

A Critical Account of
Article 106(2) TFEU

Government Failure in Public
Service Provision

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Government Failure in Disapplication Review

A. Introduction

This chapter is an assessment of government failure in disapplication review under Article 106(2) TFEU. Disapplication review, it will be recalled, is the process through which a decision is reached that other Treaty rules should not be applied because otherwise it would obstruct the performance in fact or line law of the SGEI. Given the manner of their organisation and typical content, SGEIs are susceptible to the particular forms of government failure that I outlined in Chapter 2. Critical to the establishment and mitigation of government failures are transparency challenges, whether in the form of non-existent information, or, as is more frequently the case, acute information asymmetries. The latter may give the SGEI provider an insuperable advantage over governments by obscuring both necessity and proportionality review under Article 106(2). Similarly, the lack of pertinent information, and in particular of meaningful comparators, can make distinct efficiency scrutiny effectively impossible. While efficiency can be treated as an aspect of proportionality review, such is its growing prominence and cross-cutting significance that I treat it on a stand-alone basis in this chapter. As will be apparent, the position with respect to transparency and proof affects the assessment with respect to necessity and proportionality, and in turn, efficiency, to a considerable extent.

As I set out in this chapter, critical in the prevention and mitigation of government failure in the application of Article 106(2) are information asymmetry and related organisational issues. It is, moreover, the case that the application of the competition rules (which Article 106(2) is frequently used to disapply) frequently takes place in sectors that are subject to economic regulation of varying types and degrees of sophistication. The EU has a practice of intervention in traditional utility sectors, not least in telecommunications, which remains the sector subjected to the most comprehensive system of economic regulation. Critical to the prevention of government failure is the transfer of know-how and fundamental economic insights between sectors. Given the organisation of the EU, we might expect significant cross-deployment of that know-how and, at least to some degree, its incorporation into the Article 16(2) *acquis*. In that regard, the *Altmark* judgment

looms large. It represents an embryonic form of economic regulation, albeit developed solely for the identification of advantage for the purpose of the State aid rules. While it has contributed to the contingency of Article 106(2) as described in Chapter 4, it has also heralded a collateral, albeit partial, revival in the potential for the mitigation of government failure through disapplication review under Article 106(2). The convoluted process by which that outcome was arrived at is at the core of this chapter.

The following are the elements of this chapter. The next section describes the initial period leading up to the judgment in *Corbeau*, which is referred to as the ‘strict exception’ phase in line with rhetorical claims by the European Court and the European Commission during that phase. In the following section, I track a second phase, beginning with *Corbeau* and leading up to *Altmark*, during which Article 106(2) went from being a strict exception to becoming much more of a permissive derogation. The subsequent section is a consideration of *Altmark* and its later implementation in terms of the implications for disapplication review under Article 106(2) from a government failure perspective.

B. The First Phase—The Strict Exception

1. Introduction

In this section, the issues of transparency and proof, necessity and proportionality, and, finally, efficiency are considered with respect to Article 106(2) for the period running from the establishment of the EEC up to just before the handing down of the Court of Justice’s judgment in *Corbeau*. In this period SGEIs were largely untouched by EU law. Nevertheless, judicial and administrative determination to operate Article 106(2) as a strict exception is apparent. That said, the first phase is characterised by the Commission not taking on genuinely difficult cases where distributional objectives were implicated, and equally, in the same period the Court of Justice was not confronted with any preliminary references that really tested the accuracy of the strict exception label. Nevertheless, the foundation blocks for making that claim a reality were laid, not least with respect to transparency and proof, where the judgment of the Court in *Ahmed Saeed* stood as a model exposition of how the judicial function can be used to mitigate government failure under Article 106(2).

2. Transparency and Proof

As considered in Chapter 2, information deficits and asymmetry problems are rife in Article 106(2) cases. At best these are only partially soluble through judicial intervention, perhaps in part through the deployment of presumptions.

In relation to Article 106(2), the resolution of information asymmetries becomes a challenge, mainly for the Commission in respect of which it enjoys a specific competence under Article 106(3). The Commission's first use of that power occurred in 1980 when it adopted Directive 80/723/EEC ('the Transparency Directive').¹ The Transparency Directive was primarily envisaged as a necessary intervention for the purposes of State aid control.² It included reference to the desirability of transparency with respect to compensation for burdens associated with the pursuit of ends 'other than commercial ones' but made no explicit references to SGEIs.³

The Transparency Directive required the Member States to collect basic accounting information concerning their financial relations with public undertakings (broadly defined) as well as on the financial performance of those entities, including details of compensation for non-commercial burdens.⁴ Despite its scope, the Transparency Directive included a prominent exclusion for public undertakings that operated in the water, energy, postal, telecommunications and transport sectors.⁵ As a result, many of the fields generating archetypal SGEI claims fell outside the terms of the Transparency Directive, albeit temporarily. That deficiency was subsequently rectified by the first revision to it in 1985, which ended those sectoral exclusions. The Commission justified this extension on the basis of 'developments in the competitive situation in the sectors concerned and the progress made towards closer economic integration'.⁶

Despite the limitations of the Transparency Directive from an SGEI perspective, in 1989 the Court of Justice took the strict exception characterisation of Article 106(2) to its logical conclusion concerning the nature of proof that was required in order to establish that the competition rules should be disapplied by reason of Article 106(2). This occurred in *Ahmed Saeed*, which concerned the tariff-setting arrangements between airlines and efforts to circumvent them through the sale of tickets to German residents for flights not originating in Germany but which stopped there.⁷ The Court of Justice was faced with difficult questions as to the direct effect of Articles 101 and 102, as well as the duty of national authorities under Article 106(1) when it came to tariff approval. With respect to those duties, the Court acknowledged the potential relevance of Article 106(2) considering the obligations of certain airlines to operate non-commercial routes in the general interest.⁸ The Court held that a direct link needed to be established between specific PSOs and the overall tariff system in order to qualify under

¹ Directive 80/723/EEC on the Transparency of Financial Relations between Member States and Public Undertakings of 20 June 1980.

² *ibid*, see recitals 4, 5, 6.

³ *ibid*, recital 12.

⁴ *ibid*, Art 3.

⁵ *ibid*, Art 4.

⁶ Recital 3, Commission Directive 85/413/EEC of 24 July 1985 amending Directive 80/723/EEC on the Transparency of Financial Relations between Member States and Public Undertakings.

⁷ C-66/86 *Ahmed Saeed* [1989] ECR 803.

⁸ *ibid*, §55.

Article 106(2). More specifically, the Court held that ‘without effective transparency of the tariff structure it would be difficult, if not impossible, to assess the influence of the task of general interest on the application of the competition rules in the field of tariffs.’⁹ Although it went on to acknowledge that ultimately the assessment was for the national court, the obvious inference was that absent the necessary proof, arguments for the disapplication of the competition rules should be rejected.¹⁰

From a government failure perspective, the judgment of the Court of Justice in *Ahmed Saeed* was very significant. First, the Court was live to a critical information problem, although not one that was very prominent in the argument of the case.¹¹ Second, the Court’s stipulation that the impact of any SGEI needed to be demonstrated with reference to the tariff structure was directed at the role of the national authorities. It correctly focused attention on the only meaningful way of determining the case for an exemption from the competition rules. Third, the Court’s stipulation also indicated the likely limits of feasible judicial intervention on this issue. EU experience from many sectors has since demonstrated that the quantification of the burdens and benefits associated with SGEI delivery is often complex, necessitating a range of accounting and economic techniques.¹² It would be too much to expect the Court to be any more prescriptive than it was. Finally, and perhaps crucially, by raising the inference concerning a failure to substantiate the impact of the SGEI on the tariff structure the Court was giving the Member States a compelling incentive to adhere to elementary accounting transparency.

3. Necessity and Proportionality

(a) *The General Position*

In general terms, Article 106(2) sets the substantive standard for determining the extent to which the disapplication of other Treaty rules is to be judged. Their application must give rise to obstruction of the performance of the SGEI mission, either in law or in fact. For its part, in some of the earlier Article 106(2) cases, the Court of Justice tended to take an uncompromising stance, although arguably necessity was not seriously in issue in those cases. Faithful to the literal wording of Article 106(2), in cases such as *CBEM/CLT Höfner* and *Porto di Genova*, the Court emphasised that there needed to be a demonstration of how the application of other Treaty rules would ‘obstruct’ in the sense of being ‘incompatible’

⁹ *ibid*, §57.

¹⁰ *ibid*.

¹¹ It does not feature at all in the opinions of AG Lenz on 28 April 1988 and 17 January 1989.

¹² In the field of telecommunications, Art 5 and Annex III of Directive 97/33/EC on Interconnection and Open Network Provision established, for the first time, specific rules for the calculation of the costs of universal service provision. This was based on the net cost methodology, namely the difference between operating with and without the SGEI.

with the performance of the particular tasks arising from the SGEL.¹³ According to the Court, there needed to be proof of how the application of other Treaty rules was incompatible with the discharge of the particular tasks associated with the SGEL. Framed in this way, necessity review appeared to mitigate the potential for government failure, although in the absence of testing cases, the Court was not challenged in a serious way.

Taking its cue from the Court of Justice's characterisation of Article 106(2) as a strict exception, during the strict first phase, the Commission usually took a hard-line approach to necessity under Article 106(2). In *NAVEWA-ANSEAU*, for example, the Commission indicated that it would only countenance a limitation on the rules on competition when 'the undertaking concerned has no other technically and economically feasible means of performing the particular tasks'.¹⁴ In *BT-Telespeed* the Commission asserted that it was not sufficient that compliance with other Treaty rules made the performance of the SGEL difficult.¹⁵ Similarly, in *Ijsselcentrale* the Commission dismissed the argument that ending restrictions on imports of electricity could make distribution planning more complicated. That was on the basis that to permit imports required no more than an intensification of planning that the network operator already needed to undertake in order to take account of authorised self-suppliers.¹⁶ In the same spirit, in *EBU/Eurovision System*, the Commission held that although the airing of international sports content would be made more difficult for public broadcasters by applying the competition rules, it would not be rendered 'impossible'.¹⁷

During the first phase, when the Commission faced distributional objectives (and this may have affected its choice of cases), it was fortunate that those goals were formulated in ways that facilitated strict necessity review. In *Ijsselcentrale*, the Commission was able to rely on the fact that a customer proposing to rely on imports for part or all of its requirements could no longer automatically fall back on the default 'absolute obligation to supply'.¹⁸ Similarly, in *Netherland Express Delivery Services*, in censuring the extension of PTT Post BV's dominant position, the Commission pointed out that the incumbent was not actually subject to an obligation to provide services at uniform rates throughout the Netherlands.¹⁹ While the Commission could control the cases that it took forward, availing itself

¹³ C-311/84 *CBEM* [1985] ECR 3261, §17; C-41/90 *Höfner* [1991] ECR 1979 §25; C-179/90 *Porto di Genova*, §26.

¹⁴ Commission Decision 82/371/EEC, *NAVEWA-ANSEAU*, §66. The SGEL in question (operation of a public water system) was quite remote from the practices in question, which concerned the labelling of washing machines.

¹⁵ Commission Decision 82/861/EEC, *BT-Telespeed*, §42.

¹⁶ Commission Decision 91/50/EEC, *Ijsselcentrale*, §44.

¹⁷ Commission Decision 93/403/EEC, *EBU/Eurovision System*, §79, but note the Commission cleared the arrangements under Art 101(3).

¹⁸ *Ijsselcentrale*, §44(a) and (b). The supplier of last resort was at the core of the assumed SGEL.

