payments were related to public service contracts for regional rail passenger transport. The Commission expressed its doubts concerning the fulfilment of the *Altmark* conditions 2-4. The price has been set between € 6-9/km without any objective and transparent justification. *DB Regio* is the most profitable subsidiary of the *DB Group* with a pre-tax profit of 7 % of its turnover at the time. 70 % of this turnover comes from the tendered traffic, i.e. from payments made by the Länder of Berlin and Brandenburg. The rate of 7% is unjustified high having in mind the low risk rate involved by these operations. The allegation of over-compensation cannot be rejected under these conditions. The contract had been granted by direct award and in order to prove that the fourth criterion was met Germany asked the *PWC- Wibera* to determine the cost of establishing an efficient transport. The cost estimated by *PWC- Wibera* was € 4, 4 x 10^9 for 537 x 10^6 km. The Commission expressed its doubts concerning the impartiality of *PWC- Wibera* and the reliability of the study. Consequently, further investigation has been considered to be necessary in order to establish whether the aid was compatible with the internal market.

4.4.3. C-54/2007 Emsländische Eisenbahn GmbH- Germany

Several private German companies submitted a complaint to the Commission holding that *Emsländische Eisenbahn* GmbH received both direct grants and grants under aid schemes between 1997- 2007, which amounted to € 113 x 10^6. The funds have been granted as a lump sum for discharging PSOs related to bus passenger and rail freight transport. Subsequently, it was impossible to determine whether the level of compensation corresponded with costs incurred in relation with the specific PSOs. In this case, it is obvious that the *Altmark* criteria are not met.

4.4.4. C-3/2008 Southern Moravia Bus Companies- Czech Republic

The complainant, *ČAS* is a joint-stock company active in the field of regular bus transport, chartered transport, city bus transport in Znojmo territory and international transport. Until September 2004, operation of the regional public bus transport in Southern Moravia was the core activity of *ČAS*, particularly on the basis of contracts concluded with the regional authorities. The services were provided in the Southern Moravia Region. *ČAS* alleges that the competent authorities granted, in the period between 2003 and 2005, illegal State aid to a number of five transport operators. The illegality consists in award of licences in breach with the transparency and objectivity principle.

The Southern Moravia Regional Council sent an invitation to submit tenders to 41 carriers, including *ČAS*. It envisaged that the regional authorities were willing to pay to the operators a price of not more than CZK 26 per km for providing the service[104].

The regional authorities received answers from 9 carriers who subsequently were invited to a meeting with the regional authority. A selection committee appointed by the *Southern Moravia Regional* Council assessed and rated the tenders. It recommended that the contracts for providing transport services were concluded with 6 carriers, including *ČAS*. The Commission considered that the procedure applied by the Czech authorities could not be considered a public procurement procedure because the operators from other regions or districts have not been informed about the procedure and had not been offered the possibility to submit their tenders. Furthermore, this procedure ran counter to the possibility that carriers from other Member States could be taken into account in choosing the operator providing the services. The Commission noted also that the Czech authorities did not envisage any procedure for choosing the carriers for years 2004-2005 but simply prolonged contracts with these carriers which had been chosen for providing services in 2003. The Commission can therefore conclude that the procedure applied by the Czech authorities cannot be considered a public procurement procedure as required by the *Altmark* judgment. The use of the statistical transport cost cannot per se lead to a conclusion that the operators who accepted to provide the services for CZK 26 per km should be considered well-managed carriers. Statistical data which served as the basis for establishing this amount concerned only the actual costs of transport services in the Czech Republic for the period of 2002. Therefore, there is no evidence that an average of these costs represents the costs of an efficient undertaking. The Czech authorities have not provided sufficient information on this point, including after the decision to initiate the procedure. The Commission established that the fourth condition set in the *Altmark* judgment was not fulfilled.

[104] Approximately CZK 26 = € 1

4.4.5. C-41/2008 DSB- Denmark

DSB operates rail passenger transport and receives public compensation for this service. The Commission received two complaints against *DSB* 2003 and 2006 respectively, which are related to public service contracts between *Danish Transport Ministry* and *DSB* for periods 2000-2004 and 2005-2014. Pursuant to the conditions of contract, *DSB* retains income from ticket sales and receives compensation. The Commission proceeded as usually to determine the existence of State aid by controlling whether all four *Altmark* criteria were met. In this case as in the majority of direct award cases, the presumption of State aid existence could not be eliminated and the Commission pursued to analyze the State aid compatibility. The compatibility assessment has been based on the *Regulation on PSO* and the Commission found that *DSB*'s surplus profits and compensation due to *DSB*'s delay in the delivery of rolling stock had been rectified by *Danish Authorities*. However, the Commission asked the *Danish Authorities* to revise the compensation system and introduce a recovery mechanism to prevent over-compensation in the future.

