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Acts whose titles are printed in light type are those relating to day-to-day management of agricultural matters, and are generally valid for a limited period.

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II

(Acts whose publication is not obligatory)

COMMISSION

COMMISSION DECISION

of 8 July 1999

on a measure implemented by the Federal Republic of Germany for Westdeutsche Landesbank — Girozentrale (WestLB)

(notified under document number C(1999) 2265)

(Only the German text is authentic)

(Text with EEA relevance)

(2000/392/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 provisions cited above⁽¹⁾ and having regard to their comments,

Whereas:

I. PROCEDURE

(1) By a complaint dated 23 March 1993, the Bundesverband deutscher Banken e.V. ('BdB'), representing about 300 privately owned banks in Germany, urged the Commission to initiate the procedure laid down in Article 226 of the EC Treaty against the Federal Republic of Germany. It claimed that the German Banking Supervisory Authority (Bundesaufsichtsamt für das Kreditwesen — BAKred) had infringed Article 4(1) of Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions (Own Funds Directive)⁽²⁾, as last amended by the Documents concerning the accession of Austria, Finland and Sweden, when accepting assets of the Wohnungsbauförderungsanstalt des Landes Nordrhein-Westfalen (Wfa), which had been merged with Westdeutsche Landesbank Girozentrale (WestLB), as own funds of the latter.

(2) By letter dated 31 May 1994, BdB informed Directorate-General IV, responsible for competition, of the asset transfer, alleging a distortion of competition in favour of WestLB. On 21 December 1994 it filed a formal complaint requesting the Commission to initiate the procedure laid down in Article 88(2) of the EC Treaty against the Federal Republic of Germany. In February and in March 1995 and in December 1996 ten individual banks associated themselves with the complaint of their association.

(3) By letters dated 12 January 1993, 9 February 1993, 10 November 1993 and 13 December 1993 and 16 January 1996, the Commission asked the German authorities for further information in order to determine whether the asset transfer constituted State aid. The German authorities replied by letters dated 9 February 1993 and 16 March 1993, 8 March 1994, 12 April 1996 and 26 April 1996 and 14 January 1997. A number of further letters and documents were submitted by the different parties. Commission representatives met representatives of the German authorities, WestLB and other Landesbanks and the complainant at meetings on 7 and 27 July 1994 and 3 August 1994, 18 January 1995, 2 March 1995, 20 April 1995, 29 May 1995, 27 June 1995, 23 August 1995, 9 October 1995 and 24 October 1995, 14 February 1996, 11 March 1996 and 20 June 1996 and 17 January 1997 and 17 June 1997.

(4) After this exchange of information, the Commission deemed it necessary to initiate the procedure laid down in Article 88(2) of the EC Treaty. The relevant decision was adopted on 1 October 1997. In it the Commission concluded that the measure in question probably constituted aid within the meaning of Article 87(1) of

⁽¹⁾ OJ C 140, 5.5.1998, p. 9.

⁽²⁾ OJ L 124, 5.5.1989, p. 16.

the EC Treaty and that it needed additional information to carry out the necessary appraisal. This information related mainly to the measures taken by the *Land* of North Rhine-Westphalia (hereinafter the *Land*) to ensure its proper participation in the additional profits which WestLB can generate on the basis of the capital transferred, the effects of the inadequate liquidity content of the transferred capital, the effects of the fact that the *Land*'s influence on WestLB had not increased, the effects of the preferential nature of the fixed remuneration and of any other aspects determining the appropriate level of remuneration, the level of Wfa capital available to underpin WestLB's commercial business, the value of the amount exceeding this sum but shown in WestLB's balance sheet, the tax exemptions, the waiver of liability, the profitability of WestLB and the alleged synergies.

- (5) The complaint referred to similar financial measures in Lower Saxony, Berlin, Schleswig-Holstein, Hamburg and Bavaria in favour of Norddeutsche Landesbank, Landesbank Berlin, Landesbank Schleswig-Holstein, Hamburger Landesbank and Bayerische Landesbank respectively. Since the complaint focused on the transfer of Wfa to WestLB on account of the exceptionally high volume of capital transferred, the procedure initiated addressed this case only. The Commission stated that it would review the capital transfers to other banks in the light of the findings of the present procedure.
- (6) The decision to initiate the procedure laid down in Article 88(2) of the EC Treaty was notified to the German Government by letter dated 23 October 1997. Several minor errors in that decision were corrected by a Commission Decision of 3 December 1997, which was notified to the German Government by letter dated 22 December 1997.
- (7) The removal of confidential data for publication was agreed by letters dated 7 and 25 November 1997 and 2 December 1997. The German Government submitted its observations by letter of 27 February 1998 after an extension of the deadline had been requested by letter of 19 November 1997 and granted by letter of 1 December 1997.
- (8) The Commission decision to initiate the procedure was published in the *Official Journal of the European Communities* ⁽³⁾. The Commission invited interested parties to submit their comments on the measure. It received comments from WestLB (19 May 1998), the Association française des banques (26 May 1998), the British Bankers' Association (2 June 1998) and BdB (4 June 1998). By letter dated 15 June 1998, it forwarded them to the German Government for its reaction, which it duly received by letter of 11 August 1998 after an extension of the deadline had been requested by letter of 30 June 1998 and granted by letter of 17 July 1998.

