

# **GUIDANCE ON THE OPERATION OF THE SUBSIDY CONTROL FUNCTIONS OF THE SUBSIDY ADVICE UNIT**

**RESPONSE TO CMA CONSULTATION**

18 AUGUST 2022

# 1 Introduction and summary

1. Frontier Economics is pleased to be able to respond to the CMA's consultation on the manner in which the Subsidy Advice Unit ('SAU') will operate. The SAU is an important part of the operation of the UK's new subsidy control regime following Brexit. As envisaged, the Subsidy Control Act ('SCA') will lead to a more economic approach to reviewing subsidies, with a greater focus on the effects of subsidies compared to the historic form-based approach which has been adopted under the EU's state aid regime. This is a welcome change, which has the potential to benefit the UK economy by using subsidies in a more effective way than has historically been the case.
2. This response sets out Frontier's views on the various issues raised in the CMA's consultation. We have not confined ourselves to the specific questions raised by the CMA, but have commented on the document as a whole. Annex 1 sets out the specific paragraphs of the response which directly answer the CMA's questions.
3. At a high level, Frontier considers that the approach to the operation of the SAU as set out in the CMA's consultation is broadly appropriate. The role of the SAU is an advisory one, and should be focussed on whether subsidy is being provided in an appropriate way, rather than on any assessment of the policy goals of the public authority. In our view, the consultation rightly sets out that this is the approach which the SAU plans to adopt.
4. An issue which the SAU should be aware of is potential gaming of the system by public authorities. This could occur in two ways. First, there could be attempts by public authorities to claim that a Subsidy or Scheme of Particular Interest ('SSoPI') is really a Subsidy or Scheme of Interest ('SSoI') in order to benefit from the looser review requirements around SSols.<sup>1</sup> Second, given the short period provided to the SAU for review of subsidies, there could be gaming around pre-referral engagement by authorities in order to limit the SAU's ability to effectively review a subsidy or scheme. The SAU should be (and no doubt is) aware of both issues, and should take steps to ensure that the appropriate review is undertaken regardless.
5. We also consider that transparency in the SAU's actions will be particularly important, for two reasons.
  - First, under a new regime there is likely to be a period during which public authorities and external advisors are learning about the operation of the regime, in order to be able to determine what types and levels of subsidy are permissible. While some of this will come from Competition Appeal Tribunal ("CAT") judgments following litigation against subsidies, the SAU's reports will be an important element of building this knowledge base.
  - Second, transparency will enable third parties to comment on subsidy at the SAU advice stage, improving the quality of SAU advice.
6. The detail of the SAU's assessment appears likely to focus primarily on the effects of the subsidy, rather than the form-based approach which has generally been adopted under the EU state aid regime. This is welcome, but means that there is little relevant precedent. As a result, new assessment techniques are likely to have to be adopted, particularly when trading off the costs and benefits of a

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<sup>1</sup> The primary difference between SSoPIs and SSols, as set out in section 2, is that SSoPIs are of larger financial value than SSols.

particular subsidy. We suggest that the SAU should take a flexible view, and amend the approach which it adopts to assessment as thinking both within the SAU, and in the wider competition community, develops.

## 2 The SAU's functions

7. The SAU's functions are largely set out in statute and BEIS guidance, and are therefore beyond the scope of this consultation. However, one point which it may be important for the SAU to take into account in its work is the boundary between an SSol and an SSoPI. The precise boundary between SSols and SSoPIs has not yet been finalised, and will be set by the Government before the SCA comes into effect. However, the March 2022 BEIS consultation on the topic proposed that the boundary would be set at £5m per enterprise in a sensitive sector, or £10m in any other sector.<sup>2</sup>
8. The SAU should take into account when conducting assessments that public authorities may have incentives to attempt to declare a subsidy to be an SSol when it should in fact be an SSoPI, as doing so will avoid a suspensory review by the CMA, and will avoid a cooling off period following the SAU's report being published, allowing subsidies to be given more swiftly.<sup>3</sup> Moreover, in many cases it may be unclear how great a subsidy has been given for the purposes of the SSoPI threshold, as the subsidy is not in the form of money, but soft loans or low prices from public authority owned trading companies. There have been several state aid cases considered by the EU courts where there has been considerable disagreement as to whether there has been aid, let alone the scale of the aid provided.<sup>4</sup> This is likely to remain the case notwithstanding the Government's intention to provide guidance as to how to define the Gross Cash Equivalent for a subsidy which is not a grant.<sup>5</sup>
9. Consequently, there may be instances where a scheme is referred to the SAU as an SSol, but the SAU determines that the amount of subsidy is such that it should in fact be considered as an SSoPI. In such cases, we suggest that the SAU should have scope to change the review approach such that it is aligned with that for an SSoPI. In particular, we suggest that the SAU should prioritise producing reports in such cases, and should enforce the mandatory cooling-off period.<sup>6</sup> This is likely to minimise the distortions to competition which could result if an SSoPI were put in place without appropriate advice being given by the SAU.