¹⁹ Commission Decision 90/16/EEC, *Dutch Express Delivery Services*, §17. This decision was subsequently annulled on procedural grounds. Joined Cases C-48/90 and C-66/90 *Netherlands et al v Commission* [1982] ECR I-565.

of Article 106(3), which likely entailed a consideration of Article 106(2), it had no control over questions concerning necessity and proportionality that might reach the Court of Justice through the preliminary reference procedure.

Finally, the position on the choice of means is unknowable with respect to the first phase given the absence of decisions or cases directly on point. While the strict exception characterisation of Article 106(2) might be regarded as leading inevitably to a proportionality standard based on the deployment of the least restrictive means, this is conjecture only. EC legislative intervention in sectors featuring SGEIs only began to proliferate in the wake of the adoption of the 1986 Single European Act.²⁰ It was from then on that liberalisation began to impact on sectors where SGEI claims were likely. As a result, it is unsurprising that in the first phase neither the Commission nor the Court was faced with resolving the most contentious element of disapplication review, namely whether the proportionality standard required recourse to the least restrictive means.

(b) Pragmatism Portended

The advent of liberalisation of various network industries was to have very considerable implications for the analysis of necessity under Article 106(2). Beginning with the telecommunications sector from the mid-1980s, liberalisation was introduced in the utilities and network industries. By the early 1990s these developments drew much more forensic attention to the feasibility of continuing to implement important distributional objectives while pursuing liberalisation, and in turn, giving full effect to the competition and free movement rules. In particular, the questions of necessity and proportionality under Article 106(2) came to the fore. The displacement of the competition rules was assumed to facilitate SGEI provision in many sectors. Whether in practice that was essential for the maintenance of the SGEI was far less obvious. In the Terminal Equipment Directive, the Commission had asserted boldly that even if the provision of the underlying telecommunications network was an SGEI, the abolition of special or exclusive rights with respect to importing and marketing terminal equipment would have no impact on universal network provision.²¹ That kind of declaratory approach would not be defensible with respect to the liberalisation of telecommunications services.

There were indications during the first phase that an absolutist approach to necessity and proportionality might not be sustained. One such sign came in the form of the Commission's assessment of the scope of the exclusive privilege that might be necessary in order to allow the liberalisation of telecommunications services to begin. With its adoption of the Telecommunications Green Paper in 1987,

²⁰ It set a deadline of 31 December 1992 for the completion of the internal market.

²¹ See Commission Directive 88/301/EEC on Terminal Equipment, recital 11. Obviously there may have been monopoly profits on equipment that cross-subsidised underlying network provision, but presumably not of a magnitude as would threaten the viability of underlying network provision.

the Commission signalled how it would use its margin of appreciation under Article 106(3) in order to liberalise the sector.²² The Commission approached the issue of the necessity of exclusive rights on the basis of two considerations. The first was in the context of maintaining then prevailing USOs and associated tariff structures.²³ The second, and arguably more prominent, consideration was that monopoly profits from exclusive rights were considered crucial for investment in digitalisation.²⁴ As a result, an overarching concern to ensure the survival of the incumbent firms as principal providers of ubiquitous services is a dominant sub-text, with the need for investment and the introduction of competition framed at least in part in oppositional terms.²⁵ No consideration is given to whether earlier competition would have provided even greater incentives to invest.

In the light of those considerations, the Commission adopted a pragmatic if over-generous approach.²⁶ It concluded that since most countries gave incumbents a monopoly over basic network provision and voice services, this could serve to delineate the extent of necessary exclusive rights considering the network investment challenges common to them all.²⁷ The immediate concern was not a significant contraction of existing rights but the curtailment of their extension. On that basis, the Commission proposed to use Article 106(3) to liberalise all fixed services, apart from what came to be termed ‘voice telephony’ services.²⁸ Other services regarded as ‘value added’ in nature were to be open to provision by competing undertakings, with a general date for full liberalisation of all voice services set for 1 January 1998.²⁹ If nothing else, the experience in telecommunications served to demonstrate the difficulties presented by necessity and proportionality review in mitigation of government failure in a complex and dynamic sector, even for a technically sophisticated bureaucracy like the Commission.³⁰ It also portended a possible revision in the Court’s generally absolutist stance on necessity and proportionality review during the first phase once distributional goals were implicated in a way that engaged those tests in a critical way in an Article 106(2) case.

²² COM (87) 290 final.

²³ *ibid.*, 74.

²⁴ At least at EU level this did not subsequently result in any significant enhancement in the nature of the USO obligation in line with the progressive digitalisation of networks.

²⁵ The Telecommunications Green Paper refers to these as ‘partially contradictory’ considerations, p 49.

²⁶ See in that regard, Buendía Sierra, JL, *Exclusive Rights and State Monopolies under EC Law* (Oxford University Press, 2000) 309–14.

²⁷ The fact that in many cases those exclusive rights long pre-dated even the prospect of ubiquitous digitalisation did not appear to matter.

²⁸ This was subsequently defined quite narrowly in Art 1 of Commission Directive 90/388/EEC as ‘the commercial provision to the public of the direct transport and switching of speech in real time between public switched network termination points ...’.

²⁹ See Commission Directive 96/19/EC of 13 March 1996, amending Directive 90/388/EEC with regard to the implementation of full competition in telecommunications markets. Prior to that, the Commission had liberalised satellite, cable and mobile services.

³⁰ The preponderance of state ownership of incumbents may also have been significant in the negotiating dynamic.

4. Efficiency—The Manifest Incapacity Doctrine and Article 106(2)

Although perhaps not readily apparent from the wording of Article 106(2), questions of efficiency are very heavily implicated in its operation. The specification of the SGEI may involve the realisation of goals that unavoidably have efficiency implications, depending on the incentives of providers. Especially serious efficiency failures may arise where an SGEI is supported through the grant of exclusive rights. Absent economic regulation, an exclusive rights holder will be free to limit output by setting excessive prices, leading to allocative inefficiency.³¹ In addition, not having the spur of competitive rivalry to keep costs down, frequently monopolists are productively inefficient.³² Furthermore, a monopolist may be impervious to changes in the nature of demand and in turn fail to innovate, leading to losses in dynamic efficiency.

The question then arises whether Article 106(2) has a bearing on either the censure or toleration of such inefficiencies. During the strict exception phase of Article 106(2), it appeared that even if an intervention qualified as an SGEI, Article 106(2) would not be available to excuse certain types of failure and non-performance that in very general terms might be regarded as forms of inefficiency. Those would include output restrictions and failures to innovate. The basis for the doctrine, referred to as manifest incapacity to satisfy demand ('the manifest incapacity doctrine'), was a prior finding of an Article 106(1) violation in conjunction with Article 102, but with the Court of Justice effectively refusing to extend the benefit of Article 106(2)—where it was applicable—to excuse the inefficiency.³³

The manifest incapacity doctrine is exemplified by the *Höfner* judgment of the Court.³⁴ There the federal agency that had been given a monopoly over employment placement services tolerated the activities of competing business executive placement agencies. Liability in *Höfner* turned on the Court being able to specify actual abuses that had already occurred, while implicitly finding that they were

³¹ The position is separately more complicated for network industries (where SGEIs are common) since marginal costs are frequently less than average costs and as a result pricing on that basis would not ensure solvency in the presence of significant fixed costs. While two-part tariffs based on price discrimination using inverse elasticities of demand are a potential solution, they too have significant drawbacks, not least the difficulty of calculating them. Furthermore, frequently SGEIs entail mandates to implement uniform or non-discriminatory pricing, which is at odds with systems based on inverse elasticities. See generally, Pierce, R and Gellhorn, E, *Regulated Industries*, 4th edn (West Group, 1999) ch 7.

³² The potential for productive inefficiency in the operation of networks goes beyond possible over-staffing and lack of productivity that may arise under monopoly. In addition, and depending on how prices are set through regulation, there may be extra incentives to inflate the reckonable asset base, in particular if the regulator permits a rate of return in excess of the cost of capital. This is referred to as the Averch Johnson effect. Averch, J and Johnson, L, 'Behaviour of the Firm Under Regulatory Constraint' (1962) 52(5) *American Economic Review* 1052–69.

³³ This is referred to as such in Van Bael and Bellis, *Competition Law of the European Union*, 5th edn (Kluwer, 2010) 913.

³⁴ C-41/90 *Höfner* [1991] ECR-1979.

directly attributable to the grant of exclusive rights by the Member State. In *Höfner* the Court stipulated that there would be a violation of Article 106(1) in conjunction with Article 102 where a dominant firm was ‘manifestly not in a position to satisfy demand’.³⁵ *Höfner* is a case of ‘seeing is believing’, with the Court being presented with clear evidence of monopoly non-provision.³⁶ By focusing on manifest failure to meet demand, the Court of Justice appeared to be capable of having it both ways: the conferral of special and exclusive rights was not automatically condemned under Article 106(1) in conjunction with Article 102, but could be, depending on market outcomes.³⁷ In *Höfner* the Court was quick to confirm the existence of an SGEI, but having identified the possibility of a manifest failure to meet demand, the Court was equally clear that Article 106(2) could not justify any derogation from the principle of effectiveness as applied to the competition rules.³⁸ As a result, it appeared that Article 106(2) could not be used to excuse certain kinds of government failure, especially if they were egregious.

The potential shortcomings of relying on outward manifestations of abuse become apparent when comparing the argument in *Höfner* with those recorded in the later judgment in *Italian Job Centres*.³⁹ *Höfner* proceeded on the basis that the mere existence of executive placement services (which were tolerated by the German authorities) highlighted the manifest failure to meet demand. In *Italian Job Centres*, relying on statistics, the Italian authorities made a valiant effort to argue that the public jobs placement service was at least performing adequately. In its intervention, the Commission claimed that the nature of the market was such, both in terms of size, differentiation and evolution of the labour being procured, that it was impossible to imagine that a single provider could meet all demand.⁴⁰ Rather than abandoning the inevitable abuse doctrine, Advocate General Elmer instead broadened and deepened the inquiry by carrying out a globalised review of the nature of the jobs placement market and the degree of specialisation witnessed in liberalised markets.⁴¹ For its part, the Court adopted the Commission’s assessment of the varied and dynamic nature of placement services, emphasising the challenges for a public undertaking in responding to a market undergoing significant changes.⁴²

³⁵ *ibid*, §24.

³⁶ In *Höfner* executive recruitment appears to have been left to the private sector.

³⁷ Historically, this has been a vexed and fluid issue in EU law, see Buendía Sierra, JL, ‘Article 106—Exclusive or Special Rights and Other Anti-Competitive State Measures’ in Faull and Nikpay (eds), *The EU Law of Competition*, 3rd edn (Oxford University Press, 2014) 824–34.

³⁸ C-41/90 *Höfner* [1991] ECR-1979, §§24, 25, respectively.

³⁹ C-55/96 *Italian Job Centres* [1997] ECR I-7119.

⁴⁰ This is only one step away from a first-principle argument that absent special circumstances a monopolist is always likely to restrict output, fail to innovate, and more generally not satisfy demand except at supra-competitive prices.

⁴¹ In the same vein, see AG Gulmann in *Crespelle*, where he addressed arguments to the effect that various co-operatives given exclusive rights over bovine artificial insemination were not offering a comprehensive service and were overcharging customers. In addressing claims of overcharging he suggested that ‘such examples are of interest only if they may be regarded as evidence that the system itself—as a whole or as regards sufficiently important aspect of it—is contrary to community law’. See C-323/93 *Crespelle* [1994] ECR I-5077, Opinion of 4 May 1994, §29.