4.4.6. C-6777/2009 Anhalt-Bitterfeld Bus Companies- Germany

The bus companies in Anhalt-Bitterfeld competed in order to obtain a transport license, which granted the right to receive compensation for mobility centres activities, public passenger and school transport. A standard amount will be paid for each school transport route and each mobility centre. The passenger transport has been divided in two regions, with a fixed compensation per passenger of € 0, 4 and 0, 6 respectively. The transparency duty has been complied with, since the auction conditions have been published in the Official Journal. A return on invested capital of 5% has been calculated and considered to be reasonable for the Anhalt-Bitterfeld region. The awarding procedure pursued to select the transport operators, which could satisfy a number of 20 qualitative requirements and meet the cost and profit predetermined conditions. The procedure has been found to be non-discriminative, open, transparent and objective and the Commission concluded that all the four *Altmark* criteria were fulfilled.[105]

[105] http://ec.europa.eu/community_law/state_aids/transports-2009/n206-09.pdf

5. The efficiency and quality assessment

The decision making concerning the selection of an efficient operator, as well as the set of the quality requirements to be complied with, shall be transparent. All the operators, which could be interested in the public service contract, must be informed in advance and must be offered the possibility to participate in the competitive tendering. The final decision of the awarding process has to be objective out of regard for the terms & conditions established and announced in advance. However, there are situations, where a competitive tendering might not be the best solution and the efficiency assessment shall take the form of a benchmark analysis, as in *Poste Italiane* case. There is no similar case in the field of track-based transport, where the benchmark analysis provides the insurance that the compensation constitutes only remuneration for PSO and nothing more. Notice, that *Poste Italiane* was a cross-subsidisation allegation concerning the direct award of a distribution contract for postal savings certificates, i.e. financial products. The alleged distortion of competition would not have occurred on the postal service market, but on the market for distribution of financial products. The Italian financial market is a competitive market, where a number of comparable products and similar distributors could be identified. Therefore, the benchmark analysis has been successful in this case.

Transposing the *Poste Italiane* into the public passenger transport frame, an analogous analysis can be made in order to assess whether the commission imposed on tickets distribution respects the efficiency criterion. In Sweden, the SJ agency sells train tickets for internal and external routes. The local travel bureaus sell train and bus tickets for fares within their administrative district. However, buying a fare ticket in a SJ agency will cost the passenger more than buying the same fare in a local transport agency. Furthermore, in the case of local transport agency, the urban transport from the train station to the inside city destination is included in the ticket price. Under these conditions, the passenger would suffer a loss of approximately € 3 by choosing to buy the fare ticket in a SJ agency. This line of reasoning leads to the conclusion that SJ is not an efficient distributor for local fares tickets, i.e. fares inside the territory of a certain administrative district.[106] Observe, that the distribution is a business activity that can be outsourced or not. In the case of in-house distribution, there is no room for an efficiency assessment of this activity, since the competent authority can choose to entrust an internal operator without competitive tendering.[107]

[106] The calculation does not take into account internet sales, rebates, mobile phone tickets etc, but only a plain one way ticket purchase taking place in a brick & mortar travel agency. This comparison has been made, August 2009, on the route between Malmö and Ängelholm. The price paid for a fare from Malmö Train Station to Ängelholm city in a Skånetrafiken bureau was € 9, 85 compared to the total price of € 12, 75 in the case of a SJ agency bargain, where the price of the urban bus ticket from Ängelholm Train Station to the inside city destination was € 1,50. There are no other variables than the price in this equation since in both cases, the same transport means have been used (Öresundståg 17XX + Ängelholm City bus).

[107] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, recital 18

5.1. Public Procurement Procedure- 4th *Altmark,* first part

The few cases where the fourth *Altmark* has been fulfilled and a competitive awarding procedure has been organized can give some guiding concerning the criteria to be met. Firstly, the reasonable profit specific for the region and activities to be compensated was clearly defined in percents: 9, 62 % and 10, 89% for the French broadband infrastructure and 5% for the bus transport operators in Anhalt-Bitterfeld. In case C-47/2007, *DB Regio*'s profit of 7 % has been considered to be too high in relation with the risk incurred and *DSB* had to return the profit surplus by way of deducting dividends in case C-41/2008. Secondly the publicity of the different phases during the whole awarding procedure shall ensure that all the potential tenderers are well-informed in good time. The compensation estimation has to be clear and easy to verify. The most relevant case as a negative example is C-54/2007, where *Emsländische Eisenbahn* received compensation as a financial lump sum support and no distinction has been made between the bus passenger and rail freight activities. Each cost item to be compensated has to be calculated separately.

