

**COMMISSION DECISION****of 8 April 2009****on the measures C 7/07 (ex NN 82/06 and NN 83/06) implemented by the United Kingdom in favour of Royal Mail***(Notified under document C(2009) 2486)***(Only the English text is authentic)****(Text with EEA relevance)***(2009/613/EC)*

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provision(s) cited above <sup>(1)</sup> and having regard to their comments,

Whereas:

**1. PROCEDURE**

- (1) On 3 December 2002, Deutsche Post AG (hereinafter 'DP') lodged a complaint against alleged cross-subsidies granted to the parcel activities of Royal Mail Group plc ('Royal Mail' or 'RM').
- (2) In response to Commission requests for information, the United Kingdom of Great Britain and Northern Ireland ('UK') authorities provided information relevant to the matters raised in the complaint by letters of 25 February 2003 and 13 February 2004, and by email dated 17 December 2003. This information included other Government measures in relation to RM.
- (3) On 27 May 2003, the Commission approved a series of measures in favour of Post Office Limited ('POL') which is a subsidiary of RM (case N 784/02) <sup>(2)</sup>. Under these measures, compensation was granted to POL, financed through a reserve ('the mails reserve') constituted from surplus cash generated by RM. On 22 February 2006 the Commission raised no objection to the continuation of one of these measures (rural network support) for a further period (case N 166/05) <sup>(3)</sup>.
- (4) On 8 October 2003, DP lodged an action for annulment (T-343/03) against the N 784/02 Commission Decision, arguing that this decision had implicitly rejected its CP 206/02 complaint. On 16 November 2005, the Court of First Instance rejected the action of DP saying that the N 784/02 Decision did not imply the rejection of the complaint and that the Commission was carrying on

investigations (as demonstrated by the correspondence presented before the Court).

- (5) On 10 August 2006, DP sent a letter which invited the Commission to take a position on its complaint of 2002 within the period of two months, on the basis of Article 232 of the Treaty. The same letter contained information concerning a series of alleged new State aid measures. These measures are distinct from those which were the subject of the complaint of 2002 and the complaint against them was therefore treated as a separate complaint which was attributed the reference CP 221/06, subsequently NN 83/06. The alleged measures were as follows:
  - (a) a transfer of GBP 850 million to a special account dedicated to finance RM's pensions;
  - (b) decision by Department of Trade and Industry to increase the amount of a loan granted to RM from GBP 844 million to GBP 900 million;
  - (c) violation of the Commission's decision in case N 166/05 concerning support for POL's rural network, since GBP 150 million was transferred to POL directly from the State budget and not, as approved by the Decision, from a special, ring-fenced reserve.
- (6) In response to Commission requests for information, the UK authorities provided information relevant to the matters raised in the two complaints by letters of 6 October and 31 October 2006. By letter of 5 December 2006, they supplemented this information with respect to the measures in favour of POL mentioned at recital 3.
- (7) By letter of 27 October 2006, the Mail Competition Forum (MCF), a body representing entrants to the postal market in the UK, submitted a complaint about the special account dedicated to finance RM's pensions also covered by DP's second complaint. The complaint of MCF was attributed the reference CP 164/06, subsequently NN 82/06. A non-confidential version of the complaint was sent to the UK authorities on 20 November 2006. The UK authorities provided comments on the complaint by letter of 19 December 2006.
- (8) By letter of 7 December 2006, the Commission informed DP that it did not find sufficient grounds for continuing the investigation concerning complaint CP 206/02, and that if it did not hear from DP within 20 working days, the complaint would be considered withdrawn. No response was received within the deadline. That complaint was therefore considered withdrawn.

<sup>(1)</sup> OJ C 91, 26.4.2007, p. 34.

<sup>(2)</sup> OJ C 269, 8.11.2003, p. 23.

<sup>(3)</sup> OJ C 141, 16.6.2006, p. 2.

- (9) On 7 December 2006, the UK notified the proposed extension of another of the measures in favour of POL (debt payment funding) covered by N 784/02 which was otherwise due to expire in 2007. The Commission authorised this aid under reference N 822/06 by decision of 7 March 2007 <sup>(4)</sup>.
- (10) On 8 February 2007, the UK communicated to the Commission the terms of an announcement concerning 'the pensions measure', the GBP 900 million loan facility and also a new loan of GBP 300 million to Royal Mail.
- (11) On 21 February 2007, the Commission opened an investigation procedure on the following measures:
- (a) a GBP 500 million loan granted in 2001, repayable after 2021 and granted at a fixed interest rate, which financed Royal Mail's overseas acquisitions;
  - (b) GBP 1 billion of loan facilities made available to Royal Mail from State sources in 2003, of which GBP 900 million was to be extended after 2007;
  - (c) 'The pensions measure': placing GBP 850 million in an 'escrow account' which will lengthen the period over which Royal Mail needs to address the current deficit in its pension fund and will therefore reduce the contributions it makes in the initial years of the period;
  - (d) the loan of GBP 300 million announced on 8 February 2007.
- (12) The decision of 21 February confirmed the withdrawal of complaint CP 206/02 and confirmed that the Commission raised no objection to the funding of the authorised measures for POL from the State budget rather than from the mails reserve.
- (13) By letter dated 22 February 2007, the Commission notified the United Kingdom of its decision to initiate the procedure laid down in Article 88(2) of the Treaty in respect of the measures listed in recital 11.
- (14) The Commission's decision to initiate the procedure was published in the *Official Journal of the European Union* <sup>(5)</sup>. The Commission invited interested parties to submit their comments on the measures.

## 2. DESCRIPTION OF THE MEASURES

### 2.1. The beneficiary of the alleged State aid

- (15) The beneficiary of the alleged State aid is Royal Mail Group plc, subsequently Royal Mail Group Ltd ('RM') which (through a holding company, Royal Mail Holdings plc) is a 100 % State-owned company. RM is the UK's main postal operator and had a legal monopoly over most basic letter services until the end of 2005. The post office network is operated by POL, which is a subsidiary of RM.
- (16) Before 2001, postal activities in the UK were carried out by The Post Office Corporation, a statutory body created by the Post Office Act 1969. The assets and liabilities of The Post Office Corporation were transferred to Consignia Holdings (now renamed Royal Mail Holdings plc) and to its subsidiary, Consignia plc (now RM) on 26 March 2001, under the terms of the Postal Services Act 2000.
- (17) RM has a separate parcels business division, Parcelforce, which was cited as the beneficiary in DP's complaint of 2002. Parcelforce has its own separate hub and spoke infrastructure. In 2003, a part of the parcels activity (including the provision of a universal service for parcels handed in at post offices) was transferred from Parcelforce to the letters division of RM and is now operated through that infrastructure. Today, Parcelforce only handles time-critical parcels.

### 2.2. Financial regime of the beneficiary and relationship with the State

- (18) Under the regime in existence before the incorporation and transfers of 2001, there was no requirement for The Post Office Corporation to pay any dividends to the UK authorities and it did not do so. It was, however, obliged to invest a proportion of the profits it generated each year in Government securities or National Loan Fund deposits. These investments, classed as current assets and often referred to as the 'gilts', remained with RM following the 2001 transfers and amounted to GBP 1 800 million on 31 March 2002. Following directions by the UK authorities on 30 January 2003 under section 72 of the Post Office Act 2000, RM placed these assets in a special reserve ('the mails reserve') to be used to finance specific measures as directed.

### 2.3. The measures concerned by the investigation procedure

#### 2.3.1. The 2001 loan

- (19) In February 2001, the UK authorities made a loan of GBP 500 million to RM to finance overseas acquisitions for the mail and parcels business. The loan is repayable

<sup>(4)</sup> OJ C 80, 13.4.2007 p. 5.

<sup>(5)</sup> See footnote 1.

between 2021 and 2025 and carries an average interest rate of around 5,8 %. The UK authorities have stated in correspondence with the Commission that this loan was on commercial terms, and that they followed advice from consultants designed to ensure that this was the case. The loan was secured on RM's shareholding in General Logistics Systems International Holdings BV and certain other RM assets. The loan was not notified to the Commission.

### 2.3.2. *The loan facilities*

- (20) In 2003, the UK authorities made various loan facilities available to RM to finance its 'renewal plan' (including the restructuring of Parcelforce). These facilities, described by the UK authorities as a commercial package were negotiated between RM and the UK authorities and consisted of a loan facility of GBP 544 million from the National Loans Fund ('NLF') secured on RM's accumulated cash balances (in particular the funds allocated to the mails reserve) and the acquisition by the authorities of two bonds issued by RM (one of GBP 300 million and one of GBP 200 million). Again, the UK authorities have stated in correspondence with the Commission that these loan facilities were on commercial terms, and that they followed advice from consultants designed to ensure that this was the case. They also informed the Commission that as of October 2006 these loan facilities had not been drawn down, apart from a GBP 50 million testing of the draw down process which was repaid in 7 days, and that the GBP 200 million facility had by then expired. Commitment fees of some GBP 2,5 million had nonetheless been paid by RM. These loan facilities were not notified to the Commission.