⁴² C-41/90 *Höfner* [1991] ECR-1979, §§33–35.

As will be considered in the next section, ultimately Article 106(2) was made available to excuse inefficiencies in SGEI delivery. As a result, an alternative market failure interpretation of the underlying facts of *Höfner* allows for the extraction of a more coherent government failure-driven explanation of the result. Employment markets are prone to market failures on the basis of possible information asymmetries and co-ordination difficulties. This is particularly the case where a Member State wishes to offer economy-wide placement services. At most, that general interest objective serves to justify a monopoly over the gathering of information on the availability and requirements of job seekers and prospective employees. Although Germany wished to offer a federally run universal and free service (at the point of access), that did not necessitate the grant of across-the-board monopoly rights covering information gathering, matching services and ultimately placement. As a result, if the Court had reasoned out from what was required to sustain the SGEI in the light of those market failures, it could have determined in a more convincing manner the extent of the necessary exclusivity.⁴³

C. The Second Phase—Permissive Derogation

1. Introduction

The second phase in the analysis of disapplication review from a government failure perspective runs from the handing down of the judgment in *Corbeau* in 1993 up until just before the judgment in *Altmark* in 2003. Although this period only covers 10 years, it includes a wide range of developments, which, with a small number of exceptions, disclose not just a marked change in sentiment, especially in the language of the Court, but also subtle and sometimes profound adjustments in the direction of Article 106(2). Despite some compensating legislative interventions by the Commission, particularly directed at transparency, by the end of this phase Article 106(2) was not as significant a backstop against government failure as it once was. It had become a much more permissive derogation. The strict exception mantra was shown to be an empty claim.

2. Transparency and Proof

As previously considered, the first and second iterations of the Transparency Directive did little to overcome the informational challenges inherent in disapplication

⁴³ An objection to reasoning out from Art 106(2) is that it may lead to a failure to fully particularise breaches of Art 106(1) in conjunction with another Treaty provision. For a criticism of this 'burden shifting', see Van Bael and Bellis (n 33) 916–17.

review under Article 106(2).⁴⁴ It was not until 2000 that the position was changed in several important respects, through the adoption of Directive 2000/52/EC. As reflected in its amendment of the title to the Transparency Directive, this legislation extended the underlying requirements to all undertakings engaged in SGEI provision, while also introducing a requirement that separate accounts be maintained.⁴⁵ Significantly, in terms of what was to come to pass later, Directive 2000/52/EC contained an exclusion from its requirements for SGEI support ‘fixed for an appropriate period following an open, transparent and non-discriminatory procedure’.⁴⁶ In line with an approach that in overall terms was indulgent, it was not framed so as to require that a tender be run on the basis of lowest cost.⁴⁷

Despite SGEIs being the paramount concern of the amendments to the Transparency Directive made in 2000, the separate accounts requirement was undercut by a lack of specificity as to the precise method of cost and revenue allocation. While it may be unfair to impugn that approach by reference to current standards, by 2000 the regulation of telecommunications in particular (and post, electricity and gas to a lesser extent) had generated a significant amount of know-how and legislative prescription in relation to these issues.⁴⁸ The Commission did not bring that know-how or specificity to bear in its amendments to the Transparency Directive, although by then, there were latent political strictures on recourse to Article 106(3). More generally, those sectors had demonstrated the indispensability of targeted interventions directed at the informational problem in the context of quantifying necessary support for SGEIs in classic USO form. Furthermore, the revisions to the Transparency Directive in 2000 did not include any provision to the effect that non-compliance with its terms would mean that the benefit of Article 106(2) would be denied.⁴⁹

In the absence of a sufficiently comprehensive Transparency Directive, much would turn on whether the approach in *Ahmed Saeed* would continue to be maintained. With its 2000 judgment in *Deutsche Post*, the Court began a significant retreat.⁵⁰ *Deutsche Post* concerned the non-physical re-mailing of credit card-related data, which Citibank undertook by delivering letters to the Dutch Post Office for final delivery by Deutsche Post to customers in Germany. Although Deutsche Post was paid a terminal due for final delivery, it appears to have been

⁴⁴ A third revision to the Transparency Directive in the form of Directive 93/84/EEC did not alter the position in that regard. It was principally concerned with the manufacturing sector.

⁴⁵ Commission Directive 80/723/EEC of 25 June 1980 on the Transparency of Financial Relations between Member States and Public Undertakings as well as on Financial Transparency within Certain Undertakings.

⁴⁶ Inserted as the new Art 4(2)(c) of the Transparency Directive. See also Recital 11.

⁴⁷ The process is not expressly referred to as tendering.

⁴⁸ Under Art 7(2) of Directive 97/33/EC, the Commission was permitted to draw up guidelines on cost accounting systems and accounting separation in relation to interconnection. Similarly, Art 18(3) of Directive 98/10/EC of the European Parliament and Council on the Application of Open Network Provision to Voice Telephony and on Universal Service contains relatively precise rules for cost allocation in relation to voice telephony.

⁴⁹ That would have put the result in *Ahmed Saeed* on a legislative footing.

⁵⁰ C-147/97 and C-148/97 *Deutsche Post* [2000] ECR I-825.

accepted before the referring German court that, nevertheless, Deutsche Post incurred a loss in respect of this kind of mail. As a result, it attempted to impose a surcharge, in purported operation of an international convention on postal charges, which was set at the price of the standard charge of mailing for a regular letter in Germany.⁵¹ This resulted in the referral of several questions to the Court, including as to a possible violation of Article 106(1) in conjunction with Article 102.

In his opinion in *Deutsche Post*, Advocate General La Pergola pointed out that based on the evidence before the Court, it was not apparent that Deutsche Post operated an appropriate cost allocation system, which would have been essential to assess the proportionality of levying a surcharge on all foreign-originated mail based on standard postal charges.⁵² He expressly adopted the Court's previous ruling in *Ahmed Saeed* to the effect that absent this kind of transparency, it could not be inferred that the conditions of Article 106(2) were satisfied.⁵³ In other words, the proportionality of the charge would not be assumed simply because there was a plausible argument that some level of recovery was appropriate to support Deutsche Post's USO.

The Court of Justice declined to follow the opinion of its Advocate General. It pointed to the fact that while such a system of cost transparency would be required, the relevant Directive was not then in force. Without it, and given the absence of an international agreement on the appropriate system of charges between operators, the Court refused to rule that the principle of a surcharge was not justified under Article 106(2).⁵⁴ In effect, the information asymmetry worked to the advantage of the SGEI provider. While it is true that the Advocate General's approach is 'all or nothing', it is justified considering the underlying information asymmetries. By contrast, the Court of Justice's stance appears indulgent considering that at the relevant time, Deutsche Post had not been complying with its requirements under the Postal Services Directive, which required it to separate out the costs of each element of universal service provision.⁵⁵ Compliance with those requirements would have likely disclosed that any losses on the service at issue in the proceedings could have been offset by profits from elsewhere, thereby not jeopardising the SGEI.⁵⁶

From the perspective of proof, just over a year after *Deutsche Post* Article 106(2) was further undermined by *TNT Traco*.⁵⁷ It concerned a challenge to a practice of

⁵¹ Subsequently, Deutsche Post moderated its claim to a surcharge based on the standard charge less the actual amount received from the originating postal service in respect of each letter.

⁵² Opinion of 1 June 1999 in C-147/97 and C-148/97 *Deutsche Post* [2000] ECR I-825, fn. 59.

⁵³ *ibid.*

⁵⁴ Conceivably, the Court could have taken the terms of the Directive as *prima facie* evidence of what a proportionate response might be. See an example of that approach with respect to security of supply for electricity in *Jahrhundertvertrag*, where a proposed provision of a draft Directive permitting a 20% reservation for domestic energy sources was used by the Commission to clear a measure under Art 106(2). Commission Decision 93/126/EEC, *Jahrhundertvertrag*, §30.

⁵⁵ Art 14(2) of Directive 96/67/EC.

⁵⁶ For a detailed criticism of the approach of the Court of Justice, see Bartosch, A, 'Joined Cases C-147/97 and C-148/97' (2001) 38 *Common Market Law Review* 195–210.

⁵⁷ C-340/99 *TNT Traco* [2001] ECR I-4109.

the incumbent Poste Italiane in levying a surcharge on rivals equal to its standard postal charge, even when its infrastructure and services were not being used. In addition to questioning the abusiveness of the charge, the referring court drew attention to the fact that although there were domestic legal requirements concerning the separate presentation of the revenues and costs of monopoly and competitive services, there was no regulatory mechanism to prevent the allocation of subsidies from the funding of the SGEI (including the levies) to competitive services. TNT Traco argued that the latter should have prevented recourse to Article 106(2). In rejecting this, the Court of Justice held that absent EC rules, reliance on Article 106(2) was, as was the case for Article 102, to be determined in accordance with national law.⁵⁸ As a result, the lack of domestic measures prohibiting cross-subsidies did not mean that the conditions of Article 106(2) were not met.⁵⁹ That was despite the Court of Justice stipulating that the contested surcharge also needed to be levied on Poste Italiane's own competing services, something not provided for in domestic law.⁶⁰

The effect of the Court's approach was that Article 106(2) could be satisfied through a demonstration with reference to the separate accounts requirement only. In *TNT Traco* Advocate General Alber had advised that in the absence of European rules, this issue was to be determined in accordance with national procedural rules, subject to the usual equivalence protections.⁶¹ The difficulty with this is its characterisation of this issue as procedural, considering that it went to the essence of what needed to be demonstrated in order for Article 106(2) to apply.⁶² By asserting that the position under Article 106(2) was the same as for Article 102, the Advocate General and the Court both overlooked the acute information asymmetry problems arising in SGEI litigation. As a result, the claim in *TNT Traco* that the burden of proof rests on the party seeking to rely on Article 106(2) is exposed as empty rhetoric.⁶³

3. Necessity and Proportionality

(a) *The Necessity of the Intervention*

In the second phase, the issue of necessity underwent very significant change. While the strict exception conception of Article 106(2) may have been overstated, it was based on a general objectification of the SGEI mission, a default presumption in

⁵⁸ *ibid.*, §§61–62.

⁵⁹ *ibid.*, §62.

⁶⁰ *ibid.*, §58.

⁶¹ *ibid.*, Opinion of AG Alber, 1 February 2001, §116.

⁶² AG Alber also relies on C-242/95 *GT-Link* [1997] ECR I-4449 as authority for the fact that procedural issues under Art 106(2) are to be determined by national law in the absence of EU harmonisation. Arguably, *GT-Link* only does so in respect of Art 102.

⁶³ C-340/99 *TNT Traco* [2001] ECR I-4109, §59.

favour of competition provision and the operation of markets, and finally, a pronounced willingness to hold Member States to account. The crumbling of these keystones of necessity review during the second phase will now be considered.

From SGEI Provision to the Stability of the SGEI Provider

The judgment in *Corbeau* marks the start of a distinct second phase in disapplication review under Article 106(2) from a government failure perspective. *Corbeau* concerned the operation of a rapid delivery service in Liège in competition with that of the publicly controlled provider, Régie de Postes (RdP). RdP claimed damages on the basis that the services provided by *Corbeau* infringed upon its monopoly over a basic postal service. That led to questions about the validity of the underlying monopoly under Articles 102 and 106 by a local court.