There are two different cost elements: variable and fixed. The variable costs float in proportion to the sales revenues whilst the fixed costs are relatively constant and known as an amount from the preliminary calculations. The variable costs shall be estimated in accordance to the predictable sales revenues and if necessary shall be adjusted afterwards. The quality requirements shall be well-defined and the method of awarding must be explained in great detail. No matter what is the applicable sector legislation ruling the award of public service contracts, there are some thumb rules to follow: the transparency duty and the principles of non-discrimination, objectivity and proportionality must be respected.

5.2. Efficient Operator- 4th *Altmark,* second part

Where the Member State has awarded a public service contract directly to an operator, i.e. without any prior competitive tendering or public procurement procedure, the contracts should be subject to greater transparency and furthermore should comply with the second part of the 4th *Altmark* criterion. The Member States should be able to present a comparative cost analysis and prove that the operator entrusted with *Services of General Economic Interest* is an efficient manager. This is the case in *Poste Italiane*, where Italy has presented a very well-conceived benchmark analysis, defining, classifying and comparing the financial products distributed by the operator under review with the one distributed under similar conditions by other actors on the specific market segments. The allegation of cross-subsidisation could be eliminated in *Poste Italiane* and the compensation has been found not to constitute State aid. In the public passenger transport cases, where the contract has been awarded without competitive tendering, the Member States could not provide the necessary data to convince the Commission that the chosen operator was an efficient one.

5.3. The Quality criterion- *Meet the necessary public service requirements*

The quality standard for primary PSO establishes a mix of requirements: affordability, passenger satisfaction, timeliness, convenience, safety and fitness for purpose. The wording of the *Altmark* judgment refers to adequate transport means and a typical transport undertaking, fact which suggests that the public service requirements concern quality criteria for operative transport operations and not the supplementary quality criteria for the PSO. There might be a presumption that an undertaking able to meet the necessary public service requirements will also be able to satisfy the supplementary quality standard for PSO.

The quality standard for secondary/supplementary PSO establishes a series of requirements concerning minimal working conditions, passenger rights, the needs of persons with reduced mobility, environmental protection, the security of passengers and employees as well as collective agreement obligations and other rules and agreements concerning workplaces and social protection at the place, where the service is provided.[108]

However, the borderline between the primary and supplementary PSO will be established according to the definition of *Services of General Economic Interest* and entrustment conditions established by the competent authorities, which are matters of national competence. Different Member States will practice different definitions and in some cases, what has been defined as secondary PSO in one country or administrative district can belong to the primary PSO in another geographic area. According to proposed Swedish law, a proportionality assessment must be made between the public benefit and the loss that the commercial services may suffer and if public benefit overweighs this loss then a tender procedure shall be initiated.[109]

The duty of the Member States is to minimize the competition distortion and the effect on the internal market. In order to accomplish this mission, it must be proven that the Member State has shown due diligence to collect all the necessary information in order to conclude a good deal. If there are any comparable undertakings operating in another Member State, which already fulfil similar missions as a part of their basic operative activities, then the analysis of the costs incurred by these operators would be appropriate as a comparative base. Even if the definitions and classifications of *Services of General Economic Interest* and PSO are matters of national competence, the pursuit of undistorted competition is a matter of the exclusive competence of the Union.

However, one of the main objectives of maintaining a competitive market is the safeguard of the consumer welfare. Article 1(2) in the *Regulation on PSO* provides that the sector land transport includes both "*national*

[108] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, Recital 17
[109] SOU 2009:39, p. 25

and international operation of public passenger transport services by rail and other track-based modes and by road, except for services which are operated mainly for their historical interest or their tourist value". The consumer of public transport by track-based can be the national but also the international passenger and it is the passenger welfare that must be safeguarded by the competition rules. In my opinion, the set of qualitative requirements could be standardized at EU level, in accordance with the specific characteristics of the passenger flow, e.g. suburban transport, cross-border commuting routes, connections to international airports/harbours. A common set of qualitative requirements would improve the effectiveness of State aid control in the field of PSO and it will move the focus back on the passenger benefit. Moreover, a common set of qualitative requirements would definitely simplify the application of the public procurement rules. It shall not be ignored that the liberalization of public utilities is not a goal in and of itself and the consumer welfare is the philosophical core of the competition law. The target "*better passenger satisfaction for less State money*" could be easier to transpose in reality, where the passenger satisfaction is clearly defined, measured and analyzed.