- (9) Meetings took place with representatives of BdB on 15 January 1998 and 16 September 1998 and with representatives of WestLB on 9 September 1998. By letters dated 22 September 1998, the Commission departments invited the German authorities, WestLB and BdB to a joint meeting on various aspects of the case. BdB provided information by letter dated 30 October 1998. The meeting with the three parties took place on 10 November 1998. Following that meeting the Commission departments requested additional information and documents from the German authorities and from BdB by letter of 16 November 1998.
- (10) By letter dated 14 January 1999, BdB submitted the information requested after an extension of the deadline had been requested by letter of 1 December 1998 and granted by letter of 15 December 1998. The German authorities submitted some information by two letters dated 15 January 1999 after an extension of the deadline had been requested by letter of 30 November 1998 and granted by letter of 15 December 1998. Additional information was provided by letter dated 7 April 1999.
- (11) Since the German authorities refused to provide certain information, the Commission enjoined the German Government by Decision of 3 March 1999 to submit that information. The Decision was sent to the German Government by letter dated 24 March 1999. The German Government complied with this injunction by letter dated 22 April 1999 after an extension of the deadline had been requested by letter of 8 April 1999 and granted by letter of 14 April 1999.
- (12) The Commission decided to arrange for an independent study to be carried out on the appropriate remuneration to be asked by the *Land* for the transfer of Wfa to WestLB. Representatives of the consultancy charged with that task also attended the meeting with the three parties on 10 November 1998.

II. DETAILED DESCRIPTION OF THE MEASURE

1. Westdeutsche Landesbank Girozentrale

- (13) WestLB, the beneficiary of the transfer of Wfa, is a public-law institution (*Anstalt des öffentlichen Rechts*) under a *Land* law ⁽⁴⁾ which stipulates three functions to be fulfilled by the bank:
 - WestLB acts as central bank for the legally and economically independent local savings banks in North Rhine-Westphalia. In this way, it ensures

⁽³⁾ See footnote 1.

⁽⁴⁾ Sections 36 to 46 of the North Rhine-Westphalian law on savings banks (*Gesetz über die Sparkassen sowie über die Girozentrale und Sparkassen- und Giroverbände*).

equalisation of savings banks' liquidity and provides supraregional services. Since 17 July 1992 WestLB has also been acting as the central institution for savings banks in the *Land* of Brandenburg by virtue of a contractual agreement,

few decades WestLB has developed increasingly into an independent commercial bank and is now a strong competitor on the German and European banking markets.

- WestLB is engaged in the issuing of debt instruments and handling of financial transactions for its public shareholders (State-bank function),
 - WestLB operates as a normal commercial bank in its own right.
- (14) Notwithstanding these special legal provisions, WestLB is subject to banking supervision under the German Banking Law (*Kreditwesengesetz*).
- (15) WestLB is 100 % publicly owned. The largest single stake in the nominal capital is held by the *Land* (43,2 %). Other shareholders are the municipal associations (*Landschaftsverbände*) of Rheinland and Westfalen-Lippe (11,7 % each) as well as the associations of local public savings banks (*Sparkassen- und Giroverbände*) of Rheinland and Westfalen-Lippe (16,7 % each). This ownership structure, which existed at the time of the transfer, has remained unchanged.
- (16) As a public-law institution, WestLB benefits from two forms of guarantees from its public owner: 'institutional responsibility' (*Anstaltslast*) and 'guarantor liability' (*Gewährträgerhaftung*). *Anstaltslast* means that the owners of WestLB are responsible for securing the institution's economic basis and operability for the entire duration of its existence. This guarantee does not create a liability on the part of the public authorities and the bank. Under the terms of the *Gewährträgerhaftung*, the owners meet all the bank's liabilities which cannot be satisfied from its assets. It establishes a liability on the part of the guarantor vis-à-vis the creditors of the bank. Both guarantees are limited neither in time nor in value.
- (17) Originally, WestLB was a regional institution which concentrated on supplementing the activities of local savings banks. Which in turn focused initially on a primarily social function, providing financial services in sectors characterised by market failure. However, the savings banks have long since developed into all-purpose credit institutions. Likewise, over the last
- (18) At the time of the transfer, the WestLB group ranked third among German credit institutions behind Deutsche Bank AG and Dresdner Bank AG when measured by balance-sheet total.
- (19) The WestLB group offers financial services to enterprises and public institutions⁽⁵⁾ and is an important player on international capital markets, both for its own account and as manager of other issuers' debt instruments. Like many German all-purpose banks, WestLB holds stakes in financial and non-financial enterprises. According to its annual report, WestLB operated banking offices in 24 countries at the end of 1991. One year later that number had risen to more than 30, of which 16 were in European countries. By the end of 1997 WestLB was present in more than 35 countries worldwide.
- (20) In 1997 WestLB's business operations outside Germany accounted for some 46 % (of which 28 percentage points in Europe) of the non-consolidated interest surplus, 48 % (of which 41 percentage points in Europe) of non-consolidated net income from financial transactions, 62 % (of which 45 percentage points in Europe) of non-consolidated commission surplus and 68 % (of which 60 percentage points in Europe) of non-consolidated other operating income.
- (21) According to its annual report, WestLB held at the end of 1997 major direct or indirect stakes (at least 10 % of total equity) in the following companies outside the financial services sector: Thomas Cook Group (100 %), Thomas Cook Reisebüro (100 %), Thomas Cook Inc. (100 %), TUI (30 %), First Reisebüro (20 %), First Reisebüro Management (22 %), LTU Gruppe (34 %), Köln-Düsseldorfer Deutsche Rheinschiffahrt (89 %), Kaufhof Warenhaus (13 %), TA Triumph Adler (19 %), Accumulatorenwerke Hoppecke Carl Zöllner & Sohn (25 %), Telius Grundstücksverwaltungs-Gesellschaft (20 %), Preussag (about 30 %; plus a 10 % stake held by Niedersachsen Holding, in which WestLB has a 33 % interest), Deutsche Babcock AG (10 %), Märkische Faser (100 %), Mühl Product & Service und Thüringer Baustoffhandel (25 %), ISIS Multimedia Net (50 %), Schuh-Union (36 %), AW-Beteiligungs BmbH (24 %; this company has a 10 % stake in Fresenius), Kommunale Energie-Beteiligungsgesellschaft (28 %; this company has
- ⁽⁵⁾ At 31 December 1991 55,6 % of WestLB group's long-term claims on customers were loans to public institutions (Annual Report 1991, p. 72). At 31 December 1997 such loans had accounted for 32,9 % of WestLB group's total claims on customers (Annual Report 1997, p. 74).

a 38 % stake in VEW), Westdeutsche Lotterie (100 %) and Westdeutsche Spielbanken (100 %).