The Court of Justice found that there was an SGEI to collect, carry and distribute mail on behalf of users throughout Belgium. As has already been pointed out, in *Corbeau* the Court did not particularise, but appeared to assume an automatic violation of Article 106(1) in conjunction with Article 102.⁶⁴ Furthermore, the Court of Justice might be said to have ‘reasoned out’ from requirements that it saw as flowing from the underlying SGEI, namely the operation of a national postal system. It referred to the activities of competitors such as *Corbeau*, which, it noted, were free from the obligation to operate a system of internal subsidies.⁶⁵ By contrast, the ‘economic equilibrium’ of the provider was based on the ability to offset losses on unprofitable activities through monopoly profits from reserved services.⁶⁶ It left the referring Court to determine whether *Corbeau*’s activities were directly competing services or instead value-added services.

It is important to understand the nature of the concession made by the Court in *Corbeau* to SGEI providers. In essence, the focus moved from what was required to ensure the provision of universal service to guaranteeing conditions for the survival of the SGEI provider.⁶⁷ Although not necessarily intended to collapse the necessity test into a consideration of what was needed to protect the incumbent, the emphasis on ‘equilibrium’ and its subsequent deployment had that effect.⁶⁸ Furthermore, it is not apparent that the Court needed to do any of this to resolve

⁶⁴ Buendía Sierra (n 37) 831. See also, and by way of criticism, Van Bael and Bellis (n 33) 906–07.

⁶⁵ C-320/91 *Corbeau* [1993] ECR I-2533, §18.

⁶⁶ *ibid*, §19.

⁶⁷ An alternative approach by the Court could have been to indicate that if exclusivity was strictly necessary for the underlying SGEI, then the incumbent would have had sufficient incentives to respond comprehensively to the demand for rapid delivery services, which it did not.

⁶⁸ This, for example, is how AG Darmon interprets *Corbeau* in his opinion in C-393/92 *Almelo*, §146. He suggests that the competition rules did not apply either where they would jeopardise the provision of the SGEI or, with reference to the provider, ‘where they jeopardise its financial stability’. This concern for financial stability would always persist unless the actual burden of SGEI provision was quantified. Furthermore, although in the *Gas and Electricity Cases*, the Court had been induced by the Commission’s line of argument to indicate that it would not be necessary to show that without exclusive rights (in that case) the provider would not survive, in effect the *Corbeau* equilibrium formula was little more than a superficially alluring label for taking no chances with the survival of the SGEI provider.

the issues before it. Advocate General Tesauro correctly characterised the dispute as a factual one, essentially concerned with whether Corbeau was providing rapid delivery services. On that basis the reference questions were soluble without relying on the ‘equilibrium’ formula.⁶⁹ Despite that, the Court introduced a double protection for RdP by stipulating that even if Corbeau’s offering was a rapid delivery service, it needed to be shown that its provision would not affect RdP’s economic equilibrium.⁷⁰ That even went beyond Belgium’s own assessment of what was necessary prospectively, given that it had made a decision to liberalise all rapid delivery services.⁷¹

The contrast in substance and sentiment with *Ahmed Saaed* is apparent, where the Court objectivised the requirements of SGEI delivery in a manner that avoided its conflation with the survival of the SGEI provider in accordance with *Corbeau*. In this regard, a later judgment of the General Court in *Air Inter* is revealing, not least because it resisted the equilibrium formula by insisting that Article 106(2) was not available simply because competition would hinder or make the task of the SGEI provider more difficult.⁷² In that case, the General Court was even more dismissive of generalised assertions as to the need for a system of internal subsidies (in effect the equilibrium argument in more elaborate form), finding that a loss of revenues from competition had not been particularised.⁷³ Moreover, there had been no demonstration that any such losses would lead to the discontinuance of the route.⁷⁴ Despite this, *Air Inter* is really an outlier judgment in this period (like *Ahmed Saaed*, it concerned aviation, where there had been legislative intervention), with the generic equilibrium standard usually holding sway. With the benefit of hindsight, subsequently the Commission only made things worse in pursuing the *Electricity and Gas Case*, by arguing against France that it needed to demonstrate that there would be no financial imperilment of the incumbent if the contested bans were removed.⁷⁵ The Court had probably no option but to reject that contention.⁷⁶ As a result, for the duration of the second phase, the Commission was generally tied to the equilibrium standard, and was usually only able to overcome it where those claims were loosely asserted or where they stretched credulity.⁷⁷ *Corbeau* casts a dominant shadow over the second phase and provided essential context for the rulings in *Deutsche Post* and *TNT Traco* with respect to transparency and proof respectively.

⁶⁹ Opinion of AG Tesauro of 9 February 1993, §§21ff.

⁷⁰ §19. Furthermore, it appeared that this assessment would need to be undertaken on a market-wide basis.

⁷¹ A Law of 21 March 1991, which would be effective after the period relevant in the case, provided for the liberalisation of rapid delivery services. Presumably, Belgium considered that this could occur without jeopardising the SGEI. For background, see the opinion of AG Tesauro of 9 February 1993, §1.

⁷² T-260/94 *Air Inter* [1997] ECR II-977.

⁷³ *ibid.*, §139.

⁷⁴ *ibid.*

⁷⁵ C-159/94 *Commission v France*, §90.

⁷⁶ *ibid.*, §95.

⁷⁷ See, for example, Commission Decision 1999/695/EC, *REIMS II*, §92.

Ignoring the Contradiction of Necessity

A concerning feature of the second phase is the extent to which the necessity of disapplying other Treaty rules is negated by available facts but they are ignored in the application of Article 106(2). To some degree that phenomenon begins very subtly with *Corbeau*. There, General Tesauro had pointed out that in the Commission's 1991 Green Paper on postal liberalisation, it had found that rapid delivery services had been liberalised in all but three of nine Member States studied by the Commission.⁷⁸ The Court attached no special significance to Belgian's prospective assessment (proposing the abolition of exclusive rights over rapid delivery services) and required a demonstration that even if the impugned services were of the rapid delivery kind, RdP's equilibrium would not be imperilled.⁷⁹ While Belgium's proposal was prospective, thereby requiring such a demonstration for the prior period of Corbeau's infringement, given the close proximity in time, the Court's concern appears to have been misplaced. The experience of other Member States that had liberalised these services suggested that their liberalisation was not incompatible with the underlying SGEI being sustained.

Disregard for evidence that the disapplication of other Treaty rules is not necessary emerges even more clearly from the facts in *Ambulanz Glöckner*, and with it inevitable government failure.⁸⁰ The case concerned the refusal to continue the authorisation of *Ambulanz Glöckner* to provide non-emergency medical transport services in competition with the four medical aid organisations operating in the region. The Court of Justice's approach followed the *Corbeau* equilibrium formula on the basis of it being satisfied, albeit in somewhat muted terms, that revenues from non-emergency transfers were necessary to help underwrite the costs of emergency transfers carried out under uniform conditions.⁸¹ On that basis, Article 106(2) appeared to justify the refusal of authorisation to *Ambulanz Glöckner*, but that was subject to there being no manifest inability to meet demand.⁸² As against that, according to the national court, *Ambulanz Glöckner's* participation in the sector had proceeded without any adverse effects for seven years prior to the introduction of new legislation.⁸³ The amending legislation made provision for refusing authorisation for non-emergency services in the event that this posed a risk

⁷⁸ See §19 of his Opinion of 9 February 1993 in C-320/91 *Corbeau* [1993] ECR I-2533. Although much of his analysis is concerned with showing that rapid delivery services were not subject to the same regulatory constraints as basic postal services, his reliance on liberalisation in other Member States served to implicitly demonstrate that a flow of subsidies from monopoly profits to those services was not necessary to sustain basic postal services.

⁷⁹ Taken literally, the Court appears to suggest that *Corbeau* needed to make this demonstration, something that would clearly be beyond Mr Corbeau given the information asymmetries. Even if it that was not the case, the subsequent reversal of *Ahmed Saeed* meant that exclusive rights holders enjoyed great latitude.

⁸⁰ C-475/99 *Ambulanz Glöckner* [2001] ECR I-8089.

⁸¹ *ibid*, §58.

⁸² *ibid*, §65.

⁸³ *ibid*, §14.

(the degree not being specified) to the ability of the medical aid organisations to go on providing a public medical transport service.⁸⁴ It also provided that existing special rights holders would be consulted on any applications for authorisation.⁸⁵ From a government failure perspective, such a mechanism is fraught with risks of special pleading and exemplifies the triumph of provider interests over the general interest. Seen in overall terms, the Court may have been swayed by the argument that to invalidate the exclusive rights might have increased the overall cost to the public authorities of the service.⁸⁶

More striking examples of government failure, particularly in the process for establishing necessity (or to be more accurate, for admitting exceptions on the basis that adherence to a scheme of restrictions is not necessary in a given case) are provided by the outcomes in the *Albany*, *Brentjens* and *Drijvende Bokken* cases. The context was the grant of de facto exclusive rights to supplementary retirement funds through the imposition on employers in certain sectors of an obligation to insure their employees with a specific fund. In each case, the Court emphasised the risk of certain providers targeting businesses with younger healthier workers. That appears to ignore the likelihood that in distinct economic sectors individual workforces might have had roughly homogeneous risk profiles.⁸⁷ In *Albany*, Advocate General Jacobs drew the attention of the Court to evidence that similarly obligated pension funds had been operating successfully in other sectors without recourse to special or exclusive rights through compulsory membership.⁸⁸ As a result, there appeared to be strong prima facie evidence that in the real world, competition was viable while at the same time respecting the special terms of cover for supplementary schemes. In short, there was no necessity to disapply the competition rules. That did not persuade the Court, however, which appears to have been more swayed by Member State conjecture as to the incompatibility of competitive provision with the realisation of the general interest than it was by empirical evidence of market feasibility.

While it would be going too far to suggest that in each of these instances the Court of Justice should have taken the available evidence dispositive, that may have been defensible, at least in *Albany*, *Brentjens* and *Drijvende Bokken*. An alternative

⁸⁴ Although the incumbent providers were 'not for profits', it would seem naïve to exclude self-interested exclusionary intent.

⁸⁵ At most, the public authorities needed to be able to procure necessary information while being aware of the incentives of the incumbent providers.

⁸⁶ C-475/99 *Ambulanz Glöckner* [2001] ECR I-8089, §53. See Opinion of AG Jacobs of 17 May 2001, §182.

⁸⁷ This approach to risk is fairly typical of the Court in insurance-related cases where it appears unwilling to stipulate that Member States engage in some form of probability assessment. Instead, usually it is prepared to accept a possible risk, no matter how fanciful or unsubstantiated, as justification for exclusive rights or other interventions.

⁸⁸ See Opinion of AG Jacobs in C-67/96 *Albany* [1999] ECR I-5751, §432. Furthermore, attempts by the Dutch government to explain away that example do not appear to have been successful, at least in the eyes of AG Jacobs, who recommended that the entire issue of 'obstruction' needed to go back to the national court. See §§433–35.

approach would have been to rely on that evidence to establish a strong presumption for the referring tribunal that the disapplication of the competition rules was not necessary. That is distinct from saying that the burden of proof always lies on the party seeking to rely on Article 106(2). More specifically, the Court of Justice could have insisted on the referring court being satisfied to a high degree of certainty through sufficiently cogent evidence that competition was not reconcilable with adherence to specification of cover. That would have avoided the *Ambulanz Glöckner* scenario, where the Court itself appeared only to confirm the plausibility of the underlying financial case. In the presence of significant risks of government failure, the position can only be made worse by effectively resolving difficult evidential issues summarily in a preliminary reference (*Ambulanz Glöckner*), or conversely, delegating their determination with vague guidance only to national courts (*Corbeau*).