- (21) In May 2006, the UK authorities announced their intention to extend the remaining loan facilities and to increase their level from GBP 844 million to GBP 900 million. The UK authorities indicated on 31 October 2006 that the precise terms of this extension were still being finalised but the intention was that it would be on commercial terms and that the lending would not constitute State aid.

### 2.3.3. *The pensions escrow account*

- (22) In 2006, the UK authorities decided to release GBP 850 million of the cash balance remaining in the mails reserve within RM to set up an 'escrow account', which could be drawn on by the Royal Mail Pension Plan ('RMPP') in certain circumstances if RM were to fail as a business. The background to this measure was that the

various RM pension schemes, of which the RMPP is by far the largest, showed a total deficit (excess of projected liabilities over assets, on certain prudential assumptions) of GBP 5 600 million in its 2005/2006 accounts, where for the first time this deficit was included in RM's balance sheet. The RMPP, like other UK occupational pension schemes, is a funded scheme which is required to hold assets in respect of its liabilities. According to the UK authorities, RM would not be able to pay off this deficit quickly and modernise the business at the same time, given projected cash flows. The account therefore allows RM to agree with the trustees of the RMPP a longer period for addressing the deficit thereby reducing its pension contributions in the initial years. The UK authorities have stated that they believe the use of the mails reserve for this purpose is in RM's best commercial interests, and that by enabling RM to complete its strategic plan they will bring about an increase in the value of the UK authorities' shareholding. Without the escrow account and the extended loan facilities, the UK authorities claim there is a possibility that shareholder value would be destroyed and not enhanced, and that they are therefore acting in a commercial manner.

### 2.3.4. *The new GBP 300 million shareholder loan*

- (23) On 8 February 2007, the UK authorities announced their agreement to provide RM with a GBP 300 million shareholder loan. This loan was not notified to the Commission. It was clear from the terms of the announcement that this loan is part of a package of measures with the pensions escrow account and loan facility.

## 2.4. **Grounds for initiating the procedure**

- (24) In its decision opening the investigation procedure, the Commission expressed doubts over the claims by the UK authorities that the measures did not constitute State aid because they were provided on commercial terms and therefore provided no advantage to Royal Mail. The letters and parcels delivery business is international and the Commission believes that a selective advantage in favour of RM or Parcelforce would distort competition and affect trade between Member States. The measures were all granted from funds under the direct control of the State and therefore constituted State resources within the meaning of Article 87(1) of the Treaty. The measures were all imputable to the State and were selective in that they were granted only to RM. If they provided an advantage to Royal Mail they would therefore fulfil the

criteria to be considered State aid. The Commission assessed the question of advantage in respect of the measures on which it opened the procedure.

#### 2.4.1. *The 2001 loan*

- (25) As noted in recital 19, the 2001 loan is repayable between 2021 and 2025 and carries an average interest rate of around 5,8 %. This is significantly below the reference rate applicable to the UK in 2001 (7,06 %), when the UK previously informed the Commission that the loan was granted. The UK authorities provided certain evidence that at that time, the yield curve in the UK was downward sloping and that therefore the interest rates for such a long-term loan could be below the reference rate (which at the time was based on five year rates) without contravening the market economy investor principle. However, this evidence also appeared to indicate that part of the loan was granted in 1999 and 2000. Not only did this contradict earlier information, but it involved a period when the reference rate was even higher (7,64 % in 2000). The Commission also noted that, at least in 2001, Royal Mail's financial performance was beginning to decline. This would normally be reflected in the terms of any loan. For this reason, when assessing a loan to a company in financial difficulties, the Commission may use a rate higher than the reference rate as a point of comparison.

#### 2.4.2. *The loan facilities*

- (26) The UK authorities had informed the Commission that as of October 2006 the loan facilities granted in 2003 had not been drawn down. However, it could not be concluded from this point alone that the loan facilities provided no advantage, since the availability of the loan facilities had an 'option value' to the company. It could not have been known in 2003 that they would not be drawn down. The terms of the loan facilities therefore need to be assessed in the same way as the 2001 loan. It can be noted that these loan facilities were linked to RM's renewal plan.
- (27) The GBP 544 million NLF loan was granted at '25 basis points above LIBOR or relevant gilt' <sup>(6)</sup>. It should be noted that the reference rate is set at 75 points above an interbank swap rate. The UK authorities justified the low margin by reference to the security provided, namely the cash reserves of RM. However, the Commission noted that these reserves constitute State resources over which the UK authorities had control through specific

legislation. The Commission therefore questioned whether their use as security could necessarily dispel its doubts as to the aid character of the measure. It noted that if the loan had been drawn down, a saving of 50 basis points would outweigh the value of the commitment fees which have been paid by RM.

- (28) The bonds of GBP 300 million and of GBP 200 million were issued at rates of 50 and 200 basis points above the 'relevant gilt'. The larger bond was secured by a floating charge over all assets of RM while the smaller one had lower security. The margin of 50 basis points above a rate based on Government securities (which are typically below interbank rates) implies the GBP 300 million loan may have been at a rate below the Commission's reference rate.
- (29) The UK authorities informed the Commission on 31 October 2006 that the terms on which the 2003 loan facilities, still in existence in October 2006 (namely the GBP 544 million National Loan Fund loan and the GBP 300 million bond), were to be extended were still being negotiated but that they were seeking advice from consultants to ensure that the terms were commercial.

#### 2.4.3. *The pensions escrow account*

- (30) According to information provided by the UK authorities, one effect of the escrow account was to reduce the pensions contributions that RM has to make to the RMPP in order to address its deficit in the initial years. The Commission noted that this was an indication that the measure may provide an advantage to RM and therefore constitute State aid. The Commission had doubts about the argument that the measure can be justified as the intervention of a market economy investor, which had not been supported by projections or by financial analysis.
- (31) The Commission identified three issues it would be considering. Given that the reserve funds within the reserve were already held within Royal Mail and on its balance sheet, one issue was whether the creation of the escrow account could be regarded as a commercial decision by RM in spite of the involvement of the UK authorities, which arose through the particular applicable legal regime. A second issue, given the particular powers taken by the UK authorities over these reserves, was whether a shareholder acting commercially would agree

<sup>(6)</sup> Letter from UK authorities dated 31 October 2006. A gilt is a UK Government security.



to this use of shareholders' equity. A third issue, given that the use of the reserves for the pensions measure requires the authorities to fund the POL measures from the State budget, was whether a shareholder would agree to bring new equity to fund an escrow account of this type.

#### 2.4.4. *The new GBP 300 million shareholder loan*

- (32) The terms of the loan had not been communicated to the Commission at the time of opening the investigation. The Commission was therefore unable to assess whether its terms included aid. Given the fact that the loan was part of package of measures where the Commission had not allayed its doubts that State aid may be involved, the terms of the loan could not, in any case, be assessed independently.

#### 2.4.5. *Compatibility of any State aid*

- (33) The Commission further expressed doubts whether, if they did constitute State aid, the measures could be found compatible with the common market. It noted that the legal basis of Article 86(2) of the Treaty did not seem to be available even though RM is entrusted with services of general economic interest. The loan and loan facilities had been explicitly linked by the UK authorities to other projects than the provision of such services, namely the overseas acquisitions of RM and the renewal plan adopted in 2003. The pensions escrow account had similarly not been linked to any service of general economic interest performed by RM.
- (34) The only basis for compatibility for these measures, if they contain State aid, appeared to be Article 87(3)(c) of the Treaty. However, the measures did not appear to conform with any of the rules concerning the application of that subparagraph that the Commission had promulgated to date. If State aid were involved, the Commission therefore doubted whether these measures would be compatible with the common market.

### 3. COMMENTS FROM INTERESTED PARTIES

#### 3.1. **Deutsche Post**

- (35) Deutsche Post commented that the investigation covered only part of the aid granted to Royal Mail in recent years. The Commission had approved a whole series of UK aid measures resulting in Royal Mail being the largest aid recipient in the postal sector (after Poste Italiane) in recent years. DPAG pointed out that, despite all these measures, Royal Mail's liberalised parcel delivery service provider, Parcelforce, was for many years heavily loss-making. Since Royal Mail had at the same time not earned sufficient revenue from its other businesses to offset these losses, they must necessarily be covered out

of State resources. According to the Commission's decision of 19 June 2002 (case C 61/99, Deutsche Post AG (7)), such loss of compensation constitutes State aid incompatible with the common market. DPAG regretted that the Commission had not taken this fact, which DPAG already highlighted in its complaint of 3 December 2002, into account in these proceedings.