## 3 Procedural arrangements

10. Frontier considers that the SAU's proposed procedural arrangements for undertaking its work are broadly sensible, and are well aligned with the need for the SAU to undertake expeditious reviews of subsidies provided by UK public authorities.

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<sup>2</sup> See [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1063355/ssopi-and-ssoi-consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1063355/ssopi-and-ssoi-consultation.pdf) at paragraph 39.

<sup>3</sup> Consultation, para 2.24

<sup>4</sup> See, for example, Judgment of the Court of First Instance of 17 December 2008, *Ryanair v Commission* (T-196/04, EU:T:2008:585)

<sup>5</sup> See [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1049846/subsidy-control-bill-policy-statement-subsidies-schemes-interest-particular-interest.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1049846/subsidy-control-bill-policy-statement-subsidies-schemes-interest-particular-interest.pdf) at paragraph 23

<sup>6</sup> Consultation, paragraphs 2.21 and 2.24.

11. In particular, pre-referral discussions will be vital to ensure that the SAU is able to complete its substantive assessment within the limited 30 working day window. This process appears to be akin to the pre-referral engagement which is common in merger cases, and which enables the eventual filing to take place on the basis of a common understanding of the factual matrix within which the merger is considered. We suggest that the SAU may wish to be more willing to reject the referral of a subsidy for assessment due to incompleteness where there have been no pre-referral discussions.
12. An issue which is left open by the Consultation is what happens if the submitter of an SSoPI referral request fails to engage in pre-referral discussions which would permit resource planning.<sup>7</sup> In such cases, the SAU cannot have recourse to its Prioritisation Principles to not consider the subsidy; moreover, the SAU is subject to a statutory timeline for conducting its assessment. In order to enable the SAU to plan effectively, we suggest it should strongly encourage and incentivise public authorities to engage in pre-referral discussions through its margin of discretion as to what constitutes a complete referral filing.
13. Frontier agrees that pre-referral discussions should not focus on substantive issues.<sup>8</sup> However, at least at the start of the new regime, advisors as well as public authorities are likely to be unclear as to the SAU's specific demands for information in a completed referral, as advisors will have worked on few or no cases, and the SAU will not yet have published the range of decisions which would allow third parties to determine what types of information the SAU relies on when making its decisions. We suggest that the SAU should be more willing to provide advice on required information (rather than on substantive issues) in the early period of the new regime, while the competition community builds the knowledge to advise effectively.
14. As the CMA says in the consultation, transparency is an important aspect of the UK's new subsidy control regime.<sup>9</sup> Frontier therefore agrees that it will be important and helpful for the SAU to publish details of all active cases which are under consideration, to support the establishment of a body of cases, and to enable engagement by third parties.
15. It is important to note that third parties will not necessarily have resources in place to respond immediately to submit their thoughts to the SAU, and in many industries will not be actively monitoring the SAU's website, meaning that they may take time to become aware of the potential subsidy. We suggest the SAU should therefore seek to permit third party engagement as late as possible in the review process, subject to ensuring advice is provided within the appropriate timescales, to avoid excluding third parties who only belatedly become aware of a subsidy being under review.

## 4 Analytical framework

16. The Principles which underpin the assessment approach which the SAU proposes to adopt are fundamentally different from the underpinnings of the EU's state aid regime. The EU approach is at its heart about the form of the aid being granted – it is essentially assumed that any state aid will distort competition and will affect trade between Member States, regardless of the substance of the issue. The UK approach, instead, focusses on the effects of the subsidy being granted, using an economics based

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<sup>7</sup> Consultation, paragraph 3.7.