As will be apparent from several of the cases considered, necessity review under Article 106(2) is frequently a question of risk appraisal. Seen that way, and considering the nature of judicial review at the EU level, there are significant limits on the ability of the EU Courts to scrutinise such assessments for government failure. As an alternative, they might be expected to ensure adequate protection by way of robust national scrutiny. The opportunity for that was passed over during the second phase in *Albany*, where in respect of exclusive rights for supplementary pensions, an employer wishing to buy cover elsewhere was not allowed to do so. While the possibility of exemption existed, that was only on the basis of an application being made to the holder of the exclusive rights. Unsurprisingly, that was challenged on the basis of a conflict of interest, and more collaterally, by reason of the lack of effective judicial supervision.⁸⁹ During the proceedings before the Court of Justice, it became clear that although complaints about the refusal of an exemption could be referred to an independent board, its decisions were not binding, as evidenced by the fund's non-compliance with them in the underlying proceedings.⁹⁰ From a government failure perspective, this appears to be an instance of outright regulatory capture. Despite that, the Court considered that the complexity of making an assessment for exemption from compulsory affiliation was such that 'a Member State may consider that the power of exemption should not be attributed to a separate entity'.⁹¹ Instead, the Court specified that after-the-fact judicial review needed to ensure that decision making was not arbitrary, non-discriminatory or otherwise illegal.⁹² Tellingly, it stopped short of

⁸⁹ The existence of an exemption mechanism might be taken as implicit recognition that the exclusive rights as conferred may not have been strictly necessary.

⁹⁰ See C-475/99 *Ambulanz Glöckner* [2001] ECR I-8089 at §110 of the judgment and the Opinion of AG Jacobs at §467. AG Jacobs had no difficulty identifying and condemning the conflict of interest, even considering the 'not for profit' status of these funds. See pp 5853–58.

⁹¹ C-67/96 *Albany* [1999] ECR I-5751, §120. The task was a mixed actuarial and economic one, although hardly beyond the competence of an independent ad hoc expert panel.

⁹² *ibid*, §121.

prescribing a full merits review by the national court. It also left undisturbed the egregious failure to make appeal decisions binding.⁹³

(b) *Proportionality of Means*

In overall terms, the second phase of disapplication review is characterised by significant uncertainty in relation to the proportionality standard and in particular the issue of whether or not proportionality review requires the deployment of the least restrictive means. Obviously, the issue of less restrictive means, and in particular their viability, is closely connected to the issue of the competitive counterfactual which may serve to demonstrate or disprove their suitability. In many of the second-phase cases there is no consideration whatsoever of the possibility of less restrictive means being deployed. In *Corbeau* and *Ambulanz Glöckner*—and leaving aside the fundamental argument about competitive provision—the possible pursuit of alternative regulatory solutions was not part of the debate before the Court of Justice. In neither case was the Court presented with comprehensive argument as to the ability to maintain the SGEI without recourse to exclusive rights. That is not to excuse it from raising these issues of its own motion, which again makes the ruling of the General Court in *Air Inter* so striking.⁹⁴ There, as part of rejecting the case for obstruction, the General Court emphasised that there had been no demonstration that there was ‘no appropriate alternative system capable of ensuring regional development and in particular that loss-making routes continued to be financed’.⁹⁵

The outcome in *Air Inter* can be usefully contrasted with that in *Albany*, *Brentjens* and *Drijvende Bokken*. There detailed arguments were made about possible recourse to market-based regulatory alternatives to the grant of exclusive rights in the Dutch supplementary pensions cases.⁹⁶ It was argued that generally applicable regulation would suffice to secure the desired social outcomes. Conceivably, minimum standards could have been adopted with respect to entitlement and eligibility requirements, as had been the case in respect of the prohibition on prior health screening.⁹⁷ The Court did not engage with this contention beyond an assertion that the case concerned social security, as to which Member States

⁹³ Technically, the Court’s holding on this point appears to be that there was no violation of Art 106(1) in conjunction with Art 102 concerning the review mechanism. It is, nevertheless, heavily bound up with the Court’s Art 106(2) assessment.

⁹⁴ T-260/94 *Air Inter* [1997] ECR II-977. The issue of less restrictive means does not feature in the underlying Commission Decision 94/291/EC, which was an application of sectoral legislation, Council Regulation 2408/92, but equally, does not feature as an issue in the arguments recorded in the judgment. That said, Art 6 of Council Regulation 2408/92 provides for the phasing out of exclusive rights with respect to domestic routes.

⁹⁵ *ibid.*, §140.

⁹⁶ The final three cases can be treated together since they all concerned supplementary pensions in the Netherlands and were determined by largely identical Court judgments handed down on the same day.

⁹⁷ §430 of the Opinion of AG Jacobs in C-67/96 *Albany* [1999] ECR I-5751.

had a significant margin of appreciation.⁹⁸ In addition, the Court asserted that in order for the conditions of Article 106(2) to be satisfied in the aggregate, all that needed to be shown was that without the exclusive rights in question, the entrusted undertakings could not perform the particular tasks assigned to them.⁹⁹ Taken literally, that reduced disapplication review to simplistic ‘but for’ causality analysis.

Closer to the approach in *Air Inter* is that taken in *Dusseldorp*.¹⁰⁰ There, the Court of Justice condemned an export restriction for waste recovery as disproportionate. The context was the operation by the Netherlands of a system restricting the export of oil-related waste products to other Member States against a backdrop of significant EU legislation. The Dutch authorities prohibited the export of oil filters for recovery unless it was demonstrated that the destination country operated more technically advanced facilities. They argued that the operation of a dedicated facility to handle this waste was an SGEI. This, they claimed, made it necessary to guarantee it a stable supply of waste fuel, thereby justifying a highly restrictive regime for exports. The Court held that Article 106(2) could only apply if ‘without the contested measure, the undertaking in question would be unable to carry out the task assigned to it’.¹⁰¹ In doing so, the Court expressly adopted the observations made by Advocate General Jacobs to the effect that it needed to be shown ‘to the satisfaction of the national court that the objective cannot be achieved equally well by other means’.¹⁰²

4. Efficiency

In *Höfner*, as part of an expansive approach to Article 106(1) in conjunction with Article 102, the Court condemned the operation of an SGEI provider as an exclusive rights holder on efficiency grounds while denying the availability of Article 106(2) to excuse those failings. A critical question in the second phase would be whether the Court continued to refuse recourse to Article 106(2) in that way. More generally, the issue would arise as to whether the Court or the Commission was in a position to require efficiency-enhancing measures as a condition

⁹⁸ C-67/96 *Albany* [1999] ECR I-5751, §122. The Court seeks to rely on C-238/82 *Duphar* [1984] ECR 523, which reliance is criticised by Gyselen as the Court’s ‘most sweeping (and probably most disappointing) observation’ considering that *Duphar* concerned basic compulsory cover and the operation of the free movement rules. See Gyselen, L, ‘Case Law, Case C-67/96 and Case C-219.97’ (2000) 37 *CML Rev* 425–48. Interestingly, although writing in a personal capacity, Gyselen (a former Commission official) indicates that in respect of a complaint to the Commission by Brentjens, prior to the trilogy of judgments, the Commission had anticipated that it would need to be satisfied that no less restrictive means could have been deployed.

⁹⁹ C-67/96 *Albany* [1999] ECR I-5751, §107; C-115/97, C-116/97 and C-117/97 *Brentjens*’ [1999] ECR I-6025, §107; and C-219/97 *Drijvende Bokken* [1999] ECR I-6121, §97.

¹⁰⁰ C-203/96 *Dusseldorp* [1998] ECR I-4075.

¹⁰¹ *ibid*, §67.

¹⁰² Opinion of 23 October 1997, §108.

of the applicability of Article 106(2) so as to mitigate government failures. In the second phase, the limits of the manifest incapacity doctrine became apparent and more formal recognition of Member State control over SGEI definition led to a significant overall weakening of the position on efficiency under Article 106(2).

(a) *The Limits of the Manifest Incapacity Doctrine*

In *Corbeau*, unsurprisingly, the defendant made a valiant effort to frame the case as a *Höfner*-type failure to meet demand.¹⁰³ The essential claim was that RdP had not innovated in terms of catering for rapid delivery services and that a gap in the market was being filled by *Corbeau*. Those claims were confronted head on in the opinion of Advocate General Tesauro, who acknowledged that although the service provided by the incumbent might be said to be ‘indifferent’, nevertheless there was an obligation on it to meet all requests for service.¹⁰⁴ He contended that where the exclusive rights were objectively necessary, it was beside the point under Article 106(2) if the monopolist was inefficient.¹⁰⁵ He argued that questions of efficiency were a matter for the national authorities.

In *Corbeau*, while the Court did not go so far as expressly to adopt the Advocate General’s position on efficiency, that may be regarded as inherent in the outcome. As a result, contrary to *Höfner*, it appeared that non-performance was excusable and did not rule out reliance on Article 106(2). An important difference in that regard was that in *Corbeau* such inefficiency appeared to benefit from the protection of Article 106(2).¹⁰⁶ This stems from the approach of the Court in ‘reasoning out’ from Article 106(2) as referred to above. While Advocate General Tesauro’s logic appears convincing, nevertheless, the Court could have conditioned its approval on grounds of necessity by reference to RdP’s not failing to meet demand in a manifest manner. Buendía Sierra has pointed out that such a stipulation was included in the judgment in *Glöckner*, while acknowledging that it was not subsequently taken forward in the Article 106(2) jurisprudence.¹⁰⁷

(b) *Pre-eminence as to SGEI Definition Precluding Efficiency Scrutiny*

While there is undoubtedly a need to respect the ability of Member States to make their own distributional and cohesion-based choices, it is not apparent that this

¹⁰³ See Report for the Hearing, *Corbeau*, p 2539.

¹⁰⁴ Section 16 of his opinion of 9 February 1993.

¹⁰⁵ *ibid.*

¹⁰⁶ Buendía Sierra explains this on the basis that *Corbeau* effectively reversed the burden of proof. Unlike *Sacchi* where exclusive rights were not presumed to be unlawful, the opposite appears to be assumed in *Corbeau* but with Art 106(2) providing the saving justification. See Buendía Sierra, ‘Article 106’ 832.

¹⁰⁷ Buendía Sierra has argued that *Corbeau* is moderated by *Ambulanz Glöckner* on the basis that the latter qualified Art 106(2) by requiring that it would only apply provided that there was no manifest failure to meet demand in line with *Höfner*. He acknowledges that other judgments do not support this approach. Buendía Sierra (n 37) 860.

should extend to permitting significant levels of productive inefficiency in their fulfilment. Even if the Court's abilities in this regard are heavily constrained, at least in replying to preliminary references, that does not appear to follow for the Commission. At the very least, it has the capacity to grapple with the exact modalities of SGEI provision and in turn possible efficiency implications. Furthermore, such control would appear to be legitimate even considering the hegemonic position of the Member States in respect of the definition of SGEIs. Contrary to this reasoning, in a number of judgments during the second phase, judicial affirmation of discretion with respect to SGEI formulation (in terms of the specification of particular tasks) effectively morphed into the Commission being disabled from taking steps to ensure even productive efficiency in SGEI delivery.