(22) WestLB also has a number of important holdings in the financial services sector and runs a number of subsidiaries. Furthermore, under special legal provisions, WestLB, like other public credit institutions but unlike private banks, may conduct its mortgage-lending and savings-bank activities under the same organisational roof as its other operations. WestLB therefore ranks as one of Germany's most comprehensive all-purpose banks.

(23) On the other hand, WestLB does not operate a dense network of retail branches. This market segment is covered by the local savings banks, for which WestLB acts as the central institution. The balance-sheet

structure of WestLB reflects this circumstance. Liabilities to banks accounted in 1997 for 38 % of the group's total liabilities, bonds issued for 28 % and liabilities to customers for 26 %. In connection with liabilities to other banks, it should be noted that local savings banks are required by law to deposit surplus liquidity with WestLB⁽⁶⁾. Funding through other credit institutions and the financial markets is facilitated by the bank's triple-A rating.

(24) WestLB's profitability, measured by pre-tax profits as a percentage of capital and reserves at group level, did not exceed 6,6 % on average over the eight years preceding the transfer of Wfa (1984 to 1991) and showed no clear upward tendency. This performance is substantially below the German as well as the European average.

(25) Table 1: Key figures from the WestLB group's annual reports

(million DEM)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total assets	178 821	205 205	230 305	274 708	332 615	378 573	428 622	470 789	603 798
Claims on banks	64 485	67 495	69 628	75 401	87 940	109 150	130 753	146 957	202 475
Claims on customers	81 756	93 595	109 859	137 714	157 469	170 745	174 485	180 083	227 974
Bonds	18 560	28 243	31 084	40 011	60 108	68 600	75 805	95 589	125 867
Holdings	1 516	2 689	2 776	3 769	4 268	4 949	5 141	5 606	5 238
Liabilities to banks	55 642	69 641	78 110	92 806	115 871	129 346	157 784	169 928	228 717
Liabilities to customers	40 045	45 221	50 305	57 648	79 411	91 580	98 425	111 306	156 048
Documented liabilities	69 964	75 317	84 550	92 295	101 803	123 231	135 760	150 645	170 002
Equity under German Commercial Code	4 694	5 000	5 012	11 057	11 474	12 216	12 496	12 431	13 420
Other capital and reserves	500	500	500	500	4 538	5 203	5 312	6 560	10 041
Interest surplus	1 419	1 370	1 510	1 757	2 961	3 127	3 308	3 265	3 724
Commission surplus	312	331	371	470	1 528	1 512	1 393	1 652	1 993
Other income	1 459	1 264	1 476	1 754	1 982	1 932	1 686	1 457	2 537

⁽⁶⁾ Section 4(2) of the Decree regulating the business activities of savings banks in North Rhine-Westphalia (*Verordnung zur Regelung des Geschäftsrechts und des Betriebes der Sparkassen in Nordrhein-Westfalen*).

(million DEM)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Administration	1 460	1 643	1 773	2 010	3 411	3 390	3 651	4 287	4 883
Other expenses	1 232	1 213	1 165	1 615	2 065	2 317	1 431	1 786	2 023
Taxes	154	51	192	123	514	437	637	566	620
Net income	344	58	227	233	481	427	668	735	728
Group profit	90	95	95	119	134	136	161	162	186

- (26) As can be seen from the above table, the WestLB group increased its balance-sheet total between 1991, i.e. before the transfer, and 1997 by 263 %. The balance-sheet total of WestLB alone increased in the same period from DEM 211 500 million (EUR 108 100 million) to DEM 456 700 million (EUR 233 500 million), i.e. by 216 %.

2. Wohnungsbauförderungsanstalt (Wfa)

- (27) Wfa was founded in 1957 and operated until 31 December 1991 as a public-law institution (*Anstalt des öffentlichen Rechts*). As such, it was an independent entity with nominal capital of DEM 100 million (EUR 50 million) and the *Land* of North Rhine-Westphalia as the sole shareholder. Under Section 6(1) of the former North Rhine-Westphalian Law on the promotion of housing (*Wohnungsbauförderungsgesetz*)⁽⁷⁾, Wfa devoted itself exclusively to the promotion of housing by granting low-interest or non-interest-bearing loans. On account of its non-profit character, it was exempt from corporation tax (*Körperschaftsteuer*), property tax (*Vermögenssteuer*) and tax on business capital (*Gewerbekapitalsteuer*).
- (28) As a public-law institution, Wfa was covered by the *Land's* 'institutional responsibility' (*Anstaltslast*) and

guarantor liability (*Gewährträgerhaftung*) for all its liabilities. These guarantees were not changed on account of the transfer.

- (29) The largest single source of financing for the housing-promotion activities was and still is, the *Land* housing promotion fund (*Landeswohnungsbauvermögen*), which has been built up from interest income from housing loans granted by Wfa and annual cash injections from the *Land* budget. These resources, earmarked to serve exclusively as the funding base for housing loans by virtue of Section 16 of the Law on the promotion of housing, accounted for some 75 % of Wfa's refinancing, i.e. DEM 24 700 million (EUR 12 600 million) as at 31 December 1991.
- (30) Prior to the transfer, Wfa guaranteed *Land* liabilities incurred for housing promotion purposes. Each year, in line with the *Land's* repayments of its liabilities, Wfa's guarantee was transformed into reimbursement claims of the *Land* against Wfa which reduced the value of the *Land* housing promotion fund accordingly. These liabilities of Wfa would have fallen due only when it no longer needed its revenues from interest and loan recovery in order to perform its public tasks. They amounted to about DEM 7 400 million (EUR 780 million) at the end of 1991 and were not shown directly in the balance sheet but only 'below the line'.