<sup>8</sup> Consultation, paragraph 3.8.

<sup>9</sup> Consultation, paragraph 3.19.

analysis. This has the potential to considerably improve the effectiveness of subsidies, in particular by weighing up whether the distortion to competition caused by a subsidy (and consequent harm to the economy) is less significant than the gain to the economy caused by offsetting some market failure or promoting another social good.

17. The Consultation groups the seven economic Principles into four groups, in line with the approach adopted by BEIS. We deal in turn with each of these in the following subsections.

#### **4.1 Identifying the policy objective and that a subsidy is the right tool to use<sup>10</sup>**

18. The SAU is correct not to attempt to determine whether public authorities' objectives are appropriate, which is a matter for politicians.<sup>11</sup> As such, the role for the SAU, as set out in the Consultation, should be limited to ascertaining that there is a clearly identified objective for the aid.
19. The role of the SAU in determining whether a subsidy is the correct approach to use is likely to be more important. The SAU will need to strike the correct balance between ensuring that there is a comparison with other plausible approaches to securing the policy objective (and that the public authority has not cherry picked alternatives likely to lead to a conclusion that subsidy is appropriate) and not favouring an excessively onerous approach requiring large numbers of unlikely alternatives to be considered. Particularly in the early days of the new regime, this is likely to require careful balancing by the SAU.

#### **4.2 Ensuring that the subsidy creates the right incentives and changes behaviour of the beneficiary<sup>12</sup>**

20. This is a core element of the economic assessment of whether a subsidy is appropriate. The more strongly the subsidy will change behaviour, the more effective it is likely to be in enabling the public authority's goals to be met. As such, we suggest the SAU should look more sceptically upon subsidies which are not contingent on behavioural change, particularly if they are given on a lump sum rather than an incremental basis.
21. The Consultation notes the need to determine the counterfactual. However, as this is a prospective analysis, both the expected factual and counterfactual may need to be the subject of economic analysis, as this is a prospective, rather than historic, factual, and there is unlikely to be certainty over either factual or counterfactual given the potential for the subsidy to fail to achieve its goals. We suggest that the SAU should, at a minimum, seek to ascertain that there is a broad consistency of assumptions between the anticipated factual and counterfactual situations in areas such as market size and implied elasticities of demand.
22. The monitoring and enforcement of subsidies that are granted will be an important area for the SAU to consider. Even if a subsidy is in principle conditional on changed behaviour, if it is in actuality granted irrespective of the behaviour of the recipient it will effectively become a lump sum subsidy. This may

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<sup>10</sup> Consultation, paragraphs 4.7-4.11

<sup>11</sup> Consultation, paragraph 4.8.

<sup>12</sup> Consultation, paragraphs 4.12-4.14

prove to be a relevant consideration if practice suggests that certain types of subsidies are conditional in name only.

### 4.3 Considering and minimising distortive effects of the subsidy<sup>13</sup>

23. The first element of this analysis is to determine the proportionality of the subsidy to the policy objective. This will require some form of valuation of the objective, at least implicitly. In cases where the objective is the correction of a market failure (for example, an environmental market failure) this may be relatively straightforward, as there is substantial academic literature on the costs of market failures in many situations. However, where the objective is a more normative social good such as reducing regional income disparities, the SAU's task is likely to be considerably more difficult. It is generally a subjective policy choice to pursue such goals, and the benefits are of a different type to the costs from distorted competition.
24. Indeed, in some cases the *aim* of a subsidy may be to distort competition, by providing a competitive advantage to a firm which chooses to locate in a particular region of the UK. It is unclear how the SAU would consider such a subsidy, which at the level of the UK as a whole would be welfare reducing if it just relocated business within the UK, but which could have substantial distributional effects that could be considered positive under different lenses. For instance, the "levelling up" agenda might suggest that there would be a societal benefit from relocating some economic activity from richer areas to poorer areas.
25. Given these tensions, we suggest that the SAU should, as early as possible when it starts reviewing cases, lay out the way in which it will consider evidence on the trade-off between efficiency and equity, and the type of evidence it will consider relevant to demonstrating that the benefits are proportionate to competition distortions. This issue is likely to require more novel thinking on behalf of the SAU than in some other areas.
26. In contrast, the SAU should be immediately well placed to assess the nature and extent of likely distortions to competition which will result from any subsidy. Such an analysis is closely related to the type of market definition exercise that is undertaken in many competition cases.<sup>14</sup> Similarly, whether the subsidy is being provided in the least distortive way has substantial similarities with the CMA's approach to assessing agreements, which also considers whether there are more pro-competitive means to achieve a given goal.
27. It is also important to note that some of the factors which the SAU indicates it will consider may be ambiguous, or may involve a trade-off between the impact on competition in the UK and on international trade. For example, a subsidy provided to a single recipient is likely to be more distortive of competition within the UK than a subsidy provided across all firms in a given market in the UK; however, it may distort trade less, as it only provides an advantage over international competitors for a single UK firm.