The regression on efficiency in the second phase can be traced back to the setting of the supervision standard for SGEI qualification based on manifest error. Although the manifest error standard was confirmed in *Fred Olsen*, this was predicated on a statement in *FFSA* concerning the amount of discretion vested in the Member State.¹⁰⁸ There, the Court of Justice indicated that 'the authorities of the Member States may in some cases have a sufficient degree of latitude in regulating certain matters, such as, in the present case, the organisation of public services in the postal sector'.¹⁰⁹ At its highest, that was a claim for deference in the specification of particular tasks (eg, delivery targets, number of post offices per head of population, etc). It does not follow that this should have precluded the appraisal of how efficiently the entrusted tasks were performed. The Court went further, however, in *FFSA* and stipulated that

[i]n the absence of Community rules governing the matter, the Commission is not entitled to rule on the basis of public service tasks assigned to the public operator, such as the level of costs linked to that service, or the expediency of the political choices made in this regard by the national authorities, or La Poste's economic efficiency in the sector reserved to it.¹¹⁰

In superficial terms this appears to preclude efficiency as a condition of qualification under Article 106(2). It is worth pointing out, however, that the Court made this pronouncement on efficiency in the context of arguments directed at the specification of the USO in terms of its nature and extent. In particular, it was addressing an argument seeking to question the extent of USO provision (and in turn, the related costs) through requirements as to the number of post offices to be operated by the SGEI provider.¹¹¹ In substance, that amounted to impugning the particular tasks assigned to La Poste, as to which deference to the Member

¹⁰⁸ T-106/95 *FFSA* [1997] ECR II-229, §99.

¹⁰⁹ *ibid*, §99.

¹¹⁰ The Court relied on the Opinion of AG Tesauro in *Corbeau*.

¹¹¹ See §108 of the judgment. Separately, at §86, the General Court records the Commission as having argued that it was not its role to improve the efficiency of the public postal service in France.

States is understandable. The Court could have distinguished deference on the precise tasks delegated to La Poste from an appraisal of its operational efficiency in their execution. Despite the potential for distinguishing those issues in that way, under the *FFSA* approach SGEI providers were entitled to recover compensation based on all of the costs that they actually incurred.¹¹² This meant that significant productive inefficiencies would continue to be tolerated at EU level to the extent that domestic initiatives or EU regulation did not actively target them. The General Court's excusing of the Commission in this way acted as a significant constraint on the use of efficiency control as a check on government failure.

D. The Third Phase—Partial Revival

1. Introduction

This section explores government failure under Article 106(2) in the wake of the *Altmark* judgment. The relationship between *Altmark* and Article 106(2) is both complex and nuanced. In particular, matters have been complicated by legislative interventions in the wake of *Altmark*. These have come in two rounds: first the 'Monti-Kroes Package' in 2005, and subsequently, the 'Almunia Package' in 2012.¹¹³ As a result, the structure of this section involves a split in the consideration of government failure between the implementation of *Altmark* and the position more generally pertaining under Article 106(2). This section maintains the tracking of the strictness of disapplication review by reference to transparency and proof, necessity and proportionality, and efficiency. The position based on *Altmark* implementation is in turn divided between, on the one hand, measures that fall within the relevant exempting decision, and on the other hand, the corresponding frameworks adopted by the Commission for those that do not. Both the Monti-Kroes and Almunia packages represented progressively more rigorous requirements from an efficiency perspective with respect to the delivery of SGEIs. Whether they herald a wider reorientation of Article 106(2) back towards the prevention and mitigation of government failure remains to be seen.

¹¹² See, for example, Commission Decision 2002/782/EC, *Poste Italiane*, §133, despite possible indications of efficiency problems. See §131, point (iv).

¹¹³ The Monti-Kroes Package comprised Commission Decision 2005/842/EC of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, the Community Framework for State Aid in the form of Public Service Compensation (2005/C297/04), and Commission Directive 2005/81/EC of 28 November 2005 amending Directive 80/723/EEC on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings.

2. *Altmark* and the Transformation of Article 106(2)

(a) *Altmark* and the Mitigation of Government Failure

The overall composition and tenor of the *Altmark* ruling evinces a pronounced concern to guard against government failure even though the ruling was rendered as a filter for the identification of advantage as one of the elements of State aid.¹¹⁴ In line with the nature of SGEIs, however, the PSO requirement of the first test is open ended, although it may ultimately lead to the narrower PSO requirement eventually emasculating the SGEI concept. In addition the requirements of obligation and definition replicate the entrustment requirement in Article 106(2). The second element of *Altmark*—which requires that compensation parameters be arrived at in a transparent manner and that they be determined in advance—can be understood as an attempt to guard against government failure through an emphasis on process. There is clearly a concern about the incentive effects of systems based simply on reimbursement for losses after the fact.¹¹⁵ The third *Altmark* criterion limits compensation to the costs of PSO provision and makes provision for profit. Both the nature of cost calculation and the precise allowance for profit are left open, which is unsurprising considering the technicality of both.

It is with respect to the fourth test that the Court of Justice displays great subtlety and commendable awareness of the difficulties inherent in PSO funding. This sophistication was likely informed by the fundamentals of utility regulation. Member States are given an incentive to tender based on lowest cost.¹¹⁶ As an alternative, the Court constructed a quasi-regulatory formula. While stipulating that compensation should be based on the costs of a ‘typical’ undertaking, this needed to be one that was ‘well run’. It at least places some emphasis on productive efficiency, even if that is generous in relative terms. The Court was trying to square a difficult circle. It raised the issue of comparative performance but without setting a hypothetically efficient comparator as the benchmark. Similarly, the reliance on the undertaking being ‘adequately’ resourced reflects an abiding concern in utility regulation that a provider be properly capitalised.¹¹⁷ Completing the third

The Almunia Package is more comprehensive and includes Commission Decision 2012/21/EU, on the application of Article 106(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, a European Union Framework for State Aid in the form of public service compensation (2012/C8/03), a Communication from the Commission on the Application of the European Union State Aid Rules to Compensation Granted for the Provision of Services of General Economic Interest (2012/C008/02) and Commission Regulation 360/2012/EU on the Application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid granted to undertakings providing services of general economic interest.

¹¹⁴ C-280/00 *Altmark* [2003] ECR I-7747, the critical sections of the judgment are §89–93.

¹¹⁵ *ibid*, §91.

¹¹⁶ That is even more prescriptive than Art 4(2)(c) as introduced to the Transparency Directive when amended by Directive 2000/52/EC.

¹¹⁷ See Pierce and Gellhorn (n 31) 134–44.

test, and possibly drawing (albeit without attribution) on the legislation at issue in *ADBHU*, the Court makes reference to the PSO provider being permitted a reasonable profit.¹¹⁸

Despite its very specific purpose, given its subsequent deployment for substantive compatibility assessment, it is interesting to compare the overall effect of the *Altmark* criteria with Article 106(2) during the first two phases. Clearly, it is much closer—not just in substance, but also in sentiment—to Article 106(2) in its strict exception guise. Put otherwise, if the trajectory of the strict exception approach had been maintained, this may have led to the kind of prescription for substantive assessment under Article 106(2) as used to rule out the existence of an advantage under *Altmark*. By contrast, *Altmark* seems far removed from Article 106(2) as a permissive derogation. Given that the case concerned land transport, the Court could not have actually deployed Article 106(2) considering the distinct constitutional and legislative provisions for aid in that sector. Even if it could, however, this kind of approach would have been unthinkable in the second phase. In formulating its judgment in *Altmark*, presumably the Court also understood that in other sectors Article 106(2) would still be available. The immediate question was whether the rigour and specificity of *Altmark* would be mirrored under Article 106(2), or whether the permissive derogation approach would be maintained.

(b) *Initial Stasis*

Immediately following *Altmark* it appeared as though certain types of aid would inevitably be cleared under Article 106(2), even when one or more of the *Altmark* criteria were not satisfied. Although the Commission proceeded to enforce several of the *Altmark* criteria, and the third criterion in particular, vigorously, it appeared that Article 106(2) would continue to be applied permissively. *BBC Digital Curriculum* provides an example.¹¹⁹ In that case, the Commission accepted as adequate the UK government's claim largely on the basis that the BBC would not receive all of the money that it had requested for the service (by way of licence fee). This meant that the compensation was not proportionate under Article 106(2).¹²⁰ This was despite the lack of any demonstration that the BBC's costs were those of a typical, well-run organisation. The same approach is apparent elsewhere. Accordingly, compensation for credit unions in Scotland that failed the fourth *Altmark* criterion was also cleared under Article 106(2).¹²¹ This was done on the basis that

¹¹⁸ C-240/83 *ADBHU* [1985] ECR 531. Art 13 of Directive 75/439/EEC specified that the permitted cost indemnities could take into account a 'reasonable profit'. The Court's reliance on 'profit' is distinct from the more usual reliance (in economic regulation) on a rate of return related to the cost of capital.

¹¹⁹ N 37/2003 *BBC Digital Curriculum*.

¹²⁰ That included a requirement to maintain separate accounts and the general prohibition on the BBC using the licence fee for commercial purposes. See §55. Neither of those measures provides any reassurance that the underlying service would be productively efficient.

¹²¹ N 244/03 *Credit Union Access Provision of Access to Basic Financial Services—Scotland*.

compensation would reflect net costs, compliance with which would be systematically verified.

3. Elements of Disapplication Analysis post *Altmark* Implementation

(a) *Transparency and Proof*

Transparency and Proof under Article 106(2) so as to Avoid State Aid Control

The issue of transparency was not addressed on a stand-alone basis in the 2005 SGEI Decision, but clearly the detailed elaboration of the entrustment requirement is relevant. The 2005 SGEI Decision expanded on the traditional specificity by requiring that the act of entrustment must, in addition to specifying duration, scope and nature, also include parameters for ‘calculating, controlling and reviewing compensation’.¹²² In addition, and presumably with a view to better specifying the general interest, and possibly minimising the dangers of regulatory capture, Member States were ‘encouraged’ to consult widely with respect to the SGEI mission. All of these elements are taken forward into the 2012 SGEI Decision, with the addition of a pointed evidential requirement, namely that the act of entrustment must make specific reference to the 2012 SGEI Decision. In addition there is generic reliance on the observation of general cost accounting principles for undertakings providing services of general economic interest. The 2012 SGEI Decision retains those elements and introduces a new provision on transparency for certain undertakings requiring the publication of the amount of aid by year.¹²³

Transparency and Proof under Article 106(2) for State Aid Compatibility

As already noted, the 2005 Framework adopted the same approach to entrustment as the 2005 SGEI Framework Decision, subject to the consultation addendum and a stand-alone requirement for separate accounts for undertakings providing several services. That is stated to be without prejudice to the requirements of the Transparency Directive. The 2005 Framework takes a broadly similar approach with respect to the specification of accounting and related requirements, which is maintained in the 2011 Framework. In addition, the 2011 SGEI Framework includes a new section headed ‘Transparency’. This introduces a publication obligation with respect to consultation on the specification of the PSO, its details and the amount of funding.¹²⁴ The 2011 Framework also creates new reporting

¹²² Commission Decision 2005/842/EC, Art 4(d).

¹²³ Commission Decision 2012/21/EU, Art 7.