(31) Table 2: Key figures from Wfa's annual reports

(million DEM)

	1990	1991	1992	1993	1994	1995	1996	1997
Total assets	33 234	33 049	34 953	36 487	38 021	42 365	42 988	44 041
Claims on customers	30 721	30 661	32 313	34 367	35 991	37 759	38 455	39 735
Liabilities to banks	4 952	5 001	6 201	6 853	7 271	8 058	7 593	7 737
<i>Land</i> Housing Promotion Fund and nominal capital	23 836	24 779	25 768	26 896	28 125	29 406	30 847	32 116

⁽⁷⁾ *Wohnungsbauförderungsgesetz*, in the version published on 30 September 1979 (Official Gazette of North Rhine-Westphalia, p. 630).

	(million DEM)							
	1990	1991	1992	1993	1994	1995	1996	1997
Reserves	134	138	142	142	142	142	142	142
Loans repaid	1 000	2 000	1 000	1 100	1 200	1 300	2 000	1 800
Loans granted	2 000	2 000	2 600	2 800	3 100	3 000	2 700	3 100
Interest income	365	393	410	414	436	477	561	586
Land interest subsidy	36	0	0	25	55	78	12	0
Other income	52	35	36	47	48	43	45	39
Interest expenses	78	123	187	262	304	357	367	360
Other expenses	124	106	103	103	92	115	104	108
Allocation to Land Housing Promotion Fund	248	197	156	120	143	127	147	156
Profit	4	4						

3. Capital requirements under the Own Funds Directive and the Solvency Ratio Directive

(32) Under Council Directive 89/647/EEC on a solvency ratio for credit institutions⁽⁸⁾ (Solvency Ratio Directive) and under the Own Funds Directive, banks must have own funds equivalent to at least 8 %⁽⁹⁾ of their risk-adjusted assets and risk-bearing off-balance-sheet transactions⁽¹⁰⁾. These Directives necessitated amendments to the German Banking Law which took effect on 1 January 1992. The new requirements entered into force on 30 June 1993⁽¹¹⁾. Until that date German credit institutions were obliged to have own funds equivalent to 5,6 % of their risk-adjusted assets⁽¹²⁾.

(33) As for the new threshold of these own funds have to be original own funds (*Basiseigenmittel*), which consist of capital items available to a credit institution for unrestricted and immediate use to cover losses as soon as they occur. Original own funds are therefore of crucial importance for the level of a bank's total own funds for prudential purposes, as other own funds of

lower quality, or 'additional own funds' (*ergänzende Eigenmittel*), are accepted only up to the amount of original own funds to underpin the risk-bearing business of a bank.

(34) Moreover, the amount of own funds limits a bank's exposure to large risks. At the time of Wfa's transfer, the German Banking Law (Section 13) laid down that no single loan granted may exceed 50 % of a bank's own funds and that the total of such loans exceeding 15 % of a bank's own funds may not be higher than eight times the bank's own funds. An amendment of the German Banking Law in 1994 to bring it into line with Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions⁽¹³⁾ reduced the maximum loan to 25 % of a bank's own funds and laid down that the sum of single loans exceeding 10 % of a bank's own funds may not be higher than eight times the total of own funds⁽¹⁴⁾.

(35) The size of qualifying holdings in other credit and financial institutions is limited by Article 12 of Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC⁽¹⁵⁾. Furthermore, a special provision in the German Banking Law (Section 12), not based on

⁽⁸⁾ OJ L 386, 30.12.1989, p. 14.

⁽⁹⁾ The capital requirements must be met by credit institutions on a consolidated, a subconsolidated and an unconsolidated basis.

⁽¹⁰⁾ The term 'risk-adjusted assets' is used below to describe all risk-bearing and risk-adjusted items.

⁽¹¹⁾ In fact, the new capital requirements should already have entered into force on 1 January 1993 but were implemented late in Germany.

⁽¹²⁾ However, this figure was based on a definition of own funds that was narrower than the one set out in the Own Funds Directive.

⁽¹³⁾ OJ L 29, 5.2.1993, p. 1.

⁽¹⁴⁾ It should, however, be pointed out that not only the thresholds were changed but also the definitions of 'own funds' and of 'risk-adjusted assets'.

⁽¹⁵⁾ OJ L 386, 30. 12. 1989, p. 1.

European legislation but found in other Member States limits the total amount of long-term investments, including holdings in non-financial enterprises, to the total amount of the bank's own funds.

- (36) German banks had to adapt to the new capital requirements by 30 June 1993. The own funds cushion of many Landesbanks, including WestLB, was already comparatively small before transposal of the Solvency Ratio Directive into German law. According to test calculations made by the Deutsche Bundesbank in December 1991 on the basis of the provisions of the Directives, the Landesbanks had an average solvency ratio of [...] %, compared with the 8 % required from 30 June 1993⁽¹⁶⁾. There was therefore an absolute need for these institutions to raise new capital in order to avoid restrictions on their business expansion and indeed to maintain their current level of activities. If a bank cannot demonstrate the necessary level of own funds, it will be ordered by the supervisory authorities to take immediate action to comply with the solvency rules either by raising additional capital or by reducing risk-adjusted assets.
- (37) Private banks had to satisfy additional demand for own funds on the capital markets. Public banks could not move in the same direction, as public shareholders decided not to privatise (even in part) their credit institutions. Yet the generally tight budgetary situation meant that the public shareholders could not undertake cash injections of capital⁽¹⁷⁾. Instead, other solutions were found to provide additional capital. In the case of WestLB, the *Land* decided to transfer Wfa to WestLB in order to strengthen the latter's own funds base. Similar transactions were carried out by some other *Länder* in favour of their respective Landesbanks.

4. The transfer and its effects

(a) *The transfer*

- (38) On 18 December 1991 the parliament of North Rhine-Westphalia passed a law governing the promotion of housing (*Gesetz zur Regelung der Wohnungsbauförderung*)⁽¹⁸⁾, Article 1 of which ordered the transfer of Wfa to WestLB. The transfer became effective on 1 January 1992.
- (39) According to the grounds of the Law, the primary reason for the transfer was to increase WestLB's own

funds to enable it to comply with the stricter capital requirements entering into force on 30 June 1993. By way of the transfer this could be done without any financial burden on the *Land* budget. Combining the housing promotion activities of Wfa with those of WestLB was to have the secondary effect of increasing efficiency.