- (36) In respect of the 2001 loan, DP observed that in January 1999 Royal Mail acquired the German parcel service provider German Parcel GmbH ('German Parcel') for EUR 424 million. In the autumn of 1999 German Parcel GmbH became part of newly founded General Logistics System ('GLS'). GLS went on to make numerous purchases in the European market. During the period 2000-2003, Royal Mail generated hardly any profits from which to finance these acquisitions. If the loan financing these purchases was granted on terms which at that time were unobtainable on the market, then unlawful State aid would be involved which would have to be repaid.
- (37) In respect of the loan facilities, DPAG considered it hard to see why Royal Mail did not finance the renewal of its postal infrastructure out of its recent years' revenues (according to its own figures, in the 2005/2006 financial year Royal Mail booked an operating profit of GBP 355 million). The regulator Postcomm had already taken the company's universal service obligations extensively into account in its rate approvals. It was therefore to be feared that the overall effect of the many support measures in the form of direct State payments, loans and approved pricing measures would be to overcompensate for the universal service costs in a way that is inadmissible under State aid rules. This could appreciably affect competition in the letter, parcel and express courier market in the UK, where DPAG achieved a turnover in excess of EUR 1 000 million in 2006.
- (38) DPAG urged the Commission to subject the aid measures listed in the decision opening proceedings to a critical examination against the background of the numerous State support measures already approved for Royal Mail in particular.

#### 3.2. **TNT Post UK Limited**

- (39) In a first response to the opening of procedure, TNT Post UK Ltd ('TNT') fully supported the investigation as a Member of the Mail Competition Forum which had submitted a complaint on the pensions measure. As

(7) OJ L 247, 14.9.2002, p. 27.

a market entrant, it was directly affected by any form of financing made on anything other than arms' length, commercial terms. Such financing would mean that Royal Mail is in a position to keep its prices artificially low, thus reducing TNT's ability to compete.

significantly for longer maturities. Based on the information available, they would conclude that a commercial party would not have entered into the GBP 500 million of loans with Royal Mail on the conditions published. In fact, a loan granted on arm's length market terms would have yielded a substantially higher interest rate.

- (40) TNT noted from the Royal Mail Group Limited (formerly plc) interim accounts that 'Royal Mail Group plc is in default of its borrowing facilities with Government, but has received formal waivers from the Department of Trade and Industry, in its capacity as lender'. TNT claimed that, given these conditions, no commercial lender would be willing to lend further amounts unless the terms adequately reflected the increased risk of non-payment of interest or non-repayment of capital. TNT further noted that, in a Royal Mail document dated March 2007, entitled 'Royal Mail's position on the interim review', Royal Mail confirmed that re-financing was inter-dependent with settling price control and funding the pension deficit over 17 years. TNT understood this to be an unduly long period and, if the financing were shown to be on non-commercial investor or lender terms then it would indicate this recovery period to be too long. Consequently, the price control caps set by the postal regulator Postcomm would have been set at too low a level. As a competitor, TNT said it was directly impacted by price caps on business mail which were set at a level assuming government financing and an unduly long recovery period for the pension fund deficit.
- (41) TNT made a further submission which arrived well after the official deadline for comments but which the Commission has nonetheless taken into account. TNT had undertaken analysis of the two sources of government funding made available to Royal Mail, namely (i) loan financing and (ii) the release of government controlled reserves to an escrow account accessible by the Royal Mail pension fund trustees. TNT's conclusion was that both sources of funding would not have been made by a commercial investor.
- (42) Concerning the 2001 loans, these were granted as unsecured loans in February 2001 with a duration close to, on average, 21 years and a fixed interest rate of, on average, 5,84 %. In the month of issuance of the loans, the 20-year swap rate (versus GBP-LIBOR) ranged between 5,87 % and 6,12 %. From this, it could be derived that the State loans must have been concluded at a discount from the prevailing inter-bank rates while under normal circumstances corporate unsecured debt pays a credit spread above the inter-bank rates. That this also holds for Royal Mail is proven by the credit spread of 0,25 % above LIBOR that commercial banks charged to Royal Mail for the loans with a much shorter duration. TNT also noted that credit spreads increase significantly for longer maturities. Based on the information available, they would conclude that a commercial party would not have entered into the GBP 500 million of loans with Royal Mail on the conditions published. In fact, a loan granted on arm's length market terms would have yielded a substantially higher interest rate.
- (43) With regard to the bonds issued in 2003 (that is, the loan facilities), TNT viewed the situation somewhat differently since it appeared that the bonds were secured by assets of Royal Mail. Depending on the strength of such assets (which, based on the information available, seemed to be rather strong) the spread over LIBOR would be expected to be reduced. Only the amount of such reduction would be questionable but since it was not clear to TNT what rate Royal Mail was actually paying, it was difficult to determine whether from a commercial perspective this can be justified by both Royal Mail and the UK Government.
- (44) With regard to the loans issued in 2007, TNT noted that it was not possible to determine the commerciality of the terms because they were not public knowledge and, also, because the lending was apparently connected to the escrow account and existing loan facility. However, waiving default clauses under existing facilities (as was confirmed by the Royal Mail half-year regulatory accounts<sup>(8)</sup>), at note 3 on page 18 'Royal Mail Group plc has net liabilities as at 24 September 2006, primarily as a result of the pension deficit within its main pension plan, the Royal Mail Pension Plan. Consequently, Royal Mail is in breach of its borrowing facilities with Government, but has received formal waivers from the Department of Trade and Industry, in its capacity as lender') and granting additional loan finance was something a commercial party would not under normal circumstances do.
- (45) With respect to the pensions measure, TNT questioned whether, at the incorporation of Royal Mail in March 2001, the transfer of the non-business assets and related equity known as the 'mails reserves' was commercial. According to TNT, a commercial shareholder would very probably not have established a company which included a loan asset (where the debtor was the shareholder) and then provide a similar contribution in equity. TNT commented that when Netherlands operator KPN was 'privatised' in 1989, a similar arrangement had been in place but KPN's opening balance sheet in 1989 as a Dutch NV did not contain either the associated assets or reserves.

<sup>(8)</sup> Royal Mail Holdings plc, Unaudited Interim Report for the half year ended 24 September 2006.

(46) According to TNT, the transfer into the escrow account by the UK authorities acts as a guarantee towards the pension trust, of which the benefit to Royal Mail would be that it is able to recover the deficit over a longer funding period and to use their own funds to strengthen their business. If Royal Mail had had to fund the deficit at once, depending on whether the pension liability in the balance sheet would already have reflected such deficit, they would have been confronted with a substantial loss and reduction of equity and, perhaps more importantly, a reduction of funds. In normal market conditions, if a company needs funds, it can borrow from the debt market or raise additional capital in the equity markets. In Royal Mail's case, it appeared there was third possibility, namely, agreeing to a more lenient price cap in its price control with the regulator. Prices could increase by a substantial level without reaching abusively high levels. As Royal Mail's consent was required to give effect to the price control, this was a matter within the power of Royal Mail and an option which was known to its shareholder.

(47) TNT commented that to raise money in the debt market, a borrower needs a convincing argument that it is able to repay the debt from future cash flows. To raise money in the equity market, a company needs an even more convincing argument that it will generate a significant return for the shareholder over the invested total capital contribution. As the sole shareholder of Royal Mail, the UK Government should have undertaken all necessary investigations to satisfy itself that Royal Mail would be in better financial condition if it were allowed to complete its strategic plan. The critical issue was whether making further investment by releasing funds from reserves would make commercial sense or be tantamount to putting 'good money after bad'. A very clear analysis on the return to be derived from the additional investment would be paramount to any such decision. In the absence of compelling evidence to demonstrate that the re-structuring plan — enabled by the release of funds from the reserves — would derive a commercial return on this investment for the shareholder, TNT believed that the decision would have been taken on non-commercial terms.

#### 4. COMMENTS FROM THE UNITED KINGDOM

##### 4.1. The 2001 loan

(48) In respect of the 2001 loan, the UK clarified that the origins of the loan were in 1999 when the Government endorsed Royal Mail's strategy to make certain acquisitions in order to help the competitiveness of Royal Mail's core business. In agreeing to this strategy, the authorities in particular took into account the forecast return expected as Royal Mail worked towards achieving its strategic objective. By the fifth year of its overall acquisition strategy, Royal Mail was forecasting growth in turnover of 40 % and 210 % increase in

profits. In discussions about the acquisition funding, and in particular the acquisition of German Parcel which represented Royal Mail's first major overseas acquisition, the UK authorities indicated that they wished Royal Mail to finance this transaction (and future transactions) by a loan from the Government's NLF at commercial rates. This reflected the Government's intention to impose commercial disciplines on Royal Mail and also to ensure that it competed fairly with other postal operators in the postal sector as the market was gradually opened to competition.

(49) Because the NLF was not in a position to provide the loans in 1999, the UK Government agreed that Royal Mail would fund the transactions temporarily through the use of the cash reserves on its balance sheet, following UK policy that publicly owned bodies should generally not borrow from private capital markets. The interest on the NLF loan would be applied from the dates <sup>(9)</sup> Royal Mail drew down from its cash reserves as if the loan had been in place from that point (as originally intended) to leave the company neutral to the interim financing arrangement. The UK provided the Commission with the letter dated 12 January 1999 by which the UK authorities gave Royal Mail their approval of the German Parcel acquisition, which specified how the financing would be provided.