5.4. The interplay between the competition and transport sector rules

In the beginning of this paper, I have formulated a series of questions that must be answered in order to achieve better understanding of the interplay between the competition and transport sector rules. The financing of public passenger transport has different destinations and make use of various instruments. The preservation of the public interest is often a well-founded argument to obtain derogation from the prohibition in Article 107(1) TFEU. As already discussed previously, under certain conditions the financing of public passenger transport is nothing else than a remuneration for the costs incurred by the PSO-mission. This kind of financing does not constitute State aid and subsequently escapes the stand-still obligation. Therefore it is interesting to comprehend the relation between the Article 107(1) TFEU and exoneration criteria established by the CJ in *Altmark* case. The compensation for PSO which passes the *Altmark* test will constitute remuneration for fulfilling missions in regard of public interest; no advantage is granted to the beneficiary of the compensation under these conditions and subsequently this benefit does not constitute State aid.

The next interesting connection is between the prohibition rule in Article 107(1) TFEU and the compatibility rules in Article 93 TFEU, which stipulates that State aids for transport coordination and compensation for PSO shall be compatible with the internal market. Article 93 TFEU stipulates a derogation rule from the prohibition in Article 107(1) TFEU. For the first compatibility ground, i.e. transport coordination, the Council has not issued any secondary acts of legislation and therefore the Article 93 TFEU applies directly. The second compatibility ground, i.e. compensation for PSO is covered by a

secondary legislative act and therefore Article 93 TFEU is not directly applicable in this matter. The *Regulation on PSO* applies directly, can be enforced by the National Court and covers all the compatibility conditions related to compensations for PSO in the field of land transport. The *Regulation on PSO* specifies in article 9(2) that public service compensation shall be granted only for two purposes: fulfilment of PSO or complying with tariffs obligations. With reference to coordination aspects or reimbursements for other obligations than the previously named, the Member States may grant aids for infrastructure costs[110] and for promotion of R & D in new technologies, which are more economic for the Union.

As discussed in chapter 2.1, the provision of *Services of General Economic Interest* is subject to PSO. In the case of land transport, there are two derogation articles with different objectives: the already named Article 93 TFEU and Article 107(3) TFEU, (a) or (c). Most of the compensations could not pass the *Altmark* test, and the compatibility test has been required. The air and maritime transport are subject to the general compatibility rules in Article 106(2) TFEU. In the field of land transport, Article 93 TFEU represents a *lex specialis* and therefore shall be applied instead of Article 106(2) TFEU.

The next interesting issue is the relation between the State aid definition and the procurement rules, which mean to guarantee that the award procedure in the case of public service contracts is transparent and objective and by that, they guarantee that the competition distortion and the impact on the internal market are minimal. The public service concessions are generally excluded from the scope of public procurement regime and treated under the *Regulation on PSO*. In the case of track-based transport, the tram mode is covered by the *Utilities Directive*. All the other track-based contracts are covered by the *Regulation on PSO*. The consequence is that there are two different competitive procedures, the public procurement procedure in the *Utilities Directive* and the open competitive tendering in the *Regulation on PSO*.

More problematic is the fact that the direct award is permitted in two situations. The first one concerns the in-house contracting and the second one relates to railway transport, except tram and metro. The mergers and acquisitions that have taken place lately in the railway sector show that the State-owned operators come have succeeded to achieve more market power during the financial crisis.
In the meanwhile the private operators have lost market shares and in some cases, they had to sell the control stake in order to survive the current crisis. The railway sector does not belong to the public reserves anymore but it seems to return back under the State controlling power. As established in C-47/2007 *DB Regio* and C-41/2008 DSB, the State-owned undertakings in the track-based transport can

[110] Communication from the Commission — Community guidelines on State aid for railway undertakings, OJ C 184, 22.7.2008, p. 13–31 provides the legal framework for granting State aid for coordination of transport in the railway sector.

afford to maintain a high profit rate in the area of tendered traffic and have easier access to public funds at a low risk rate and under indulgent terms and conditions, e.g. the ones related to delay in delivery of rolling stocks. In my opinion, a competition neutral award is not possible as long as the State-owned undertakings compete directly or indirectly against the private operators. The State position has to be anchored in the area of public administration and the direct involvement in the commercial area has to be reduced. The threat of cross-subsidisation is imminent since most of these State-owned companies are present on several markets: bus passenger, track-based passenger, public freight transport by road and rail, both on the tendered and commercial segments of these markets.