- (40) As part of the transfer, the *Land* waived Wfa's guarantee of about DEM 7 400 million (EUR 3 780 million) for liabilities of the *Land* in connection with funds raised for housing promotion (see point II.2.).
- (41) WestLB became the universal legal successor to Wfa (except for Wfa's liability vis-à-vis the *Land* for debts entered into by the *Land* for reasons of housing promotion, which was waived prior to the transfer). Wfa became an organisationally and economically independent public-law institution without legal capacity within WestLB. Wfa's nominal capital and reserves must be shown in WestLB's balance sheet as a special reserve (*Sonderrücklage*). The *Land* continues to guarantee Wfa's liabilities under the *Anstaltslast* and *Gewährträgerhaftung*.
- (42) The assets transferred, i.e. nominal capital, capital reserves, the *Land* housing promotion fund and other claims of Wfa, as well as any future return flows from housing loans, remained earmarked for housing promotion under Article 2, Section 16(2) of the law even after their transfer to WestLB. The same provision established that the assets transferred also serve as equity capital within the meaning of the German Banking Law (and hence the Own Funds Directive), on the basis of which the solvency ratio of a bank is calculated. Therefore, they also underpin WestLB's competitive business.
- (43) On the occasion of the transfer, WestLB's owners changed the covering agreement (*Mantelvertrag*) and agreed that the assets earmarked for housing promotion must always be preserved, even if WestLB suffered losses which absorbed the original capital. Internally, Wfa's capital should be subordinate in its liability only to WestLB's remaining equity. It was clarified in the agreement that WestLB's owners' 'institutional responsibility' (*Anstaltslast*) also covers Wfa's special reserve. If WestLB were to be wound up, the *Land* would have a priority claim on Wfa's capital. It was also stated in this covering agreement that the increase in WestLB's equity base through the integration of Wfa constitutes an act in money's worth (*geldwerte Leistung*) by the *Land* and that the annual remuneration for this

⁽¹⁶⁾ Deutsche Bundesbank, monthly report, May 1993, p. 49.

⁽¹⁷⁾ See, for example, Document 11/2329 of the parliament of North Rhine-Westphalia.

⁽¹⁸⁾ *Gesetz zur Regelung der Wohnungsbauförderung* of 18 December 1991 (Official Gazette of the *Land* of North Rhine-Westphalia, No 61 of 30 December 1991, p. 561).

act should be agreed on by the owners once the first financial results for the years from 1992 onwards were available⁽¹⁹⁾. This was done in a protocol note to the covering agreement dated 11 November 1993. Notwithstanding the internal agreement to guarantee Wfa's assets and the internal subordination of Wfa's capital, no distinction is drawn in WestLB's external relationships between Wfa's housing promotion activities and its function as a provider of own funds to WestLB. The transferred assets are fully and instantaneously available to WestLB to cover losses or, in the event of bankruptcy, to cover creditors' claims.

- (44) The management contract regarding the housing promotion law (*Geschäftsbesorgungsvertrag zum Wohnungsbauförderungsgesetz*) concluded between the Land and WestLB lays down that WestLB will use the special reserve to underpin its own business activities only in so far as fulfilment of Wfa's legally binding tasks is guaranteed.
- (45) Although Wfa lost its legal independence by becoming a housing promotion division of WestLB and is integrated into WestLB's accounts, it was not integrated operationally into WestLB but remained a distinct entity within WestLB under the name *Wohnungsbauförderungsanstalt Nordrhein-Westfalen — Anstalt der Westdeutschen Landesbank Girozentrale*. This new housing promotion division of WestLB is included in WestLB's accounts but also publishes separate ones. WestLB's existing housing promotion department was merged with Wfa.
- (46) Wfa's transferred capital, reserves, other assets and future profits are still earmarked for housing promotion and must therefore be administered separately from WestLB's other commercial activities. At the same time this separation is a prerequisite for continuing recognition of the housing promotion activities as non-profit-making under German tax legislation. Since the German authorities assumed that the integrated Wfa did indeed remain a non-profit-making entity, the tax exemptions mentioned at point II2 were not abolished.
- (47) WestLB's competitors also opposed the merger of the monopoly-like Wfa and WestLB because they feared that WestLB would be able to take advantage of information gathered in the housing promotion field to acquire new customers for its commercial business. The

authorities responsible have undertaken to ensure that no distortions of competition are caused by such proximity, in particular by separating the housing promotion division from the commercial divisions of WestLB in terms of personnel, information, etc.⁽²⁰⁾.

(b) *Value of Wfa*

- (48) As at 31 December 1991 the nominal value of Wfa's capital transferred to WestLB was about DEM 24 900 million (EUR 12 730 million), of which nearly DEM 24 700 million (EUR 12 680 million) was accounted for by the Land housing promotion fund. However, these resources served to finance housing promotion loans, which are either non-interest-bearing or low-interest loans and often have long grace periods. Therefore, in order to establish its actual value, the nominal capital had to be heavily discounted.
- (49) On 1 January 1992 WestLB commissioned a valuation of Wfa which was delivered on 30 April 1992. It should be noted that the valuation was carried out only after the Land had decided on the transfer of Wfa.
- (50) As to the valuation method, the auditors stated that, because of the continuing obligation to reinvest all future income of Wfa in low-interest or non-interest-bearing housing promotion loans, the institution would in fact have no capitalised earnings value. However, this obligation would cease in the event of the realisation of Wfa. The advantage of Wfa for WestLB was said to consist, firstly, in the increase in own funds and the resulting ability to expand business and, secondly, in the increase in its credit standing following the considerable strengthening of its equity capital. Since WestLB received no advantage from Wfa's normal activities, the latter's value had to be established as the possible proceeds in the event of its sale — without the reinvestment obligations that exist only in the internal relationship. The assets had to be valued at an amount which would result in a normal return, i.e. they had to be discounted to a value which could serve as a basis for considering their nominal return flows as a normal market return.
- (51) The auditors revalued various items of Wfa's assets and liabilities — the housing loans were adjusted from DEM 30 700 million (EUR 15 700) to DEM 13 500 (EUR 6 900 million), i.e. by 56 % and arrived at a net asset value for Wfa of DEM 5 900 million (EUR 3 020 million). This corresponds to an overall discount of 76 % when compared with the nominal net asset value of Wfa of DEM 24 900 million (EUR 12 700 million) at

⁽¹⁹⁾ According to the German Government, the expression 'act in money's worth' used there is in fact imprecise and was clarified later.