(50) In order to consider whether the proposed acquisitions by Royal Mail were strategically and commercially sensible, the UK authorities enlisted the assistance of an external adviser for the German Parcel acquisition. For subsequent acquisitions which were also funded by the GBP 500 million loan and requiring the consent of the UK authorities, advice was sought from Deloitte & Touche LLP ('Deloitte'), who evaluated each acquisition on an individual basis, before the UK authorities permitted the acquisitions concerned to go ahead. Deloitte did not advise against any of the acquisitions.

(51) Deloitte was also retained to help determine commercial interest rates on advances from the NLF to Royal Mail and in particular on the credit rating for Royal Mail based on assessing its creditworthiness as a standalone business, independent of Government ownership. Deloitte assessed RM's credit risk as a function of business and financial risks, and using comparators and financial ratios, determined a credit rating of between AA and AA-. Deloitte further recommended that the rate of interest charged to Royal Mail be determined by reference to rates for comparably rated issuers based on a screen

<sup>(9)</sup> The '2001 loan' consists in fact of 20 loans of GBP 25 million each, for which the interest rate is determined according to the date in 1999-2000 of the corresponding drawing on the cash reserves. These individual loans are referred as 'tranches' of the 2001 loan in this decision.

pricing 'index' of spreads for the given credit rating against benchmark Government bonds. On this basis the relevant spread charged to Royal Mail ranged between 76 and 165 basis points.

company's indebtedness, the security over the GLS shares given under the new facilities was also extended to cover the 2001 loan. At the same time, the loan was secured by a fixed and floating charge over certain of Royal Mail's assets.

(52) Royal Mail sought a long-term loan since, in order to implement its strategy, it intended to hold the businesses it acquired for the long term. Based on the commercial rates of interest available at the time (when long term interest rates were considerably lower than short term interest rates), Royal Mail requested loan durations of between 20 and 25 years, as appropriate, for the long-term acquisitions concerned, enabling GBP 100 million of the total amount lent to become repayable in each of the years 2021 to 2025, rather than Royal Mail being required to repay the entire GBP 500 million in one year. The loan tranches had differing maturities ranging between 20 to 25 years which was not unusual given the relative attractiveness of long term interest rates at that time. The loan rates were based on similarly unsecured reported 20 and 25 year maturity AA credit-rated debt and then annual rates were interpolated to derive an appropriate rate for the Royal Mail loan.

(53) The UK maintained that the Commission's reference interest rates were not a valid comparator for the rates on the 2001 loan, in particular because the Commission's rates are based on five year maturity dates and the loan in question consisted of long-term debt with a range of maturity dates between 20 and 25 years, because the loan advanced to Royal Mail reflected commercial rates available to similarly positioned long-term borrowers, and because the UK yield curve in 1999-2000 (the relevant period for calculating interest) was moving downwards making corporate borrowing cheaper.

(54) No security on the loan was deemed necessary or appropriate as the credit rating of Royal Mail was considered to be AA for debt facilities of up to GBP 1 000 million. The proposed loan would still keep Royal Mail's long-term debt within this level and would by itself comprise the substantial majority of Royal Mail debt with maturity of greater than one year. At the same time as negotiating the 2003 debt facilities, however, the UK authorities decided to restate the 2001 GBP 500 million loans in a similar form of document to the 2003 arrangements. This new document did not change the amount of the loans, the duration of the loans or the interest rates applicable but, given the overall increase in the

## 4.2. The loan facilities

### 4.2.1. The facilities granted in 2003

(55) The UK provided further details about the loan facilities made available in 2003. The terms required that the loans be backed by security over certain of the cash deposits held on Royal Mail's balance sheet and were therefore especially low risk debt justifying a margin of [...] (\*). In response to the Commission's observation that these cash deposits constituted State resources over which the UK authorities had control through specific legislation, whose use as security could therefore not necessarily dispel doubts as to the aid character of the measure, the UK authorities stated that they were seeking to achieve the use of the cash deposits and other assets of the company in a manner that would reflect commercial principles so that effective disciplines were placed on the company with regard to the facilities. The authorities directed Royal Mail, using the powers under section 72 of the Postal Services Act 2000, to credit its cash deposits with the NLF generated by the accumulated profits of the business (totalling some GBP 1 800 million) to a special reserve on the Royal Mail balance sheet (the Mails Reserve). A separate letter agreement allowed GBP 549 million of the reserve to be used as security for the GBP 544 million loan facilities with the NLF.

(56) In response to the Commission's questions concerning the commitment fee paid by Royal Mail for the NLF loan facilities, the UK clarified that the annual commitment fee in this case was [...] basis points of the loan value, that is, [...] % of the [...] basis point margin charged over LIBOR. They stated that the market convention is that commitment fees are generally 50 % or less of the margin over LIBOR, and adduced examples to illustrate this point. Relatively low margins — around 50 basis points or less — were common for senior debt in this period. Given the fact that the availability of the other facilities (the bonds) was conditional upon Parliament approving the supply of funds to the relevant Government department at such time as it required the funds to purchase the bonds to be issued by Royal Mail, a commitment fee for these other facilities was not appropriate since the facilities were never actually committed to Royal Mail. Market

(\*) Business secret.



practice, in a private lending context, is that a commitment fee be paid only once the lender has obtained all necessary internal approvals so that the money is formally committed to (and unconditionally available for) the borrower.

- (57) The UK also described the analysis of the proposed loan facilities which was undertaken before they were granted, including calculation of the Net Present Value ('NPV') of cash flow returns from the proposed refinancing as well as some alternative options. The proposed option was assessed to have a recovery of GBP [...] whereas the alternatives had recovery of GBP [...] at best. The UK further confirmed that the facilities granted in 2003 were not drawn on, other than a test drawdown repaid within a week, before they either came to an end or were restated in the facilities granted in 2007.

#### 4.2.2. *The facilities granted in 2007*

- (58) The UK explained that loan facilities granted in 2007 consisted of a GBP 900 million senior debt facility. It forms part of a financing package which includes the pensions measure and the GBP 300 million subordinated loan. The debt facilities are intended to finance the Royal Mail transformation and investment programme, including redundancy costs. The GBP 900 million senior loan replaces and extends the GBP 844 million loan facilities provided in 2003 and is structured in two tranches: the GBP [...] tranche which is permitted only to fund the transformation and GBP [...] which is for general working capital purposes within the business (excluding Post Office Limited). The measure became effective from 19 March 2007 and has a maturity term of [...] years from this date. It has a margin of [...] bps over relevant LIBOR<sup>(10)</sup> for the first [...] months. Thereafter, the margin depends on the level of fixed charge cover (profitability as multiple of interest payments), with a minimum of [...] bps. The GBP 900 million facility is secured against shares in a new subsidiary company which Royal Mail have established, Royal Mail Estates Limited, which holds virtually all of its property assets (excluding those relating to Post Office Limited), with a total market value estimated by Atis Real in September 2006 of GBP [...].

- (59) The UK described the measures taken to ensure that the requirements of the Market Economy Investor Principle (MEIP) were met, while noting that commerciality of the

2007 financing package needed to be assessed as a whole (see further in recitals 64 and 65). Both Credit Suisse and Deloitte had advised that the facility is on commercial terms and the interest payable is at market rates, including through a benchmarking with loans made in the market. Although that analysis suggested that the term of seven years is at the upper end of the market range, the arrangement fee, commitment fee, and the tests for draw-down and default all appear in line with market norms for loans secured on the basis of the Royal Mail loans (in this case predominantly on real estate). The security arrangements were different from market practice (charge over shares rather than property) but the UK considered that this was actually more advantageous from a lender's perspective for cost, timing and administrative reasons.

- (60) As regards the submission of TNT referring to the breach of RM's borrowing facilities with the Government, and receipt of formal waivers from the Department of Trade and Industry, the UK explained that the waiver was necessary because of a purely technical matter regarding the introduction of new accounting requirements for pensions (FRS17), and not as a result of any underlying deterioration of the commercial performance of the business. They also noted that the 2007 facilities were not 'additional' as suggested by TNT, but rather, replaced the 2003 facilities.

#### 4.3. *The pensions measure*

- (61) The UK clarified the mechanics of the establishment of the escrow arrangement, including the security given to the pension fund trustees over the amount. In the event the GBP 850 million escrow account was funded from the mails reserve for GBP 796 million and via a capital injection for the remaining GBP 54 million. Under the arrangements the Trustees are entitled to exercise the security over the escrow accounts upon the occurrence of certain limited events of default, principally relating to the relevant business (Royal Mail Holdings plc or Royal Mail Group Limited) going into insolvent liquidation or the security constituted by the escrow accounts becoming unenforceable. The security agreements also set out the circumstances in which funds in the accounts may be released from the security created by the security arrangements, which broadly will be once the pension fund reaches a 75 % solvency level. Once funds are released from the security created by the Royal Mail Holdings security agreement, the parties have acknowledged that the shareholder may decide that the GBP 850 million escrow funds (plus accrued interest) that are released from the security created by Royal Mail Holdings security agreement may be given

<sup>(10)</sup> [...].

to the shareholder using powers under the Postal Services Act 2000 or other applicable rights or powers.