Returning to the notion of "*reasonable profit*", it should be mentioned that the *Regulation on PSO* provides a definition of the term:

> *Reasonable profit must be taken to mean a rate of return on capital that is normal for the sector in a given Member State and that takes account of the risk, or absence of risk, incurred by the public service operator by virtue of public authority intervention.*

The rate of return on capital[111] is a financial ratio, which measures whether a company is efficient and profitable. The rate of return on capital of a certain operator should be compared with its weighted average cost of capital[112] in order to determine if the operator is able to pay the expected remuneration for all the employed sources of capital.

A more modern financial ratio is EVA[113], which is the measure of residual income, calculated as difference between the net operating profit after tax and the cost of capital. The residual income is a source of accumulation allowing the company to support future investment projects related to social and environmental responsibility, without any State intervention.

The other key notion in the definition of "*reasonable profit*" is the risk incurred; a study of the case-law will disclose the legal significance of this term. Risk is a measure of the standard deviation of the average returns of a specific investment. The finance theory holds that there is a relationship between the risk and the profit and this relationship entitles investors to be compensated for taking additional risks. The amount of loss that the operator stands to suffer if some unexpected events occur is divided by expected profit in order to calculate the risk/reward ratio. If the contract stipulates that the public authorities compensate all

[111] ROCE = Earnings before Interest & Tax/(Total Assets- Current Liabilities)
[112] WACC= Pre-tax Debt Rate * (1- Corporate Tax Rate)* Market Value Debt/ (Market Value Debt + Market Value of Equity) + Cost of Equity * Market Value of Equity/ (Market Value Debt + Market Value of Equity), Estimated Value Added where Cost of Equity = Risk free Rate + Market Risk Premium * Equity Risk Beta + Liquidity Premium. If ROCE > WACC, then the operator is profitable and efficient.
[113] EVA = NOPAT - (WACC * Invested Capital)

the losses caused by unexpected events, then the risk is zero and the reasonable profit has to be adjusted accordingly.

The term pursues to mark the borderline between the service concessions and the other public service contracts.

> *It is clear from the case law of the CJ that a* service concession *exists where the agreed method of remuneration consists in the right of the service provider to exploit for payment his own service and means that he assumes the risk connected with operating the services in question*.[114]

However in *BUPA*, the GC held that "*a distinction must be drawn between a special or exclusive right conferred on an operator and the Services of General Economic Interest mission which, where appropriate, is attached to that right*" and established that compensation for risk is lawful, where an operator belongs to a higher risk profile connected with operating the services in question. The *Services of General Economic Interest* mission has been entrusted in the context of a non-exclusive concession in *BUPA* case and the suppliers of private health insurances received compensation for assuming a risk higher than the average on the market.[115]

The GC in BUPA found that the financial measure satisfied the efficiency criterion, because the compensation was neutral "*by reference to any costs associated with inefficiency incurred*"[116]. Inefficiency has been treated as a result of the losses caused by insuring "*bad risk*" customers, i.e. old and sick people. In my opinion, risk management is the core business in the health insurance sector and this *inefficiency* can be estimated in advance and in a transparent manner. A necessary condition for obtaining the concession right should be that the insurers are able to provide health insurances to all potential clients on equal and non-discriminatory terms. The health insurers should subsequently receive compensation for the "*bad risk*" in form of a higher *reasonable profit* rate, since this argument is consistent with the classic finance theory.

In the financial sector, as we could learn from *Poste Italiane* and *BUPA*, it is convenient to calculate and compare profitability and risk and a benchmarking analysis report is easy to accomplish. In the passenger track-based transport, a comparison test is often impossible, because there is no competition on the track and a comparative analysis of the potential competitors, which operate on different routes under different conditions, is not fully eloquent.