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<sup>13</sup> Consultation, paragraphs 4.15-4.17

<sup>14</sup> See, for example, Consultation paragraph 4.18(a), which effectively considers product market definition, and paragraph 4.18(b) which is effectively geographic market definition. The elements of Consultation paragraph 4.18(d) are likely to require a well-defined market in order to conduct the assessment of impact on competitors, customers and suppliers.

## 4.4 Whether the beneficial effects of the subsidy outweigh its harmful effects

28. This element of the SAU's assessment will effectively pull together all of the previous elements of the review, particularly regarding ensuring the subsidy is provided in the least distortive way. As set out in section 4.3 above, there may be occasions where the SAU has to consider the trading off of costs and benefits of different types, and we suggest the SAU's decisions should clarify how it considers this balancing exercise should be undertaken.

## 4.5 Other points on the SAU's proposed analytical approach

29. We suggest that the SAU's reports should, initially at least, provide as much guidance as is practical on the manner in which it considers public authorities' assessments should be undertaken, and how a proposed scheme might be improved (e.g. by adjusting the nature of the subsidy provided to reduce distortions while retaining the desired beneficial effects). The SCA represents a new regime where parties and advisors are initially likely to be unclear over the appropriate approach. In due course, as knowledge of best practice in this area develops, the SAU can reduce the level of advice provided and allow external parties to draw from earlier precedent.
30. We expect that the SAU's guidance on the approach to undertaking an assessment is likely to evolve considerably over time, reflecting the results of litigation in the CAT. The SAU will no doubt seek to reflect the outcomes of such proceedings in its approach. We suggest it should consider issuing revised guidance on the approach of the SAU in due course which takes account of any such judgments.
31. The Consultation also asks what should be included in the SAU's monitoring report, which is due to be published three years after the new regime comes into effect. At this stage, Frontier considers that it is premature to determine this, as the regime is not yet established. Instead, we suggest that the CMA should consult on the appropriate approach 18 months to two years into the operation of the SCA, allowing respondents to take account of emerging issues and practice in this area.

## 5 Prioritisation principles

32. At a high level, Frontier considers the SAU is correct to prioritise cases based on their impact and significance, and the resources which it will require to consider the case. However, we suggest there should be a priority placed on the first two of these principles. It would be unsatisfactory for the SAU to not review a subsidy which has the potential to be particularly distortionary due to a resource shortage. This may require the SAU to re-prioritise within its existing caseload if there are other ongoing cases which are more clear-cut, or to develop procedures for resource sharing with other parts of the CMA at times of peak demand.

## Annex A - Responses to questions

**Question 1: Do you agree with the objectives for pre-referral engagement?**

See paragraphs 11 to 13

**Question 2: Do you agree with the proposed approach to transparency (including publication of summary information at the time of a referral)?**

See paragraphs 14 to 15

**Question 3: Do you agree with the proposed approach to the treatment of confidential information?**

As confidentiality is a legal rather than an economic issue, Frontier does not have any views on this question.

**Question 4: What might public authorities, beneficiaries, and other interested parties expect to be included in SAU reports. In particular, how much advice should the SAU give on how to improve the assessment or modify the subsidy or scheme?**

See paragraphs 29 to 30

**Question 5: What might stakeholders find useful to see included in the SAU's monitoring reports?**

See paragraph 31

**Question 6: Do you agree with the SAU's Prioritisation Principles?**

See paragraph 32





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