- (62) The provision of the escrow account resulted in the agreement of the trustees to a period of 17 years for the recovery of the pension deficit. The UK authorities drew attention to statements by the pension fund regulator that recovery periods longer than 10 years would be subject to particular scrutiny, including whether trustees had made use of a 'contingent asset' (such as an escrow account) to reduce risks arising from the recovery plan. The UK disputed the Commission's suggestion that the escrow arrangement enables Royal Mail to reduce its pension contributions, arguing that the outcome in the absence of the escrow account would be subject to negotiation and could not be predicted. Failure to agree would have placed the availability of funds for business investment at risk.

#### 4.4. GBP 300 million shareholder loan

- (63) The UK confirmed that it was providing Royal Mail with a shareholder loan by way of a subordinated debt of GBP 300 million at an interest rate of [...] % with such interest rolled up until maturity of the loan. The facility was available for two years, with maturity being the later of the final repayment date of the senior debt facility [...], or the release of the pension escrow monies. The terms of the subordinated loan were negotiated as part of the total package as opposed to a stand-alone facility. The UK stated that the condition under which repayment could take place only after release of the pension escrow was a consequence of the subordinated nature of the loan. This was in turn reflected in the high interest rate which, in recognition of the business risks, was higher than the range put forward by the Government's advisors for the appropriate opportunity cost of equity. The arrangement had been confirmed by the Government's advisors to be 'fully commercial'.

#### 4.5. Market Economy Investor conformity of the 2007 package

- (64) The UK stated that the components of the 2007 financing package were negotiated as elements of an integrated whole and that their commerciality were not and should not be evaluated on a stand-alone basis, although their individual terms were benchmarked against commercial equivalents. The commercial nature of the package, and in particular of the escrow arrangement, were analysed by Deloitte and Credit Suisse and the Government relied on their advice.

- (65) Deloitte's approach was to consider the enterprise value of the business under the Strategic Plan assuming the escrow investment of GBP 1 billion is made. This enterprise value is estimated by discounting projected pre-financing cash flows at the weighted average cost of capital of the business. According to the UK, the escrow investment is appropriate for a rational existing commercial equity investor if:

- (a) it delivers a positive equity value to the investor (deducting the net financial debt, value of the pension deficit and the net cost of the escrow from the enterprise value); and
- (b) a higher value could not be achieved by not investing in the escrow accounts as proposed.

Deloitte also calculated an associated internal rate of return 'IRR', defined as the discount rate for future cash flows which reduced the equity value of the business to [...]. The analysis performed by Deloitte indicated a post-investment equity value of over GBP [...] and an internal rate of return ('IRR') of [...], and that these returns were robust to a range of sensitivity analyses. Two alternative scenarios without escrow investment were examined under which, according to Deloitte, the value of the shareholder's equity would potentially become significantly impaired. In contrast, with the proposed investment, the value of the investment was expected to be significantly enhanced over time.

#### 5. ASSESSMENT OF THE MEASURES: EXISTENCE OF STATE AID

- (66) As noted in the opening decision, the question of whether each of the measures under consideration constitutes State aid depends on the presence of an advantage to Royal Mail within the meaning of Article 87 of the Treaty, the other criteria for the existence of aid being clearly met. In order to determine whether the measure provided an advantage to RM, the Commission examines whether a private operator, acting in a market economy, would have been prepared to provide finance on the same terms.

##### 5.1. The 2001 loan

- (67) The clarifications provided by the United Kingdom authorities explain why the interest rate at which the loan tranches were made was set at the long-term

(20-year) rate average of 5,8 %, below the Commission's reference rate then prevailing, which is a shorter term rate <sup>(11)</sup>. They also explain, in the letter referred to in recital 49, how the origins of the loan were in 1999 and how the terms were set at this date. They answer the points made by TNT (see recital 42) because TNT made comparisons with the loan rates in 2001, which was not when the loan rates were set. They also explain the absence of security on the loan (which was in any case subsequently amended when the 2003 loans were issued). Finally, they answer the point raised by the Commission in the decision opening the procedure that, at least in 2001, the decline in Royal Mail's financial performance was beginning. This was not the case in 1999 when commitment was given to the loan and in the period 1999-2000 which are the relevant dates for setting interest rates.

(68) At the time the loans were agreed, the Commission's reference interest rates were set under the Commission notice of 1997 on the method for setting the reference and discount rates ('the 1997 reference rate notice') <sup>(12)</sup>. Under that notice, the Commission defined rates based on the five-year interbank swap rates, plus a premium, but reserved the right to use a shorter base rate (for example, LIBOR one-year rate) or a longer base rate (for example, the rate on 10-year bonds) than the five-year interbank swap rate. Because of the fixed longer duration of the loans, the Commission believes that the use of such a longer term rate is appropriate in this case.

(69) The Commission has noted that the rates charged were arrived at by a process based on observed commercial loan transactions which were then compared with the relevant Government bond <sup>(13)</sup>. The spread over Government bonds ranged between 76 and 165 basis points, which is therefore sufficient in comparison with the 75 basis points set in the reference rate notice. The Commission also compared the rates charged with 20 year interbank swap rates on the relevant dates. The rates charged are extremely close to these rates (generally less than 10 basis points of difference). The Commission notes that the UK and its consultants did not base themselves on the relevant interbank swap or other published rate but rather sought direct commercial benchmarks. In

the light of all the above, the Commission accepts that the measure in question did not provide an advantage to Royal Mail and did not constitute State aid.

## 5.2. The loan facilities

### 5.2.1. The facilities granted in 2003

(70) As noted in the opening decision, these facilities were never used in the period before they were extended or modified in 2007. The Commission did not therefore open the procedure concerning the terms of the loan and this decision does not assess the adequacy of the agreed rate. The Commission did, however, raise the question of whether the facilities nonetheless had an option value to the company which should be assessed for State aid content. On this subject, the Commission has established that the facilities, despite not being used, were nonetheless the subject of a commitment fee of [...] per annum for those facilities which were committed. The Commission has established to its satisfaction that this was a market rate, being set as a percentage of the margin over LIBOR of the underlying loan, which is the market practice, and at a level ([...]) in line with that practice (the Commission has noted examples ranging from 16 to 50 %). Other facilities were never approved by Parliament and were never therefore committed, which would not normally therefore give rise to a fee. The Commission is therefore satisfied that the facilities granted in 2003 did not in practice confer State aid on Royal Mail.

### 5.2.2. The facilities granted in 2007

(71) In 2007, the outstanding facilities from 2003 <sup>(14)</sup> were replaced by a 'senior debt facility' of GBP 900 million, under revised terms. The Commission has reviewed the terms of this facility. The interest rate charged is [...] basis points above relevant LIBOR for the first 12 months, with the rate thereafter varying according to fixed charge cover but never below [...] basis points above relevant LIBOR. The facility is secured by a floating charge <sup>(15)</sup> over the assets of Royal Mail, a fixed charge over the shares of a new subsidiary Royal Mail Estates Ltd which holds RM's property portfolio, and a floating charge over the assets of that company. The market value of the property held in RM Estates was valued at GBP [...]. The Commission has assessed these terms under the 1997 reference rate notice which applied

<sup>(11)</sup> The term of the Commission's reference rates was 5 years under the methodology in effect until 31 December 2007, one year under the Communication adopted at the start of 2008.

<sup>(12)</sup> OJ C 273, 9.9.1997, p. 3.

<sup>(13)</sup> Because the loan consists of different tranches for which the rate depends on the date and duration for which the relevant funds were first drawn down from Royal Mail's reserves (see footnote 6 above), each tranche is subject to a different rate. This explains why 5,8 % is an average rate. The relevant Government bond rate was the rate for a bond closest in duration to the tranche in question on the date of drawing.

<sup>(14)</sup> One part of the loan facilities had lapsed by this point, so the outstanding facilities were GBP 844 million.

<sup>(15)</sup> A floating charge is a form of security which does not attach to a particular asset but rather to a class of assets.

when they were established. Given that the value of the assets over which a charge is held in respect of the loans exceeds the value of the loans by nearly 50 % the collateral is judged to be 'high'. The margin over LIBOR of between [...] and [...] bps is therefore sufficient in terms of the notice which set a margin of 75 bps (as noted in recital 68, the Commission envisaged in the 1997 reference rate notice the possible use of LIBOR as a basis for assessment). In addition, the Commission has noted the information provided by the UK authorities drawn from other transactions secured on property companies which appears to show that the terms have been 'benchmarked' to comparable commercial transactions. The Commission has determined on the basis of its reference rate analysis that, taken independently, these loan facilities do not constitute State aid.

- (72) Given that the 2007 facilities were made available as part of a package together with other measures, and given the UK's insistence that the components of the 2007 financing package should not be evaluated on a stand-alone basis, the Commission would need to determine whether the separate assessment in the recital 71 can be conclusive. This question is treated further in section 5.5 below.