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[114] Case C-382/05, Commission v Italy, ECR 2007 I-6657, para 34; (see Case C-324/98 *Telaustriaand Telefonadress* [2000] ECR I-10745, para 58; the order in Case C-358/00 *Buchhändler-Vereinigung* [2002] ECR I-4685, paras 27-28; and *Parking Brixen*, para 40)

[115] See T-289/03, paras 178-179, 183

[116] Supra n 113 para 256

What is a typical undertaking well run and adequately equipped? I reproduce here some of the criteria used in public procurement procedures in order to evaluate the offers under review: the number of fares operated per day; flexibility and comfort; ease of access; interoperability & interconnection with the other transport networks; compliance with the tariff planning; grant of discounts for disadvantaged categories of passengers; compliance with the urban mobility plan; energy efficient driving; the availability & quality of passenger information; clean and energy-efficient vehicles; an efficient sales organisation; labour costs to sales ratio.[117] From this enumeration, one can see that most of these criteria reflect the society perspective on efficiency or in other words a corporate social responsibility approach on what an efficient manager is supposed to deliver.

Should there be a judgment on efficiency? The pursuit of less and better targeted State aids can only be reached by way of efficient allocation of resources. A compensation paid to an inefficient operator constitutes an advantage granted to the latter and consequently amounts to State aid in the meaning of Article 107(1) TFEU. While compensations granted to efficient operators are exonerated from the prohibition in Article 107(1) if the other three *Altmark* conditions are also satisfied, the compensation granted to inefficient operators may be compatible and derogated from the general prohibition in Article 107(1) TFEU. However, the compatibility rules for land transport require a competitive tendering procedure for all the public service contracts inclusively public service concessions. The direct award of public service contracts is limited to exceptional situations: heavy rail contracts for a period of maximum 10 years, contracts granted to internal operators and contracts estimated at less than € 1 000 000 average annual value or less than 300 000 km of passenger transport.[118] This set of procedures shows that there is a special concern for the efficiency issue, in all the cases where either compensation for PSO or exclusive/special rights are conferred to a transport operator in the field of public passenger transport. This concern is perfectly justified, since the lack of efficiency control would cause damages to most of the interested parties, from the passenger level up to the Union's broader interests. An efficient allocation of resources is a premise for a competitive market economy. State aids are meant to correct market failures and solve crisis situations, but each and every amount of State aid in excess will cause imbalance on the internal market, which in its turn has to be corrected by further authority intervention. Therefore, it is so important to make sure that the cure is not worse than the disease.

Public service compensation means any benefit, particularly financial, granted directly or indirectly by a competent authority from public funds during the period of implementation of a public service obligation or in connection with that period. The decision of granting compensation for PSO should reflect a desire

[117] For instance, N-207/2009, 15th September 2009, Finanzierungssatzung für den Öffentlichen Personennahverkehr im Landkreis Anhalt-Bitterfeld, paras 15-17 and Action Plan for Urban Mobility COM (2009) 490 final
[118] Regulation on PSO, OJ L 315, 3.12.2007, p. 1–13, art 5(4)- 5(6)

for efficiency and quality of service; the contracting entities have an obligation to avoid over-compensation. The over-compensation can occur in following situations:

- the costs incurred for discharging PSO are overestimated;
- the profit for PSO is much higher than the rate of return on capital for the sector or inappropriate in relation with the risk incurred by the operator;
- the revenues or other financial positive effects are underestimated.

The second condition opens the discussion related to the applicable risk/reward ratio. If the service contract stipulates that the operator shall support 50 % of the losses caused by unexpected events, then this operator is definitely entitled to a higher amount of compensation in form of expected reasonable profit than another operator which can expect full compensation for the losses in conformity with the terms of the service contract.

The difficulty related to this condition is the fact that an efficient operator normally expects a larger reward for its management performance. The pursuit of exploiting assets and liabilities in an efficient way is sustained by the expectance of a higher reward. In my understanding, the notion of reasonable profit, which is an integral part of the over-compensation definition, cannot be left outside the efficiency assessment. In this equation *reasonable profit* is a measure of future reward and there is a direct determination between the management performance measured by various efficiency ratios and the expected profit. According to this line of reasoning an efficient operator is entitled to expect a higher profit. In my view, the amount of compensation C_e can be the same as the one calculated by an inefficient operator C_i. Let's assume that:

- The costs incurred by the inefficient operator are higher $Costs_i = Costs_e + a$, where $a > 0$;
- The profit expected by the inefficient operator is naturally lower $Reward_i = Reward_e - b$, where $b > 0$;
- The extra revenues expected by the inefficient operator are also lower $Revenues_i = Revenues_e - c$, where $c > 0$,
- The risk assumed is equal, $Risk_i = Risk_e$.