¹²⁴ [2012] OJ C8/03, §60.

requirements to the Commission, including complaints as to non-compliance with its terms.¹²⁵

Perhaps more importantly for government failure purposes, and considering the wider consideration of transparency in this chapter, the 2011 Framework includes a provision to the effect that non-compliance with the provision of the Transparency Directive means that the aid is regarded as affecting the development of trade contrary to the interests of the Union.¹²⁶ This is a very significant change, creating precisely the kind of incentive necessary to secure compliance with its terms. Such an amendment was not included in the Transparency Directive, even when recast as Directive 2006/111/EC. The Transparency Directive had been amended in the immediate wake of the *Altmark* judgment to change the scope of covered undertakings, which had been defined as including SGEI providers that were recipients of State aid. Directive 2005/81/EC simply amended the Transparency Directive to bring within its terms SGEI providers that were in receipt of any form of public service compensation.¹²⁷ In turn, Directive 2006/111/EC was largely a codification exercise.¹²⁸ By contrast, through the consequences of non-compliance, the 2011 Framework creates an essential and compelling incentive long missing from the transparency regime, at least for some SGEIs.

The Residual Position on Transparency and Proof under Article 106(2)

With respect to the case law on transparency and proof in the period since *Altmark* there have been no fundamental changes. As such, absent the Court of Justice reviving *Ahmed Saeed* or further legislative intervention, there appears to be a significant gap between, on the one hand, compensation that falls within the 2012 SGEI Decision or that is compatible with the 2011 Framework, and on the other hand, measures falling outside. Moreover, as *Deutsche Post* demonstrated in the second phase, not even non-compliance with sectoral legislation has led the Court to conclude that necessity could not be established.

(b) *Necessity and Proportionality*

Proportionality under Article 106(2) so as to Avoid State Aid Control

In respect of the calculation of PSO compensation, the 2005 SGEI Decision followed the third *Altmark* requirement by stipulating that all revenues derived from the provision of the SGEI must be taken into account. It went further by specifying that all of the variable costs of providing the SGEI could be recovered in addition to a contribution to common costs and an adequate return on capital.¹²⁹

¹²⁵ *ibid.*, §62.

¹²⁶ *ibid.*, §18.

¹²⁷ Art 2.1(d) as inserted by Directive 2005/81/EC.

¹²⁸ See recital 1 of Directive 2006/111/EC.

¹²⁹ Art 5 of Commission Decision 2005/842/EC.

That could include a ‘reasonable’ profit, which was linked to that of the average of the ‘sector in recent years’.¹³⁰ In line with a more economics-oriented approach, the concept of ‘profit’ was recast as ‘a rate of return on capital’, for which recourse to benchmarking was permitted.¹³¹ Despite that, the approach to cost recovery remained indulgent. Recital 11 confirmed that the permissible level of cost recovery for SGEIs under Article 106(2) ‘should be taken as referring to the actual costs incurred by the undertakings concerned’. As a result, in practice, cost recovery was likely to be based on some form of fully distributed historic costs. This can be contrasted with previously established methods of allowing for the recovery of efficient costs only, such as long run incremental cost (LRIC) models deployed in telecommunications.¹³² From the Commission’s perspective, initial reserve was likely a pragmatic calculation both in terms of the invasiveness of the intervention and the need to begin reform through the introduction of elementary accounting principles ahead of more efficiency-oriented hybrid economic accounting models such as LRIC.¹³³

The 2012 SGEI Decision takes forward these requirements with some additional detail and limitation. It rows back on the limits for compensation that were declared compatible with Article 106(2) and in turn exempted from notification under the 2005 SGEI Decision.¹³⁴ Under the 2012 SGEI Decision, allowable costs are limited to avoidable costs for undertakings providing services in addition to the SGEI.¹³⁵ There is, however, no suggestion of any limitation of costs to ‘efficiently incurred’ costs only, even if in principle such an approach can be reconciled with taking the modalities of PSO provision (as expressed through entrustment) as a given. With respect to the cost of capital, the 2012 Decision introduces a safe harbour that in all events, a rate of return not greater than the relevant swap rate plus a specified premium is reasonable.¹³⁶

¹³⁰ *ibid*, Art 5(4). Significantly, the 2005 Decision does not stipulate the return on capital must not exceed its cost.

¹³¹ *ibid*.

¹³² These access-pricing models are designed to simulate marginal cost pricing. It should be acknowledged that in the very early days of access price regulation in telecommunications, approaches such as those based on Fully Distributed Historic Costs were initially permitted as a basis for calculating interconnection prices but by 1998 were being criticised by the Commission as likely producing prices that were not efficient. See Commission Recommendation 98/195/EC on interconnection in a liberalised telecommunications market. (OJ L73/42). More generally, the treatment of common costs is frequently a major issue in the cost of SGEIs. On the nature of possible alternatives (in the context of test for cross-subsidies), see Hancher, L and Buendía Sierra, JL, ‘Cross-subsidization and EC Law’ (1998) 35(4) *CML Rev* 906–08.

¹³³ Significantly, the 2005 Decision does not stipulate the return on capital needed to equal the cost of capital.

¹³⁴ Art 2 of Commission Decision 2012/21/EU creates a general maximum for annualised compensation at €15 million.

¹³⁵ *ibid*, Art 3(3). In practice this may result in less compensation than on a stand-alone cost basis.

¹³⁶ *ibid*, Art 5(7). Again reference to benchmarking is permitted where an approach based on a rate of return on capital is not feasible.

Proportionality under Article 106(2) for State Aid Compatibility

The 2005 Framework adopted a more or less identical approach to the proportionality of PSO compensation, including the same requirements with respect to cost allocation as contained in the 2005 SGEI Decision. With respect to the calculation of SGEI compensation, it provided that non-SGEI activities must recover at least all of their variable costs, an appropriate contribution to fixed common costs, and an adequate return.¹³⁷ The 2011 SGEI Framework specifies an approach to the proportionality of PSO compensation that is in keeping with the 2012 SGEI Decision. With respect to the calculation of compensation, while expressly permitting compensation based on expected costs and revenues, it ties the underlying assumptions to validation by sectoral regulators and other independent agencies.¹³⁸ Separately, and by way of further specification of the net avoidable cost methodology, attention is drawn to telecommunications and postal legislation as guidance.¹³⁹ There is also, for the first time, some specificity with respect to the allocation of common costs, but with sufficient flexibility to accommodate any objective, rationally defensible method. There is also greater nuance introduced in relation to the position on the rate of return, with departures from the safe harbour identified in the 2012 SGEI Decision where the SGEI provider faces a meaningful commercial risk.¹⁴⁰

The 2011 SGEI Framework also provides that the act of entrustment itself must include a mechanism for avoiding and repaying any over-compensation. While the 2011 SGEI Framework carries forward the 2005 approach with respect to entrustment, it introduces an important new requirement targeting open-ended mandates. It stipulates that in principle, entrustment should not extend beyond the period necessary to depreciate the most significant assets underpinning SGEI delivery.¹⁴¹ Quite obviously many SGEIs may be provided using already highly depreciated assets (at least in accounting terms) so absent significant justified capital expenditure, lengthy concession periods may be difficult to justify. From a government failure perspective this is a significant intervention, considering the sharpening of the position on tendering also included in the 2011 SGEI Framework.¹⁴²

The 2011 SGEI Framework introduces a very significant change with respect to tendering. This links compatibility to actual or prospective compliance with the applicable procurement rules.¹⁴³ The impact of this requirement cannot be understated, even if a Member State avoids initial compliance through promising future adherence. Furthermore, its potential effects must be assessed considering

¹³⁷ 2005/C297/04, §16.

¹³⁸ 2012/C8/03, §23.

¹³⁹ *ibid.*, §26.

¹⁴⁰ *ibid.*, §38. This is where the SGEI provider is wholly indemnified through after-the-fact compensation.

¹⁴¹ *ibid.*, §17.

¹⁴² A similar requirement does not appear in the 2012 SGEI Decision.

¹⁴³ 2012/C8/03, §19.

that open-ended entrustment is no longer acceptable. Given the ambiguity of the drafting, on one view, the tendering requirement arises independently of the literal scope of the pertaining procurement rules.¹⁴⁴ Such an interpretation has, however, encountered significant objections, which Geradin has justified with reference to the General Court's judgment in *SIC*.¹⁴⁵ Those are that in *SIC* the General Court appeared to rule out that non-compliance with tendering (absent a sectoral obligation) could preclude reliance on Article 106(2), and that in any event, the appropriate remedy for such non-compliance was regular enforcement action by the Commission. Separately, and maybe more importantly, there may be objections to the Commission effectively amending procurement law through Article 106(2) enforcement.

As against these objections, the Commission's approach in paragraph 19 of the 2011 SGEI Framework possibly reflects two distinct but congruent considerations. First, and as alluded to in Chapter 1, occasionally Article 106(2) has been deployed dynamically to take account of possible changes in circumstances over time. As such, the Commission's reserve position of possibly extracting a future compliance commitment on procurement may be both defensible and realisable in practice. Second, the Commission also has the possibility of calibrating the 'most economically advantage tender' requirement in a way that addresses essential Member State concerns. While two prominent sectors, namely land transport and public service broadcasting, remain outside the scope of the 2011 SGEI Framework, and even considering the safe harbours contained in the 2012 SGEI Decision for other sectors, if the new procurement requirement included in paragraph 19 has teeth, then it is likely to have far-reaching consequences for SGEI provision.¹⁴⁶ It may result in greater recourse to market mechanisms for the resolution of government failures in the design and calculation of SGEI compensation.¹⁴⁷

Finally, in the 2011 SGEI Framework, the Commission reserves its discretion to impose additional requirements where the competitive distortions may affect the development of trade contrary to the overall interests of the Union.¹⁴⁸ This may serve to operationalise the requirements of the second sentence of Article 106(2).¹⁴⁹

¹⁴⁴ From a literal perspective, the word 'applicable' in §19 may be crucial.

¹⁴⁵ Geradin, D, 'Public Compensation for Services of General Economic Interest: An Analysis of the 2011 European Commission Framework' (2012) 2 *European State Aid Law Quarterly* 51. Case T-442/03 *SIC* [2008] ECR II-1161, §§145–47, which relies on T-17/02 *Fred Olsen* [2005] ECR II-2031, §§ 238–39. Despite that, §238 of *Fred Olsen* appears to admit of the possibility of guidelines (at least concerning Art 107) having such an effect. While the 2011 Framework could be regarded as an implementation of Art 106(2), it is not an Art 106(3) Directive or Decision. Alternatively, while it may be treated as a set of guidelines on the application of Art 107 when deploying Art 106(2) as the specific test for compatibility, not even the procedural assimilation of Art 106(2) within the State aid rules (as typified by *Banco Exterior*) could be said to have extinguished Art 106(2).

¹⁴⁶ In particular, considering that open-ended entrustment is effectively prohibited.

¹⁴⁷ See Bartosch, A, 'Editorial' (2004) 1 *European State Aid Law Quarterly* 1, commenting in the immediate wake of *Altmark* on the unlikelihood of the Member States ever taking that course unilaterally.

¹⁴⁸ 2012/C8/03, §2.9.

¹⁴⁹ There are significant parallels with the attempts as part of the Refined Economic Approach to specify the requirements concerning competition and the development of trade for State aid purposes.

From a proportionality perspective, the 2011 SGEI Framework contains an important stipulation with respect to entrustment connected with special or exclusive rights. While acknowledging that Article 106(1) remains the primary vehicle for dealing with those matters, the Commission states that where the exclusive rights provide for advantages not properly assessed according to the net cost methodology, then the aid itself might not be deemed compatible.¹⁵⁰ Although one step removed from the justification for the underlying special or exclusive rights, this raises the question of whether such grants are not capable of being interrogated on the same basis as direct PSO compensation.