### 5.3. The pensions escrow account

#### 5.3.1. Existence of aid

- (73) Following the comments and explanation of the United Kingdom authorities the Commission was able to understand the mechanism involved in the pensions measure. As described at recital 22 above, Royal Mail is required to account for its large pensions deficit on its balance sheet, and UK pensions law requires it to agree with the trustees a plan, and in particular a period, for eliminating that deficit through deficit payments to the scheme's fund. The measure allowed Royal Mail to extend that period with a consequent effect on the payments it must make. The Commission noted at the outset that the legal nature of the measure (involving the release of reserves over which the State had effective control through specific legislation for use in an escrow arrangement in favour of the pension fund) had no immediate parallel in normal commercial transactions, even if the model of placing funds in an escrow account can be envisaged in the private sector<sup>(16)</sup>. In order to assess the United Kingdom's claim that the

measure was on commercial terms, therefore, the Commission had to determine the appropriate benchmark against which to compare it.

- (74) The measure releases funds that were totally under shareholder control to be used by RM to alter the deficit payments which it is obliged to make to its pension scheme by putting those funds in an escrow account (despite the Mails Reserve being formally on its balance sheet RM could not make use of the reserves and associated assets without the Government's approval). Although this release of funds is not a pure equity injection, it can be best assimilated, in terms of its effects, to such an operation. If the funds had not been released, Royal Mail could not have constituted the escrow account without raising capital from other sources or drawing on other reserves. It is true that the measure prescribed that, on release of the escrow account, the funds would return to the control of the State. However, the length of time expected to be necessary for this to happen (17 years), the associated uncertainty concerning whether the funds could in practice be returned to the shareholder if RM's financial performance were to decline over this period, and the lack of guaranteed interest income led the Commission to discard the possibility of assimilating the transaction to the provision of a loan. The Commission decided that this conclusion was all the more reasonable given that when the mails reserve amounted only to GBP 796 million on 31 March 2007, the UK authorities injected GBP 54 million as new equity in order to bring the mails reserve to the agreed level of GBP 850 million before establishing the escrow account. In the light of the above and for the purposes of analysing its conformity with the market economy investor principle, the Commission has analysed the release of funds that were totally under shareholder control to be used by RM as an equity injection.

- (75) The Commission's approach to the market-conformity of equity injections is to compare the net present value of the public authorities' equity holding with (post money) and without (pre money) investment<sup>(17)</sup>. If the difference is greater than the injected capital the injection is deemed to be MEIP conform. This 'incremental' approach is necessary because otherwise it would not be obvious what part of the returns to the shareholder (dividends or in the case of the sale of the shareholding the sale price) would result from the investment and what would occur regardless of it. The method for calculating the value of an equity holding in both post and pre money

<sup>(16)</sup> The possibility is mentioned in *Regulatory Code of practice 03*, published by the UK Pension Regulator, 'Funding Defined Benefits', February 2006, paragraph 104. However, the UK did not adduce any examples of the possibility being used.

<sup>(17)</sup> See for example the *Landesbanken* cases such as HSH decision NN 71/05, also NN 72/05, NN 19/06 and NN 34/07.



cases over a defined period is to add the discounted value of the future cash flows extracted from that equity holding over that period (normally dividends but a capital reduction would be another possibility) to any increase in the value over the period.

- (76) The UK's initial response enclosed a report by consultants Deloitte which purported to show an IRR for the planned investments of [...]. On investigation, however, there were several problems with the methodology used.
- (77) Firstly, the calculation only concerned the investment case and was not based on a comparison between the invest and non-invest scenarios. In response to this criticism, the UK replied that for the non-invest case an equity value of [...] was supposed. The argument that the non-invest case resulted in an equity value of [...] was however neither made in, nor borne out by, the Deloitte report. Thus the Commission could not perceive the original Deloitte report as having followed what the Commission considers as the proper methodology, namely that based on the comparison between the projections with and without investment.
- (78) Secondly, the method for valuing the equity holding was to calculate an enterprise value (that is, the sum of claims of debt-holders as well as shareholders) using enterprise level cash flows and terminal value and to deduct debts afterwards. While this is not an incorrect method, it does not show clearly the free cash flows available to shareholders only, which is one of the indicators (even if not the sole determinant) whether an equity injection conforms to the market economy investor principle. The Commission therefore prefers the method which involves discounting cash flows directly paid out to the shareholder (dividends) and using a terminal value which represents not an enterprise value but an equity value. This also involves using the cost of equity as discount rate instead of the Weighted Average Cost of Capital. This was the method used in the previously cited Landesbanken cases (see footnote 17).
- (79) Thirdly, the senior debt facility discussed in recital 71, and the release of the Mails Reserve, were assessed together in this calculation whereas normally the test for a loan and equity injection is different (private investor vs private lender test) and thus should be carried out separately<sup>(18)</sup>. While it is true that it is not

uncommon that a shareholder also acts as a lender in large groups, the Commission considers that it is difficult to assess the two measures within the same framework given their different nature. This does not mean, however, that the effects of the two measures on each other are not to be taken into account. On the contrary, the analysis of the release of funds that were totally under shareholder control for use by RM is based on cash flows that reflect the assumption that the loans discussed in this decision are made to RM.

- (80) The Commission therefore requested that the UK provide the incremental equity valuation over the best possible, but nevertheless realistic, 'non-invest' case. As concerns the identification of the alternative case, RM's own non-invest forecasts (the 'manage for cash case' or MFCC) led to [...]. Deloitte therefore sketched a different 'alternative case' (AC) under which [...] and addressed its pension deficit over 12 instead of 17 years. However, Deloitte's assessment of this case was that while the pension problem would be effectively addressed in the short term [...]. It should be noted that the Commission cannot be sure that this alternative is the 'best available' non-invest case, which would of course form the basis of a market economy investor's assessment. It can, however, be said that any doubts concerning the investment case would be magnified against any 'better alternative' that could be conceived.
- (81) At the Commission's request, the United Kingdom provided figures allowing the investment case to be assessed against both alternatives. For reasons outlined in recital 78 the Commission required that the projections use free cash flows available to equity holders, an equity value for terminal value and the cost of equity as discount rate.
- (82) The UK supplied the following projections<sup>(19)</sup>. The table shows the calculation of the Government's equity holding with investment (investment case), followed by the result of the same calculation in the alternative case. Based on these figures, the value of the Government's equity holding is GBP [...] in the investment case whereas it would be GBP [...] in the alternative case without investment.

<sup>(18)</sup> The UK insists its public enterprises borrow only from the State. The Commission does not question this policy in this decision but takes the view that measures should be capable of separate scrutiny. It would in any case be highly unusual for a market economy investor to be both sole shareholder of a company which is not part of a wider group, such as Royal Mail, and sole banker to the company.

<sup>(19)</sup> For the purposes of these projections the investment included the GBP 300 million of the shareholder loan, since the Commission considered at a certain point of the investigation the possibility that this measure could also be assimilated to equity. The Commission has finally decided to assess this measure as a loan, as described below. The change of treatment in the table would not alter the Commission's conclusion as to the market conformity of the pensions escrow account measure.



- (83) As the difference of GBP [...] is greater than the invested sum, the UK argues that it has demonstrated that the investment is on a commercial basis. The Commission determined, however, that that claim requires further examination.
- (84) From the table it can be seen that:
- (a) the cash generated under the investment case provides no return to equity holders in the first [...] years of the plan;
  - (b) the investment case thus relies heavily on the terminal value calculated in 2016/2017;
  - (c) the investment case is cash-negative for the first [...] years, after which cash generated is devoted entirely to debt and pension deficit payments until 2013/2014;
  - (d) for the years after 2016/2017 (and accepting that only limited reliance can be placed on projections at that distance) the alternative case generates stronger returns because the pension deficit has been repaid, cancelling out the positive returns in 2013-2016. This consideration therefore places even greater weight on the terminal value in the investment case.
- (85) Furthermore the Commission confirmed that even beyond the first [...] years, it is uncertain whether the figures in years [...] are in effect dividends capable of distribution to the shareholder. This is because the inclusion of RM's pension deficit on the balance sheet (following new accounting rules) results in a negative worth of the company on an accounting basis, placing severe constraints on any extraction of cash in the form of dividends even from [...]. In the original Deloitte report submitted by the UK, [...].
- (86) Given the pattern of returns to the shareholder (practically all of it resulting from the terminal value and practically nothing from dividends) the Commission believes that a private investor would expect some returns in cash in the [...] years after the investment and would be uneasy that the whole or the predominant share of the return from the investment comes from the terminal value in the [...] year. The terminal value being in essence the value of cash flows from the [...] year onwards discounted to the [...] year, the private investor is asked to believe that even though its investment produces no returns in [...] years, it is nevertheless a good investment on the basis of prospects following the [...] year. Given that the forecasts on such a long period are exposed to many unforeseeable variables and are therefore by their very nature of limited reliability, the Commission finds that a private investor would not be willing to invest on such terms especially in the postal sector, the long-term prospects of which are uncertain. The Commission also questions whether such an investor would have been prepared to subordinate its interests as shareholder so extensively to those of employees/pensioners and to debt repayment.
- (87) Not only does the investment case rely heavily on the terminal value calculated in 2016/2017, but the terminal value can also be questioned both because of the calculation methodology and because of the underlying figures. As regards methodology, the terminal value was arrived at by taking the EBITDA figure in the terminal year multiplied by a factor that is the ratio between Enterprise Value and EBITDA at sector equivalents. TNT and Deutsche Post/DHL were chosen on the ground that even if RM is not on a par with those companies now, it will be after [...] years of the investment plan. The result of this approach is an Enterprise Value (roughly debt plus equity), which is not consistent with the approach described in recital 81, which requires the use of an equity value as terminal value. If an appropriate equity value is used the terminal value changes significantly — it becomes lower. As regards the underlying figures leading to the terminal value, the Commission notes in particular that RM's earnings before interest, tax and depreciation (EBITDA) were projected to grow at over [...] annually in the plan period. The Commission regarded this projection as extremely optimistic in a newly-liberalised, regulated and mature sector.
- (88) The Commission subjected the calculation presented by the UK to various tests by varying the assumptions used and the calculation methodology, in particular for the terminal value. It found that, given the importance of the terminal value in the figures supplied, only minor variations in the methodology such as calculating the terminal value differently and less optimistic profits growth would change substantially the assessment of the investment.
- (89) In conclusion, the Commission has not been able to find that the release of funds that were totally under shareholder control to be used by RM to alter the deficit payments which it is obliged to make to its pension scheme by putting those funds in an escrow account complies with the MEIP.
- (90) The Commission has therefore proceeded to an examination of the compatibility of any aid contained in the measure (see section 6).