$C_e = Costs_e + Reward_e \times (1 + Risk_e/Reward_e) - Revenues_e$

$C_i = Costs_i + Reward_i \times (1 + Risk_i/Reward_i) - Revenues_i$

$C_e - C_i = -a + b - c;$ $\qquad C_e - C_i = 0 \Rightarrow a = b - c$

The conclusion is that there is a possibility that two operators an efficient and an inefficient one may calculate the same amount of compensation, if the surplus of costs of incurred by the inefficient operator "*a*" equals the surplus of profit required by the efficient "*b*" one minus the extra revenues obtained by the efficient operator "*c*". On the other hand, in a dynamic perspective, the efficient operator will probably be

able to operate the service under commercial terms in a near future and deliver an appropriate quality of service without any public intervention. This quite simple calculation shows that the static perspective adopted by the present compatibility rules does not attach sufficient attention to the efficiency issue and its relation to business development and capital accumulation. Only the efficient operator has the right premises to compete in the near future under free competition terms.

The condition that "*the revenues or other financial positive effects shall not be underestimated*" is even more problematic. The credit-worthiness of a State-owned undertaking is always higher than the one of the private competitors operating in utilities markets. Easier access to funds and the goodwill related to the reputation of traditional operator for instance are difficult to estimate in money, but there is no doubt that these advantages constitute serious entry barriers and subsequently generate market failures. This line of reason entitles me to assert that a competition neutral award is not going to become reality before all these advantages are disclosed, calculated and neutralized.

When is it necessary to notify a State aid in the form of public service compensation to the Commission? If a financial measure is granted by State or via State resources, in a selective way and a presumption exists that competition can be distorted and a negative impact on the internal market may occur, then an assessment concerning State aid existence is necessary. The benefit granted by State can constitute remuneration for PSO and/or a financial advantage that the PSOs do not cover up for. The *Altmark*- test is used in order to assess whether an advantage has been conferred. No advantage implies no State aid and such financial measures are exonerated from the stand-still clause.

The second situation refers to article 9(1) in the *Regulation on PSO*, which stipulates that compensations paid in accordance with this act shall be exempted from the obligation in Article 108(3) TFEU, i.e. the stand-still clause. In order to conclude, an exemption from the stand-still clause can be obtained, where there is an efficiency assessment based on a clear, objective and transparent definition of the PSO and a competitive and fair procedure of selection. The selection criteria are both qualitative and quantitative and can be translated into best fulfilment of the PSO to be entrusted for the public money. An efficient allocation of public money at national level implies preventing distortion of competition at EU level and better welfare for the European passenger.

However, difficulties in the interpretation of the concept *advantage* and its *effects* can still occur. The reason for this latent conflict is the fact that the *real advantage* theory is not consistent with the *effects* approach adopted in the Treaty definition of the State aid.

What are the legal consequences if the compensation is indeed a State aid covered by the stand-still clause and non-notified? If an advantage is probably conferred by a certain measure, then it has to be investigated whether the *Regulation on PSO* has been complied with. If this is not the case then the measure constitutes State aid, which does not fulfil the compatibility conditions as State aid for PSO-missions or tariff compliance. Other grounds for compatibility can be invoked anyway. However, the State aid has to be notified unless it will constitute illegal State aid. Even if the Commission will issue a positive decision in the compatibility matter, the State aid is still in breach with the stand-still clause. A competitor can still bring a complaint against the State aid before the National Court and claim damages. The National Court can decide that the State aid shall be repaid and the competitor is entitled to damages. In all the situations, where there is some uncertainty concerning the transparency and objectivity of a competitive tendering, or the accuracy of the benchmark analysis, it is recommendable to use the pre-notification service provided by the Commission.[119]

[119] Code of Best Practice for the conduct of State aid control procedures, 2009/C 136/04, pp 14-15

6. Conclusions

In this paper, I have set focus on the award of public service contracts for track-based passenger transport and aimed to determine the relevant State aid rules and to analyze the importance of the efficiency criterion as an instrument of minimizing the State intervention and preventing the undue distortion of competition.

Before the *Altmark* ruling, the legal approach concerning compensation for PSO has been clearly defined as:

- State aid inside the scope of Article 107(1) - *State aid* approach
- State aid outside the scope of Article 107(1) - *Compensation* approach.

The *Altmark* ruling appears as a compromise solution allowing compensation for PSO to escape the prohibition rule under *quid pro quo* terms.

