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# State aid in loans to wholly owned subsidiaries

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While the European Commission has provided plenty of guidance (including the 2008 Communication) on the provision of public funding to economic undertakings using the market economy operator principle, this usually assumes an arms' length relationship between the parties.

Decision 2019/1712 on a public loan granted by Slovakia to Železničná Spoločnosť Cargo Slovakia [ZSSK Cargo] is a key decision for public bodies, from universities establishing spin-outs to local authorities funding trading companies. This is because it applies the market economy operator principle to circumstances where the borrower is wholly owned by the lender, and the different considerations that apply in these circumstances.

## Facts

Zssk Cargo was established in 2005 after the incumbent railway operator was split into three companies. The Slovak government was and remains the founder and 100% shareholder of ZSSK Cargo.

A loan of EUR 166 million was authorised by Government Decree in March 2009 and paid to ZSSK Cargo in April 2009. The loan was granted for a period of 10 years with a grace period of 2 years before the first instalment was due. This grace period was extended several times in 2011 and 2012 by 18 months in total. The loan was repaid in advance by November 2015.

The loan was aimed at financing salaries and staff costs, charges for use of railway infrastructure and financial charges resulting from a significant drop in revenue

The variable interest rate on the loan was the 6 month Euro Interbank Offered Rate (EURIBOR) plus 3.2% + base rate per annum. On the 6 April 2009 the agreed annual interest amounted to 4.44%. Prior to the loan being granted in 2009 three commercial banks indicatively offered ZSSK Cargo a loan of the same amount over the same repayment period with slightly lower interest rates – although no information is given on how credible these offers were.

The Commission also considered evidence that the rate used was towards the lower end of what might be available on the market based on credit default swap rates for undertakings with the same credit rating.

The Commission considered that the loan may have been granted more favourable terms than the rates set out in the Reference Rate Communication. There were also doubts as to the compatibility of the loan with the internal market for the following reasons:

1. why the loan was given on more generous terms (including using a different base rate) than the 2008 Communication
2. the interest rate did not appear to take into account the financial difficulties of ZSSK Cargo; and
3. if the loan did constitute state aid, whether it would be compatible with the Treaty

The 2008 financial crisis impacted ZSSK Cargo and their financial reports showed a downturn in performance in the last quarter of 2008 the result being decreased from a net profit of EUR 22 million in the first half of 2008 to a net loss of EUR 47 million in the first half of 2009. The loan along with additional restructuring measures was considered necessary to improve the financial situation of ZSSK Cargo amongst other restructuring and cost cutting measures.

# Argument against state aid

The Slovak authorities argued that they decided on the terms of the loan based on the offers of three commercial banks.

The use of the 6 month EURIBOR rate was based on the fact that it would also be used by commercial banks that were providing loans on the market. They were interested in granting a loan at interest rates similar to that which ZSSK Cargo could have borrowed on the market at that time. On this basis the Slovak authorities argued that they acted as a private operator and the loan did not therefore constitute a financial advantage nor give a more favourable competitive position of ZSSK Cargo over other competitors.

The Slovak authorities argued that as there were real offers by the banks there was no reason to apply alternative reference methods (including the 2008 Communication) to establish whether the loan was granted on market terms. They acted in accordance with the private investor principle in a market economy and thus the loan did not entail any advantage for ZSSK Cargo.

# Market investor test

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 member 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 would have acted the same.

# Would a market operator have granted the same loan?

The question was whether a market operator would have granted the same loan on the same terms. 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 fact that ZSSK Cargo were able to repay the loan 4 years early and recorded operating profits does not on its own mean a market lender would have also granted the loan with reasonable assurance of being repaid. The early repayment only confirmed the reasonableness of the assessment on the information available. Indeed it is well established that when assessing compliance with the Market Economy Operator Principle (MEOP), the circumstances known at the time are relevant rather than the later success, or otherwise, or the investment or loan.

# Was it on market terms or conferring an advantage?

Although little detail is provided, it appears that commercial banks were willing to lend on more generous terms than the loan eventually granted.

The 2 year grace period which was later extended by an additional 18 months was unlikely to have significant effect on the assessment of the terms of the loan. Interest was paid on a 6 monthly basis since the start of the loan period so the benefit of the postponed repayment was outweighed by higher interest payments.

In addition the other loan offers also used the same 6 month EURIBOR rate indicating this was standard practice and thus in line with market conditions.

This is consistent with the principle that when applying the MEOP the 2008 Communication provides a starting point which can be trumped by evidence that the market would offer different funding terms.

## The impact of being wholly owned

The final consideration was that 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.

## Take home

This case is perhaps one of the clearest expositions of the concept that a rate of interest that is 'lower' than the relevant market rate can still comply with MEOP on the basis of associated shareholder benefits in the case of wholly owned companies. Secondly it confirms that the 2008 communication provides a starting point rather than the final say.

It also supports the outcome of the Ricoh Arena case where 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 MEOP.

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 aid as a result, and the terms of their loans will be relevant to the MEOP 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 be a logical extension of the principles in this decision, but would need to be considered carefully on a case by case basis as they would need to sufficiently associated with the hypothetical private market lender.

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