⁽²⁰⁾ Section 13 of the law concerning the asset transfer states that the housing promotion division must carry out its tasks in a manner that is neutral in its effect on competition (*führt ihre Aufgaben wettbewerbsneutral durch*). The actual measures to be taken to this end are laid down in an agreement between WestLB and the Land authorities.

that time. Following this revaluation, DEM 5 900 million (EUR 3 020 million) was entered in WestLB's accounts as a special capital reserve for housing promotion (*Sonderrücklage Wohnungsbauförderungsanstalt*).

(52) After being asked by WestLB to accept an amount of DEM 5 900 million (EUR 3 020 million) as WestLB's original own funds, BAKred commissioned another auditing firm to carry out a valuation. This valuation was delivered on 30 September 1992. The valuation for BAKred examined the plausibility of the one made for WestLB and accepted its methodological approach. However, mainly because of the choice of a different discount rate and differing treatment of possible redemptions before maturity (*Vorfälligkeitstilgungen*), the valuation for BAKred arrived at a net asset value for Wfa ranging from DEM 4 000 million (EUR 2 050 million) to DEM 5 400 million (EUR 2 760 million).

(53) On the basis of this valuation, BAKred finally accepted on 30 December 1992 DEM 4 000 million (EUR 2 050 million) as WestLB's original own funds within the meaning of the German Banking Law. Neither the amount shown in WestLB's balance sheet — DEM 5 900 million (EUR 3 020 million) — nor the amount accepted as original own funds has been changed since.

(54) Both valuations of the transferred assets were based on the situation after the waiver of Wfa's liability vis-à-vis the *Land*, which they valued at around DEM 7 300 million (EUR 3 730 million).

(c) *Effects of Wfa's transfer on WestLB*

(55) On 31 December 1991 WestLB's recognised own funds came to DEM 5 100 million (EUR 2 600 million), of which DEM 500 million (EUR 260 million) were profit participation certificates (*Genußrechte*). The bank's solvency ratio was around [...] % on the basis of the provisions of the German Banking Law before its adaptation to the EU Banking Directives, i.e. [...] percentage points above the minimum level stipulated by that Law.

(56) As a result of the acceptance of Wfa's capital as own funds of WestLB by BAKred, WestLB's total own funds were boosted to DEM 9 100 million (EUR 4 650 million), an increase of 79 %. Taking into account an allocation of DEM 100 million (EUR 50 million) to reserves from profits, WestLB's own funds amounted to DEM 9 200 million (EUR 4 700 million) at 31 December 1992. This corresponded to a solvency ratio of [...] %, including Wfa's capital and the risk-adjusted assets.

(57) Table 3: Capital requirements and own funds of WestLB and Wfa (based on data provided by the German authorities)

(million DEM)		
(At 31 December)	1991	1992
Risk-adjusted assets of WestLB (without Wfa)	[...]	[...]
Risk-adjusted assets of Wfa	[...]	[...]
Risk-adjusted assets of WestLB (with Wfa) (*)		[...]
Required own funds of WestLB (**) (= a)	[...]	[...]
Required own funds of WestLB without Wfa (**) (= b)		[...]
WestLB own funds (=c)	5 090	9 190
West LB own funds without Wfa (=d)		5 190
Utilisation rate of WestLB own funds (=a/c)	[...] %	[...] %
Utilisation rate of WestLB own funds without Wfa (=b/d)		[...] %

(*) The transfer of Wfa took effect on 1 January 1992.

(**) Based on the 5,6 % requirement in force at that time.

- (58) This solvency ratio of [...] % includes an increase in WestLB's risk-adjusted assets unrelated to housing promotion of some DEM [...] (EUR [...]), or 9,9 %, in 1992. If this increase had taken place without the transfer of Wfa, WestLB's solvency ratio would have fallen to [...] % by 31 December 1992 [...].
- (59) Whereas all of Wfa's capital is tied up in its housing promotion activities, only part of its own funds within the meaning of the solvency rules is needed to underpin its risk-adjusted assets. According to information provided by the German authorities, DEM 1 500 million (EUR 770 million) was needed for this purpose at the time when the new capital requirements entered into force. This means that the remaining DEM 2 500 million (EUR 1 280 million) could be used by WestLB at that time as own funds to underpin its competitive business.
- (60) On 31 December 1991 the solvency ratio of the WestLB group was [...] %, i.e. [...] percentage points above the minimum. One year later, after Wfa's capital had been accepted by BAKred, the ratio was about [...] %, including Wfa's risk-adjusted assets. If the asset transfer had not taken place and the group had increased its non-housing-related risk-bearing assets as it actually did, the group's solvency ratio would have fallen to [...] %, or [...] percentage points [...] the minimum level required at the time.
- (61) On 30 June 1993, when German credit institutions had to comply with the new capital requirements set by the Own Funds Directive and the Solvency Ratio Directive, the group's solvency ratio (including Wfa's capital requirements), calculated on the basis of the new provisions, was [...] %, i.e. [...] percentage points above the minimum level. (The original own funds accounted for [...] percentage points, additional own funds for [...] percentage points.) Excluding Wfa's capital contribution and its risk-adjusted assets, the group would have had a solvency ratio of about [...] % as at 30 June 1993. The ratio of [...] % was achieved by raising more additional own funds in the form of subordinated loans amounting to some DEM 2 900 million (EUR 1 480 million) in early 1993. Over the whole of 1993 WestLB raised DEM 3 100 million additional own funds, bringing the total own funds of the group within the meaning of the German Banking Law to DEM 12 900 million (EUR 6 600 million) by the end of that year. The solvency ratios had fallen slightly by the end of 1993, compared with 30 June.