"*Something, such as money, given or received as payment or reparation, as for a service or loss*"[120] is the dictionary definition of the word "*compensation*". According to the word definition, a financial benefit that exceeds the fee paid to the private operator for the fulfilment of PSO constitutes an excessive compensation or so-called over-compensation. The over-compensation has been treated differently by the Court, depending on the approach adopted. According to the *State aid* approach, no distinction is made between compensation and over-compensation, since both of them fall under the scope of Article 107(1) TFEU and are prohibited unless compatible according to the *Regulation on PSO*. This approach offers the most legal certain solution. All the benefits granted by State to certain beneficiaries imply an advantage and the compatibility of the measure has to be proved as long as the internal trade may be affected. According to the *effects* approach, the prohibition in Article 107(1) TFEU does not distinguish between the reasons for or the objective of a measure, which reduces the burdens normally, imposed on an undertaking, but defines that measure by reference to its effects. The *State aid* approach is the only one which is fully consistent with the *effects* approach. The disadvantage of the *State aid* approach is that the Commission administrative burden might be much heavier and the administrative costs will be consequently much higher.

According to the *Compensation* approach, it is very important to distinguish between compensation and over-compensation, since the over-compensation is illegal per definition, while the compensation is exonerated from the prohibition in Article 107(1) TFEU. This approach is also easy to apply and provides a legal certain solution. In my understanding, a public service over-compensation cannot be justified by

[120] http://www.thefreedictionary.com/compensation 2010-05-18 14:15

either PSO-mission or tariffs obligations. The decision to define over-compensation as a payment for PSO-mission is incorrect and it comes in conflict with the transparency and objectivity principles. The exceptions provided by article 9(2) in the *Regulation on PSO* refer to allocation of infrastructure costs and promotion of R & D in new technologies, which are more economic for the Union.

Having in mind the previous conclusions, the *Compensation plus* approach adopted in *Altmark* is by comparison more difficult to apply and more uncertain as legal solution. Firstly, it is necessary to determine whether the four criteria in the definition of State aid are met. This appraisal comprises an assessment of the *Altmark* conditions related to the existence of an advantage. In the third phase, if the State aid exists then a compatibility test is necessary. However, the compatibility rules in the *Regulation on PSO* are similar with the advantage prerequisites imposed by the *Altmark*-test. The only difference is that the expression of efficiency pursuit is rather diffuse in the *Regulation on PSO*. The wording of the *Regulation on PSO* requires that the amount of compensation shall reflect a "*desire for efficiency and quality of service*".

I argue in this paper that the efficiency issue is so important that it should be included in the compensation calculation. There is an interconnection between the efficiency of the operator and the compensation calculation. In a logical sentence, I would express this interconnection as follows: efficiency $\Rightarrow$ expected reward $\Rightarrow$ reasonable profit $\Rightarrow$ compatible compensation.

Inefficiency incurred in the fulfillment of PSO amounts to State aid and because of the undue and concealed distortion of competition, which may arise, the State aid should be notified. The inter-correlation between efficiency and reasonable profit and further between reasonable profit and the amount of compatible compensation cannot be ignored.

The award of public service contracts in violation of 108(3) TFEU, even if apparently inoffensive has a legal consequence that might affect the beneficiary of the compensation. The State aid is compatible as the decision of Commission or/and Court established, but any candidate can attack the State aid in front of National Court and claim damages under allegation that the State aid has been granted in breach of the stand-still clause. The risk implied by a repayment of State aid lower the legal certainty of the approach adopted by *Altmark* ruling. The *Compensation* approach gives a better definition of the compensation for PSO, whereby over-compensation is considered to be illegal per definition. I agree with this approach, since the primary objective of the over-compensation cannot be related to PSO missions; according with the legal terminology, over-compensation implies an overestimation of costs, an unjustified profit surplus or an underestimation of revenues/other financial benefits and the assessment is done by comparison with the necessary costs, expected revenues and reasonable profit incurred to achieve the PSO-mission. This

excess might not be justified by referring back to PSO-missions. It may be true that the financial measure satisfies other compatibility conditions, such as R & D promotion or allocation of infrastructure costs, but the main primary objective has to be declared transparently and in advance in order to make sure that the stand-still clause is respected as well.

In my opinion, there are three steps that could facilitate an effective application of the legislation related to financing of public passenger transport. The first one is a standardized definition of the qualitative requirements at the Union level, in accordance with the specific characteristics of the passenger flow, e.g. suburban transport, cross-border commuting routes, connections to international airports/harbours. The second one is a compensation formula that includes risk and efficiency as integral elements. The third one is adopting a more effective and legally certain approach that can support a competition neutral award of public service contracts and gives an equal and just chance to the private track-based operators.

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