### 5.3.2. Quantification of aid

- (91) The effect of the measure on Royal Mail is on its payments to the pension scheme to address the pension deficit, which can, as a result of the measure, be spread over a larger number of years than would otherwise have been the case. These payments are therefore lower for the first years (because without the measure, RM would have to address the deficit more quickly and make therefore higher deficit contributions) but higher in the later years, when the deficit would otherwise have been addressed.
- (92) Valuing this advantage, through the calculation of the net present value of the amended cash flow payments, requires making certain assumptions, notably about the period over which the deficit would need to be addressed in the absence of the measure, and selecting a discount rate. The Commission accepted to use a period of 12 years for addressing the deficit, which was the basis of the 'alternative case' examined at recital 80 and which was put forward by Royal Mail to the UK postal regulator in the context of the pricing review. This figure slightly exceeds the period of 10 years which is used as a benchmark by the UK pensions regulator<sup>(20)</sup>. However, given the use of the figure of 12 years for other purposes and in addition the large size of the deficit relative to the company, which would generally therefore require a longer period for being addressed, the Commission believes this is an acceptable assumption. The Commission has applied a discount rate of 12 % representing the cost of equity. On this basis the value to Royal Mail of the change in pension contributions as a result of the measure amounts to a figure of GBP [...].

### 5.4. The GBP 300 million shareholder loan

- (93) As already noted, the shareholder loan is subordinated both to RM's other debt and to the pensioner interest (it cannot be repaid before the escrow account is released). This led the Commission to consider whether the measure should not be assimilated to an injection of equity (see also footnote 19).
- (94) The Commission has however determined<sup>(21)</sup> that subordination does not prevent loans from being assessed for the existence of State aid in the same way as non-subor-

dated loans. Such loans may therefore be assessed according to the terms of the notice on reference rates<sup>(22)</sup>, albeit at a lower rating level than their non-subordinated equivalents.

- (95) The 1997 reference rate notice, which was in force in 2007 set rates by reference to observed rates of a specific duration, namely five years. The measure under assessment, however, would last as long as the escrow account, estimated at 17 years. At the time the loan was issued, the UK yield curve was downward sloping as it had been in 1999. Although the reference rate was 5,9 %, sterling 15 year interest rate swaps at end March 2007 were at 5,2 %. The benchmark used in the 1997 reference rate notice was interbank swap rates of five years and the Commission therefore regards the corresponding 15-year rate as an appropriate benchmark for the measure in question. This should be increased by the standard premium under the notice of 75 basis points, to 5,95 %.
- (96) The rate thus determined would need to be further adjusted to reflect the degree of security and of subordination.
- (97) The shareholder loan is not secured and its collateralisation must therefore be regarded as below what would normally be required by banks. In such cases, the 1997 reference rate notice sets a margin over the relevant benchmark of 400 basis points or more if no private bank would have agreed to grant the relevant loan. In line with previous Commission decisions<sup>(23)</sup> under the 1997 reference rate notice, the Commission believes that the rate should be increased by a premium of 400 basis points reflecting the lack of security and 200 basis points for the subordinated nature of the instrument.
- (98) Noting that the loan rate of [...] % is greater than the sum of 5,95 % and 600 basis points, the Commission can accept that, taken independently, the measure does not constitute State aid.
- (99) Given that the 2007 facilities were made available as part of a package together with other measures, the Commission would need to determine whether such a separate assessment can be conclusive. This question is treated further in section 5.5.

<sup>(20)</sup> The Pensions Regulator: The regulator's statement, May 2006, 'How the Pensions Regulator will regulate the funding of defined benefits', paragraph 3.16.

<sup>(21)</sup> N 55/08 — Germany — GA/ERDF subordinated loans. See also case C 38/05 — Germany — Biria which concerned a 'silent participation' assessed under the 1997 reference rate notice.

<sup>(22)</sup> Commission notice on the method for setting the reference and discount rates (OJ C 273, 9.9.1997, p. 3).

<sup>(23)</sup> Cases C 38/05, Biria (OJ L 183, 13.7.2007, p. 27); C 38/07, Arbel Fauvet Rail SA (OJ L 238, 5.9.2008, p. 27); C 95/01, Siderurgica Añon (OJ L 311, 26.11.2005, p. 22); C 20/2000, Sniace (OJ L 108, 30.4.2003, p. 35).



### 5.5. Separate assessment of the 2007 measures

- (100) The Commission has determined that two of the 2007 measures taken independently (loan facilities of 2007 and shareholder loan of GBP 300 million) do not constitute State aid, but has not been able to make such a determination with respect to the pensions measure. Given that the measures were announced simultaneously, the Commission must assess whether it can confirm the findings of no aid, in the light of the Court's jurisprudence <sup>(24)</sup>.
- (101) The Commission has noted that the loan facilities extended in 2007 were, in practice, the continuation of measures granted in 2003, albeit with revised terms. It follows that when the measure was first granted, the pensions measure was not in existence. The purposes of the loan facilities and the pensions measure can also be distinguished: the former provides an external source of finance for Royal Mail's transformation plan, while the latter is to provide security for the repayment of the deficit over 17 years. As noted above, the security taken over RM's assets in respect of the loan facilities was in conformity with market practice. The three criteria established by the court (chronology, purpose, and the situation at the time the measure was taken) all plead in favour of the aid character of the loan facilities being assessed separately.
- (102) As regards the shareholder loan, the decision to grant this measure took place later than the other 2007 measures. The loan was added to the previously announced finance framework to provide sufficient funding headroom to enable Royal Mail to meet its transformation plan, following a decrease in the projected outturn over the plan period. The purpose of the measure can be distinguished from that of the pensions measure in the same way as for the loan facilities. Lastly, the situation of RM at the time the loan was granted does not invalidate the finding of no aid, since the situation is already taken into account in the assessment of the adequacy of the interest rate.
- (103) The Commission therefore concludes that the only measure for which an aid element cannot be excluded, and which therefore needs to be assessed for compatibility, is the pensions measure. That assessment follows in the next section.

## 6. COMPATIBILITY WITH THE COMMON MARKET

### 6.1. Basis for assessment

- (104) The pensions measure could only be declared compatible by the Commission pursuant to Article 87(3)(c) of the

Treaty, which states that aid to facilitate the development of certain economic activities or of certain economic areas may be declared compatible with the common market where such aid does not adversely affect trading conditions to an extent contrary to the common interest <sup>(25)</sup>. There is in addition case law concerning the application of Article 87(3)(c) of the Treaty to the specific situation of pensions measures, and the analysis below assesses the measure in the light of that case law. It follows that the current decision does not represent an application of the guidelines on State aid for rescuing and restructuring firms in difficulty for the purposes of section 3.3 of the Community guidelines on State aid for rescuing and restructuring firms in difficulty <sup>(26)</sup>.