(62) Table 4: Capital requirements and own funds of the WestLB group (based on data provided by the German authorities)

(million DEM)							
Average amounts	1992 (*)	1993	1994	1995	1996	1997	1998
Total assets	271 707	332 616	378 573	428 622	470 789	603 797	
Risk-adjusted assets	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Required original own funds (=a)	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Required total own funds (=b)	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Original own funds (=c)	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Additional own funds	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Total own funds (=d)	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Utilisation rate of original own funds (=a/c)	[...] %	[...] %	[...] %	[...] %	[...] %	[...] %	[...] %
Utilisation rate of total own funds (= b/d)	[...] %	[...] %	[...] %	[...] %	[...] %	[...] %	[...] %

(*) Anomalies in this year should be attributed to changes in the method of showing Wfa's assets in the balance sheet, to changes in the definition of own funds and in the solvency ratios, and to the timing of the acceptance of Wfa's capital by BAKred.

- (63) In absolute figures, the original own funds of DEM 4 000 million (EUR 2 050 million) increased by DEM 72 000 million (EUR 36 800 million) the theoretical capacity to extend business volume with 100 % risk-adjusted assets under the former German Banking Law (5,6 % minimum solvency ratio). On the basis of the minimum solvency ratio of 8 % applicable since 30 June 1993, the relevant figure would be DEM 50 000

million (EUR 25 600 million). Assuming that DEM 2 500 million (EUR 1 280 million) of Wfa's capital was available to the WestLB group's competitive business, its 100 % risk-adjusted lending capacity was increased by DEM 31 300 million (EUR 16 000 million).

increased by DEM 32 000 million (EUR 16 400 million) (i.e. eight times the increase of own funds) as a result of the transfer of Wfa⁽²²⁾.

(d) *Remuneration for the transfer of Wfa*

(64) However, since a bank's assets are normally not 100 % risk-adjusted, the actual credit volume capacity increased by a greater amount. At the end of 1993 the WestLB group's risk-adjusted assets (including Wfa's business) amounted to DEM [...] (EUR [...]). The balance-sheet total came to DEM 332 600 million (EUR 170 100 million). This indicates an average risk-weighting of [...] %⁽²¹⁾. Given a constant risk structure, the DEM 2 500 million (EUR 1 280 million) of original own funds available permitted a total expansion (or coverage of existing business) of about DEM [...] (EUR [...]) on the basis of the 8 % threshold laid down in the EU Banking Directives. Since the increase in original own funds allowed WestLB to raise further additional own funds (up to an amount equal to the original own funds), its actual lending capacity was indirectly increased even further.

(65) Several conclusions can be drawn. Firstly, without a capital increase, WestLB would have had difficulties remaining above the minimum solvency ratio under the German Banking Law before its adaptation to the EU Banking Directives. Secondly, without Wfa's transfer, the WestLB group would have satisfied the minimum solvency ratio under the Solvency Ratio Directive only by reducing its risk-adjusted assets or by mobilising other sources of own funds (e.g. disclosure of hidden reserves). The raising of additional own funds could have provided only temporary relief because the level of such funds is limited by the amount of original own funds available. Thirdly, the capital increase, together with the fresh additional own funds raised in 1993, exceeded the amount needed by the group to meet the stricter capital requirements of the revised German Banking Law.

(66) As regards the supervisory restrictions on individual large loans, the 50 % threshold laid down by the former German Banking Law was equivalent to about DEM 2 500 million (EUR 1 280 million) before the acceptance of Wfa's capital. After acceptance of Wfa's capital and a DEM 100 million (EUR 50 million) allocation to reserves from profits, the threshold rose to nearly DEM 4 600 million (EUR 2 350 million). The 15 % threshold stipulated on large loans, which in total may not be higher than eight times the bank's own funds, was equivalent to about DEM 760 million (EUR 390 million) at 31 March 1992. One year later, i.e. after the acceptance of Wfa's capital, the threshold had risen to nearly DEM 1 400 million (EUR 720 million). WestLB's capacity to grant such large loans was

(67) The transfer of Wfa did not lead to a change in the ownership structure of WestLB. Therefore, the *Land* is not remunerated for the capital provided, either by way of a higher share in dividends paid or by way of a higher share in the capital gains of the holdings in WestLB.

(68) As already mentioned, the agreement governing the relationship between the owners of WestLB (*Mantelvertrag*) was amended on the transfer of Wfa. Under Section 5(2) of that agreement, the owners agree that the enlargement of WestLB's capital base by the *Land* constitutes a financial advantage for them. The level of remuneration for the capital provided was to be fixed after WestLB's first financial results for 1992 were known, i.e. a short time after the transfer. The grounds of the law on the transfer contain similar wording as regards the value of the transfer and the remuneration.

(69) The remuneration for the capital provided was finally fixed at an annual rate of 0,6 %. It must be paid by WestLB from profits after tax, giving a pre-tax burden or around 1,1 % for WestLB⁽²³⁾. It is payable only if profits are made.

(70) The basis for this remuneration is the capital of Wfa recognised by BAKred as original own funds, i.e. DEM 4 000 million (EUR 2 050 million). The remuneration is paid only on the part of this capital not needed by Wfa to underpin its housing promotion activities and thus available to WestLB to underpin its commercial business. This part amounted to DEM 2 500 million (EUR 1 280 million) after the new capital requirements entered into force and has been increasing since then⁽²⁴⁾.

⁽²²⁾ It should be borne in mind that, under the new rules, not only the ratios changed but also the definitions of 'own funds' and 'risk-adjusted assets'.

⁽²³⁾ According to a study submitted by the German Government on the remuneration paid by WestLB, the corporation tax rate was 46 % until 1993 and 42 % thereafter. To this must be added a solidarity surcharge of 3,75 % in 1992, 0 % in 1993 and 7,5 % thereafter.

