


Update on local authority owned companies: Part 1 subsidy control

24 July 2024  Alex Kynoch

This update reminds local authorities that a subsidy will not arise under the Subsidy Control Act 2022 where a commercial market operator would offer the loan, or other financial assistance, on the same terms. This need not be a commercial market operator at arm's length, but as a shareholder who will benefit from the company's success. However, public policy objectives may not be taken into account in this assessment.

Subsidy control

Subsidy control is a key concern for public authorities establishing and funding commercial entities, whether wholly or jointly owned. A subsidy will arise where:

1. The financial assistance is given, directly or indirectly, from public resources by a public authority;
2. The financial assistance confers an economic advantage on one or more enterprises;
3. The financial assistance is specific, such that it benefits one or more enterprises over others; and
4. The financial assistance has, or is capable of having, an effect on competition or investment in the UK and/or on international trade or investment.

Financial assistance will not meet limb B of the subsidy test above if it could reasonably be considered to have been given on the same terms as it could have obtained on the market (the **Commercial Market Operator**, or **CMO** principle). It will not be an 'advantage' unless it is provided on more favourable terms than on the market. In order to avoid giving subsidy, public authorities can ensure that the terms of the loan or other financial assistance are consistent with what a Commercial Market Operator might reasonably offer. Provision of public funding to an entity using the Commercial Market Operator principle need not assume an arm's length relationship between the parties.

The previous state aid regime recognised that different considerations applied to the previous market economy operator principle where the borrower was wholly owned by the lender. Decision 2019/1712 on a public loan granted by Slovakia to Železničná Spoločnosť Cargo Slovakia [ZSSK Cargo] found that whether an economic advantage is granted depends on whether the state was acting as a shareholder or as a public authority. In considering the market investor test, the state must establish unequivocally that it acted as an investor seeking a return. The decision to grant the measure would also need to be grounded on economic evaluations similar to those a market investor would have carried out, with a view to determining the profitability of the investment. As such, the conduct of the private investor must at least be that of a private holding company, or a private group of undertakings pursuing a structural policy, guided by the prospects of profitability in the longer term. The Slovak Republic claimed it acted as a prudent shareholder when granting the loan, and provided evidence available to it demonstrating the factors it took into account before granting the loan. The question therefore was whether in similar circumstances, and with the same information a market investor, they would have acted the same. The relevant operator for the assessment was not, however, a commercial bank with little or no past credit relationship, but a market investor being the sole shareholder and granting the loan with a view to allowing its controlled company to meet operating costs after a sharp and unexpected decline in activity and revenue. The state held 100% of ZSSK Cargo's shares. The state's economic considerations of the expected profit from the loan were not therefore limited to the interest rate payments. The loan would improve ZSSK Cargo's ability to reach future profits and increase/maintain the value of the state's shareholding. The conclusion reached was that the conditions of the public loan granted were in line with market conditions, and such a loan would have been granted by a market economy operator.

Likewise, under the previous state aid regime, in the Sky Blue Ricoh Arena case the Court of Appeal confirmed the relevance of Coventry City Council's ownership of the operator of the Ricoh Arena (ACL) when assessing whether its loan to ACL complied with the previous market economy operator principle.

The Statutory Guidance for the United Kingdom Subsidy Control Regime confirms that the Commercial Market Operator principle need not assume an arm's length relationship but it will be the Commercial Market Operator in the shoes of the public authority as a shareholder. The Statutory Guidance provides that:

A private operator can include vendors, **investors**, and creditors. The relevant operator will depend upon on the type of financial assistance that the public authority is providing, which may include loans, direct funds, or purchases of goods and services. For example, a loan provided by a public authority will not be considered to confer an economic advantage to an enterprise, if the loan might be provided by a private sector bank or **private sector shareholders on the same terms**.

There is nothing to suggest that these principles will not apply equally, where public funds are loaned to a partially owned entity (for example a development joint venture) where the return on the loan will not be the only return realised by the public body; both the benefits received as shareholder and lender should be relevant. Care should be taken as the other investor(s) in the joint venture may also receive a subsidy as a result, and the terms of their loans will be relevant to the Commercial Market Operator principle assessment.

The extent to which contractual benefits could also be taken into account remains to be confirmed. In reality, many wholly owned companies will provide additional benefits to the parent authority alongside the return on a loan and the release of profits. For example, universities may benefit from value in intellectual property generated, and local authorities may benefit from reduced service costs. This would need to be considered carefully on a case-by-case basis, as they would need to be sufficiently associated with the hypothetical private market lender.

The Statutory Guidance is very clear, that for the purposes of the Commercial Market Operator principle, it is only a public authority's commercial objectives that are relevant for the assessment and not any public policy objectives, when assessing whether the financial assistance in question confers an economic advantage, because public policy objectives would not be applicable to private operators in the relevant market.

Take home

Private sector investors may offer very favourable intra-group loans, so local authorities should ensure that they are not too cautious in looking at market rates for arm's length lenders. Local authorities should seek commercial or financial advice on what rates a private shareholder, who will benefit from dividends, would offer the company. This might include a lower rate of interest or lower non-utilisation fee.

The Statutory Guidance is very specific on how the CMO principle should be applied in practice, so it is important for authorities to carefully align their decision-making (and crucially the audit trail in their governance documents) with the Statutory Guidance and (limited) Case Law in order to ensure a robust, defensible position.

And finally, just a reminder that public-owned companies can give subsidies as well as receive them if they pass on public funds. Public resources can be granted where a public authority has influence over a company, and is able to direct the use of its resources.

[Read part 2](#) →

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