### 6.2. The history of Royal Mail's pension arrangements

- (105) In order to assess the compatibility of the pensions measure, it is necessary to first describe the history of Royal Mail and its pension arrangements.
- (106) In 1969, Royal Mail (then called the Post Office) ceased to be a Government department and became a 'statutory corporation', under the Post Office Act 1969. Under section 43(1) of the Act, the pension arrangements for Post Office staff were subject to the approval of the Minister for Posts and Telecommunications. Employees ceased formally to be civil servants, but retained their acquired pension rights and continued to acquire further rights on essentially the same terms as civil servants. Under these terms, the final pension was determined as function of years of service and final salary. It was thus a 'defined benefit' scheme in that the pension level was set by the rules of the scheme. The pension scheme was separated off from the civil service scheme and became a funded scheme holding assets against future liabilities (in common with other corporate pension schemes in the UK).
- (107) Significant revisions to the pension arrangements took place in 1987 and 2008 (in the latter case, these measures were already in preparation when the pensions measure was adopted). The 1987 revised terms were still 'defined benefit' terms, that is, pension based on final salary and proportionate to number of years' service. Under the 2008 revision, new members join on a 'defined contribution' basis where the level of the final pension will depend on the performance of the fund's assets. In both cases, new employees were obliged

<sup>(24)</sup> Judgment of the Court of First Instance (Second Chamber, extended composition) of 15 September 1998, *BP Chemicals Limited v Commission*, Case T-11/95, ECR [1998] p. II-3235, paragraphs 170ff.

<sup>(25)</sup> The United Kingdom has not invoked Article 86(2) of the Treaty as justification for the compatibility of any aid granted to Royal Mail under the pensions measure.

<sup>(26)</sup> OJ C 244, 1.10.2004, p. 2.

to join under the revised terms while existing employees continued to acquire rights on the same or similar terms as before.

### 6.3. Previous Commission's decisions concerning pensions liabilities and their applicability to the situation of Royal Mail

(108) In its decision of 16 December 2003 on the State aid granted by France to EDF and the electricity and gas industries <sup>(27)</sup>, the Commission declared compatible with the common market State aid that relieved the undertakings in a particular sector of specific pension liabilities which exceeded those resulting from the general retirement arrangements and which had been defined during the monopoly period. It also took the view that the partial mitigation of the costs arising from the mechanism for financing the specific pension rights acquired before the date of the reform constituted State aid within the meaning of Article 87(1) of the Treaty that could be declared compatible with the common market. In its analysis of the accounts, the Commission concluded that the situation of EDF was not very intrinsically different from that of 'stranded costs' in the energy sector.

(109) In its decision of 10 October 2007 on the State aid implemented by France in connection with the reform of the arrangements for financing the retirement pensions of civil servants working for La Poste <sup>(28)</sup>, the Commission took the view that the aid measures in question relieved La Poste of specific pension liabilities which exceeded those resulting from the ordinary pension arrangements and which had been defined during the monopoly period. These liabilities arose from, first, the higher pension contributions payable in respect of employees with civil servant status and, secondly, the requirement to ensure the equilibrium of its retirement scheme for these employees.

(110) The Commission found the measures to constitute State aid which was nonetheless compatible with the common market under Article 87(3)(c) of the Treaty. In doing so, it noted that the measures were limited to what was strictly necessary to establish a level playing field for social security contributions and tax payments and ultimately would therefore favour the development of competition and further liberalisation of the postal sector. It further noted, by way of drawing a parallel with the EDF decision, that La Poste no longer recruited civil servants, that the future pensions payments of La Poste placed it in a comparable situation vis-à-vis its competitors as regards social security contributions and tax payments, and that the obligations resulting from the 1990 Law prior to the liberalisation of the postal sector would have affected La Poste's competitiveness in an environment undergoing liberalisation.

(111) In France, occupational pension ('pillar 2') schemes are compulsory and are financed on a pay-as-you-go basis. In general, payment by the employer of the contributions discharges it of further responsibility for financing the resulting pensions entitlements. By requiring La Poste under a Law of 1990 to ensure the equilibrium of its retirement scheme for civil servants, the undertaking was subject to an obligation that other enterprises did not have to bear.

(112) In the United Kingdom, pensions arrangements differ from those in France. Most occupational pension schemes are 'contracted out' of the State pension arrangements known as the State Earnings Related Pension Scheme. Most large employers run their own pension schemes. Under UK pensions law, these schemes must provide a pension entitlement which meets certain standards, and employers have certain obligations to ensure that schemes are adequately funded. Under current accounting standards (IFRS), employers must record deficits on such pension schemes on their balance sheets. The rules requiring Royal Mail to account for its deficit are not therefore different from those applying to other companies. However, the level of that deficit arises from terms and conditions which were set as a result of Government ownership.

(113) The factual and legislative context of Royal Mail is therefore different from that of the EDF and La Poste decisions. Nonetheless, there are certain aspects of those cases which the Commission believes are applicable to Royal Mail. In particular, the cases indicate that higher pension contributions arising from specific status (and in particular civil servant status) and defined during a period of monopoly may be considered abnormal costs whose defrayal by the State may be compatible with the common market under Article 87(3)(c) of the Treaty.

### 6.4. Assessment of the pensions measure

(114) In the case of Royal Mail, pension rights acquired by employees who joined the pension scheme before 1987 were clearly aligned with those of the civil service. As of 31 March 2007, the pension scheme had 153 125 members already retired and drawing their pension who had joined the scheme on those terms. These are therefore former employees who have already retired and whose services are no longer of benefit to the company. According to information provided by the UK authorities, the terms applicable to members joining the scheme after 1987 can neither be clearly described as civil service terms nor as private sector terms of the type likely to be practised by RM's competitors in the newly liberalised postal market. As already noted, these terms ceased to be available to new members after 2008. On average, liabilities in respect of the members who joined the pension scheme before 1987 considerably exceed those of members who joined the scheme on

<sup>(27)</sup> OJ L 49, 22.2.2005, p. 9.

<sup>(28)</sup> OJ L 63, 7.3.2008, p. 16.

the terms which obtained following the reform of 1987 until the further reform of 2008. The value of those additional liabilities has been quantified at GBP [...] per employee.

(115) It follows that Royal Mail's pension scheme still carries substantial liabilities which arose solely as a result of employing staff on civil service terms, and over a period of time when Royal Mail enjoyed a monopoly over ordinary letter mail. These conditions correspond to those which existed in the La Poste case. The Commission has established, on the basis of information provided by the UK, additional such liabilities to an amount of GBP [...] (the product of 153 125 and GBP [...]) which therefore exceed, by some considerable margin, the quantification of GBP [...] for the possible aid content of the measure. The Commission has not found it necessary, in carrying out this analysis, to establish whether these liabilities of the pension scheme constitute the full amount of the scheme's liabilities that can be considered abnormal, once it has established that they in any case exceed the possible aid content of the measure.

(116) The Commission has also established that, in common with the features of the measures in La Poste described at recital 107, the terms giving rise to the additional costs are no longer available to new employees and indeed have not been since 1987, and that the obligations resulting from those terms prior to the liberalisation of the postal sector would have affected the development of effective competition in an environment undergoing liberalisation. In Royal Mail's case, the measure does not affect social security contributions and tax payments for current employees and therefore does not put RM in a better position vis-à-vis its competitors in this regard.

(117) The Commission also noted that the form of the measure left the pension liabilities of Royal Mail intact and only allowed the company to address the deficit over a longer period, rather than lifting those liabilities entirely. The latter was the form of the measure in La Poste, meaning that the beneficiary was permanently relieved of liabilities which it would otherwise have had to bear and was as a consequence not required to account for them on its balance sheet. In the case of Royal Mail, the measure makes no difference to the amount of the pensions deficit for which the company is required to account on its balance sheet under international accounting rules. The company remains required, under UK pensions law, to take steps to eliminate this deficit. The effect of the measure is only to lengthen the period over which it can do so. While this feature is already

reflected in the analysis above that any aid element is assessed at GBP [...] and not GBP 850 million, the Commission believes that, in general, a measure requiring a beneficiary to address its accrued liabilities in full is likely to be less distortive than a measure which relieves them.

(118) In terms of the effect of the measure on competition, it can be noted that the deficit payments which Royal Mail is required to make to the pension scheme, once established following negotiations between the company and the pensions trustees, do not vary according to levels of output or input. Their reduction in the initial years by means of the measure does not therefore affect marginal costs and is not such as to affect Royal Mail's commercial decisions, and in particular its future investment decisions<sup>(29)</sup>. The Commission therefore finds that the effect on competition is not such as to adversely affect trading conditions to an extent contrary to the common interest in the sense of Article 87(3)(c) of the Treaty.

(119) On this basis, the Commission has determined that, to the extent that pensions measure contains an aid element, such element would be compatible with the common market.

## 7. CONCLUSION

(120) The Commission finds to the extent that the pensions measure contains an aid element, this was unlawfully implemented by the United Kingdom in breach of Article 88(3) of the Treaty. However, the Commission finds that aid to be compatible. The Commission finds that the other measures do not constitute State aid,

HAS ADOPTED THIS DECISION:

### Article 1

The 2001 loan, the loan facilities and the 2007 shareholder loan do not confer State aid on Royal Mail.

### Article 2

The pensions measure, to the extent that it contains State aid, is compatible with the common market.

<sup>(29)</sup> See paragraph 170 of the decision on La Poste.

*Article 3*

This Decision is addressed to the United Kingdom of Great Britain and Northern Ireland.

Done at Brussels, 8 April 2009.

*For the Commission*

Neelie KROES

*Member of the Commission*

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