The Residual Position on Necessity and Proportionality under Article 106(2)

With relatively few cases reaching the European Courts on these issues since *Altmark*, it is difficult to point to any emerging trend. Judgments such as *AG2R Prévoyance* from 2011 tend to confirm that the generally permissive nature of proportionality review that was characteristic of the second phase is still enduring.¹⁵¹ As against that, in *Hanner*, and relying on *Dusseldorp*, Advocate General Léger asserted that the least restrictive means must be deployed for the purposes of proportionality review under Article 106(2).¹⁵² It will, however be recalled that the Court held that Article 106(2) could not be used to exempt a violation of Article 37. In *AG2R Prévoyance*, exclusive rights had been vested in an undertaking with respect to the provision of supplementary cover for workers in the French bakery sector. At issue in the case was the lack of a mechanism that could be used by particular employers so as to secure an exemption permitting them to purchase cover elsewhere for employees. In considering that issue, the Court implicitly endorsed the necessity of exclusive rights on the basis that competition would mean that *AG2R Prévoyance* would ‘run the risk of defection of low-risk insured parties.’¹⁵³ As a result, it would end up with an increasing share of bad risks. This is presented as conjecture only, there being no evidence relied upon by the Court as to the gravity of that risk.¹⁵⁴ The possible homogeneity of risk profiles raised a general question about the necessity for exclusive rights, but at minimum it may have pointed to the need for an exemption mechanism. Despite that, the Court was not prepared to insist on such a requirement.¹⁵⁵ As a result, even the veneer of domestic supervision that was deemed adequate in *Albany* was found to have been permissibly jettisoned by the French authorities in *AG2R Prévoyance*.

A much stricter approach to proportionality review is apparent in the 2016 judgment of the Court in *ANODE* concerning regulation for certain providers

¹⁵⁰ 2012/C8/03, §57.

¹⁵¹ C-437/09 *AG2R Prévoyance* [2011] ECR I-973.

¹⁵² C-438/02 *Hanner* [2005] ECR I-4551, Opinion of 25 May 2004, §157.

¹⁵³ *AG2R Prévoyance* [2011] ECR I-973, §77.

¹⁵⁴ Again, the elementary issue of the homogeneity of risk profiles is not considered properly.

¹⁵⁵ §§75–81.

of gas tariffs to consumers and SMEs in France. The Court indicated that under Directive 2009/73, any measures departing from tariffs set on a free market basis had to be proportionate and verifiable, while also respecting the principle of equal access to consumers for competing undertakings. By way of introduction to its proportionality review, the Court, in reality dealing with what would be necessity review under Article 106(2), undermined fatally the claim that the intervention could in any way be said to be necessary to ensure security of supply, there being no link back to the long-term contracting that was said to characterise underlying supply arrangements. With respect to territorial cohesion, which was also relied upon, the Court was less scathing but still clearly sceptical. In particular it emphasised that the national court would have to investigate whether the measure was appropriate, such, for example as price intervention with respect to ‘customers in remote areas identified according to objective social criteria’.¹⁵⁶ Equally, the Court was concerned about the open-ended nature of the intervention and about the apparently discriminatory nature of the measure. Overall, and although commendable, the result is probably more attributable to the specificity of the Directive in aid of disapplication review.

(c) *Efficiency*

Efficiency under Article 106(2) so as to Avoid State Aid Control

It is perhaps efficiency, and in particular the issue of productive efficiency, that has witnessed the greatest change in the period since *Altmark*. That has come about gradually, with a general ratcheting up of pressure on the Member States to move towards tendering and to impose safeguards against inefficiency.¹⁵⁷ The 2005 SGEI Decision began that process tentatively by noting that in the context of determining a reasonable profit, the Member States were free to introduce incentives in relation to quality and productive efficiency.¹⁵⁸ That approach is carried forward into the 2012 SGEI Decision, although the Commission is more prescriptive and requires that there must be ‘balanced sharing’ with respect to productive efficiency incentives where they are introduced.¹⁵⁹ It also clarifies that gains in productive efficiency should not lead to deterioration in the quality of output.¹⁶⁰

Efficiency under Article 106(2) for State Aid Compatibility

The 2005 SGEI Framework replicates the 2005 SGEI Decision by including the same provision with respect to the possible incentivisation of improvements in

¹⁵⁶ §59.

¹⁵⁷ Clearly, the desire is that Member States will resort to tendering.

¹⁵⁸ Art 4 of Commission Decision 2005/842/EC.

¹⁵⁹ Art 5(6) of Commission Decision 2012/21/EU.

¹⁶⁰ *ibid*, recital 22. Obviously this then requires much greater surveillance of the nature of output by the SGEI provider.

productive efficiency. In the 2011 SGEI Framework the Commission tightens the position in relation to efficiency. It unveiled an important new requirement by obliging the Member States to ‘introduce incentives for the efficient provision of SGEIs of a high standard, unless they can duly justify that it is not feasible or appropriate to do so’.¹⁶¹ Understandably, Member States are allowed a broad discretion, with the Commission citing non-limiting examples, subject to a requirement of independent verification.¹⁶² Furthermore, the link to quality, and in turn the need for adequate specificity through entrustment, is emphasised.¹⁶³ Separately, over-compensation is only permitted with respect to performance in excess of expected efficiency gains.¹⁶⁴

The Residual Position on Efficiency under Article 106(2)

In the aftermath of *Altmark*, litigation before the General Court, in particular, has confirmed the general permissibility of a much less exacting approach to efficiency in line with the approach in *FFSA* in the second phase. In *M6 and TF1*, the principle that compensation should not exceed the net costs of service provision under Article 106(2) was endorsed, with the Court also confirming that the issue of whether it could be performed at lower cost was in principle irrelevant.¹⁶⁵ According to the General Court the more general issue of the provider’s efficiency was of no consequence for the purposes of Article 106(2) in the absence of EU rules.¹⁶⁶ While the result might in part be explained as driven by the subject matter, namely PSB, the principle was also applied by the General Court in its 2012 judgment in *Brussels Hospitals*.¹⁶⁷ In that case, the Court acknowledged that it had been confronted by a ‘theoretical’ argument to the effect that bad administration should not be compensated through State aid, which the applicant had described as a ‘black hole view’.¹⁶⁸ The General Court did not engage with this objection except to repeat the position established in *M6 and TF1*, and by asserting that in line with *FFSA*, the choices made by the Member State with regard to the efficiency of the SGEI provider could not be second-guessed.¹⁶⁹ This may assume a degree of informed planning on the part of the Member States that does not exist in practice. Finally, the third phase shows signs that the manifest failure to meet demand

¹⁶¹ 2012/C8/03, §39.

¹⁶² *ibid.*, §42.

¹⁶³ *ibid.*, §§42, 43.

¹⁶⁴ *ibid.*, §47.

¹⁶⁵ T-568/08 *M6 v Commission*, T-573/08 *TF1 v Commission*.

¹⁶⁶ *ibid.*, §§139–40.

¹⁶⁷ T-137/10 *Brussels Hospitals* ECLI:EU:T:2012:584, §298. The argument appears to have been far from theoretical. As Hancher and Sauter point out, the possibility of comparing cost information between public and private hospitals was at least viable, considering the commonality of many regulatory obligations. See Hancher, L and Sauter, W, ‘This Won’t Hurt a Bit: the Commission’s Approach to Services of General Economic Interest and State Aid to Hospitals’ (2012) *TILEC Discussion Paper* 012, 20.

¹⁶⁸ T-137/10 *CBI*, §298.

¹⁶⁹ *ibid.*, §300. The Court states that this was the position ‘as EU law now stands’.

doctrine still exists. It is referred to by the Court of Justice in its judgment in *AG2R Prévoyance* where it mentions lack of evidence of the relevant fund not meeting the requirements of customers.¹⁷⁰ The manifest failure to meet demand doctrine was also directly relied upon by the Commission in its condemnation under Article 106(1) in conjunction with Article 102 of the conferral of exclusive rights over hybrid mail (and an associated failure to meet demand for a derivative service) on the Slovakian postal incumbent.¹⁷¹

E. Conclusions

In this chapter I have set out the extent of government failure tolerated in disapplication review under Article 106(2). The underlying argument is that with greater laxity in its enforcement, the extent to which government failure is tolerated increases. The division of the analysis into three phases demonstrates the variability of the position across those periods. The first phase was characterised by a strong underpinning presumption with respect to the efficacy of markets and the desirability of their integration. As illustrated by *Ahmed Saeed*, that in turn led to a pronounced disinclination to displace the competition rules. Although government failure may not have been a prominent or conscious concern, its prevention and mitigation was the inevitable result. Simplifying matters, the critical conflict that Article 106(2) was intended to address never reached a resolution point in the first phase. Without suggesting a reverse of the adage that hard cases make bad law, it is clear that in many of the first-phase cases the strict exception approach came at a relatively low political price to the Court.¹⁷²

Although the EU Courts continue to refer to Article 106(2) as a ‘strict exception’, that ceased to be the reality as soon as the liberalisation of network industries began.¹⁷³ From the handing down of the judgment in *Corbeau*, Article 106(2) was characterised by progressive laxity, with a corresponding rise in the incidence of government failure. Although several sectors were the subject of extensive regulation in that period, the general approach under Article 106(2) was one of considerable indulgence for SGEI providers. The judgment in *Corbeau* unnecessarily introduced the amorphous ‘equilibrium’ formula, taking the focus off what was necessary to guarantee SGEI provision as an objective and distinct task.

¹⁷⁰ C-437/09 *AG2R Prévoyance* [2011] ECR I-973, §72. The Court’s reliance on this point comes just before its consideration of the SGEI issue.

¹⁷¹ See Commission Decision C(2008) 5912 final of 7 October 2008, *Slovakian Hybrid Mail*, which was rejected in T-556/08 *Slovenaká Pôsta a.s v Commission* ECLI:EU:T:2015:189.

¹⁷² ‘Great cases like hard cases make bad law’, *Northern Securities Co. v United States*, 193 US 197, 400 (1904), Justice Holmes dissenting.

¹⁷³ Buendía Sierra observes that as an exception Art 106(2) is ‘in theory’ to be interpreted strictly. Buendía Sierra (n 37) 855.

That was a crucial failure from a government failure perspective. Separately, the judgments in *Deutsche Post* and *TNT Traco* meant that the position in *Ahmed Saeed* on transparency and proof was effectively reversed. Necessity review was attenuated and proportionality obscured by the emergence of ongoing uncertainty as to the applicable standard. The second phase also saw an unqualified retreat by the Court on efficiency. During that period, the Commission had further recourse to its Article 106(3) powers but its generic interventions remained timid and served as a limited corrective to the change of direction led by the Court of Justice. Article 106(2) ceased to be a significant constraint on government failure for SGEIs.

The third phase of the analysis is focused on the post-*Altmark* environment for the operation of Article 106(2). This comprises a picture of considerable complexity and change brought about mainly by legislative intervention and soft-law guidance. The approach of the Commission reflected in the Almunia Package raises several difficulties. The first concerns those areas where Article 106(2) is implicated but which do not involve public service compensation, whether classified as State aid or not. It would appear that they continue to be governed by a permissive derogation version of Article 106(2). The difference between this and the 2011 Framework is not just significant, arguably it is unsustainable. To take one example, the received interpretation of *FFSA* prevents any assessment of efficiency, even by the Commission, which is completely at variance with the multifaceted intervention and prescriptiveness introduced by the 2011 SGEI Framework on this issue. Moreover, the justification for this differential treatment is not apparent either for this or any other of the elements of disapplication review considered in this chapter. This hardly assists with the overall clarity of Article 106(2) or, for that matter, overcoming its contingency. The possible resolution of this profound anomaly raises difficult legal, political and institutional challenges that I consider in the next chapter.