⁽²⁴⁾ For the sake of clarity, where the amount on which the remuneration is to be paid is discussed, reference is always made to the situation at the end of 1993, i.e. the split between DEM 1 500 million (EUR 770 million) and DEM 2 500 million (EUR 1 280 million), irrespective of the fact that the division between the capital tied up in Wfa business and the amount available for WestLB changes.

⁽²¹⁾ This calculation leaves out of account the risk-bearing off-balance-sheet transactions.

- (71) Table 5: Special capital reserve for housing promotion and own fund requirements of Wfa (based on data provided by the German authorities)

(million DEM)

(At 31 December)	1992	1993	1994	1995	1996	1997	1998
Special reserve for housing promotion	5 900	5 900	5 900	5 900	5 900	5 900	5 900
Of which accepted as original own funds	4 000	4 000	4 000	4 000	4 000	4 000	4 000
Needed for housing promotion loans of Wfa	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Available for WestLB	[...] (*)	[...]	[...]	[...]	[...]	[...]	[...]

(*) Since BAKred accepted Wfa's capital only on 30 December 1992, the capital share of DEM [...] (EUR [...]) was available for WestLB in 1992 for two days only. This results in an average available capital for WestLB of DEM [...] (EUR [...]) for that year.

III. COMMENTS FROM INTERESTED PARTIES

1. Complaint and observations by BdB

- (72) BdB submits that the application of the 'market economy investor principle' is not limited to enterprises which are loss-making or in need of financial restructuring. Such an investor is not guided by the question of whether the enterprise in question is profitable at all but rather by whether the profitability corresponds to the market rate. If capital injections by the public authorities were examined only in the case of loss-making enterprises, this would discriminate against private enterprises and thus infringe Article 86(1) of the EC Treaty.

- (73) It also submits that Article 295 of the EC Treaty cannot be used to exempt the transfer of Wfa's assets from the competition rules, arguing that the Article in question may well protect the freedom of the *Land* to create such a special asset but, as soon as it is transferred to a commercial enterprise, the competition rules must be applied.

(a) *Appropriate remuneration for the capital*

- (74) BdB argues that, like any other original own funds, the recognised original own funds of DEM 4 000 million (EUR 2 050 million) can be used to underpin business activities and, at the same time, to raise additional own funds for solvency reasons. Thus, by way of the transfer, the *Land* enabled WestLB, which was operating at the very edge of its equity base, to avoid reducing its business activities and even to expand those business activities open to risk. Furthermore, the amount by which the own funds exceed actual requirements also influences the funding costs on the financial markets.

According to BdB, a market economy investor would not inject capital into his company if that company's financial results had been consistently poor for years and there were no signs of a considerable improvement, i.e. no indications that a higher return could be expected in the future.

(i) *Level of the remuneration*

- (75) BdB stresses that WestLB was in urgent need of original own funds and that the transfer of Wfa nearly doubled WestLB's original own funds from DEM 4 700 million (EUR 2 400 million) to DEM 8 700 million (EUR 4 450 million). No private investor would have brought such a huge amount of equity capital into WestLB, given its weak financial performance at that time. In return for providing capital under such conditions, a private investor would have demanded a premium of at least 0,5 percentage point on top of the normal return on equity capital. BdB quotes WestLB's profitability as an average of 5,6 % before tax for the ten years prior to the transfer. This compares with profitability figures for large private German banks of between 12,4 % and 18,6 %, with an average of 16,8 % (before tax) for the same period. Other Landesbanks are said to have generated profits of between 9 % and 11 %. BdB submitted a calculation of the return on equity of German banks made on its behalf by an external consultancy.

- (76) As regards the appropriate method of calculating a comparison of returns on equity, BdB submits that historical rates of return should be calculated as an arithmetic average, not as a compound annual growth rate. The latter method implies that the investor reinvests dividends and takes the additional income from these reinvestments into account for the calculation. However, the way in which dividends are reinvested cannot influence the original investment

decision but has to be considered as a new, separate decision. A method based on an arithmetical average should therefore be used.

any reduction in the risk attaching to the transferred capital is merely the result of an increased risk for the *Land* as WestLB shareholder. Thus, the risk profile of Wfa's equity is no different from that of normal equity.

(77) If, however, the compound annual growth rate method is used, the average return of some large German private banks for the period 1982 to 1992 comes to 12,54 % after tax. In calculating this figure, BdB took into account all possible holding periods for investments and sales between 1982 and 1992 in order to avoid any possible bias as a result of taking only one base year, if share prices were unusually high or low in that year. Applying many holding periods simultaneously is said to smoothen the effect of stockmarket fluctuations. BdB submits that the corresponding figures given by WestLB are too low because income from the sale of subscription right is not taken into account.

(78) As regards the capital asset pricing model, which is used in the central study provided by WestLB to justify the remuneration of 0,6 %, BdB submitted its own external study, which arrives at returns on equity of 12,21 % (on the basis of the normal risk premium on the German market for the period 1982 to 1991) and 14,51 % (on the basis of a higher expected risk premium), these figures being higher than the ones provided by WestLB. The difference can be attributed to two factors. Firstly, BdB applies a higher risk premium for equity (3,16 % and 5 % respectively). Secondly, it applies a higher beta factor for credit institutions (1,25 %). The risk-free base rate used is the same as in WestLB's calculation. Considering the various methods of calculating return on equity, BdB finally quotes a range of 14 % to 16 % as a normal return on equity.

(79) BdB further states that a private minority shareholder would not inject any additional capital without requesting an increase of his share in the company. Only with such an increase could he duly participate in the profit of, and exercise greater influence on, the company.

(80) BdB also stresses that the agreement between WestLB's shareholders, whereby Wfa's capital should only be subordinate in its liability to the other equity of WestLB, has in fact no real effect because the *Land* must, by virtue of its institutional responsibility (*Anstaltslast*), step in if WestLB is in difficulties. In fact, as owner of WestLB, the *Land* now guarantees not only WestLB's entire liabilities but also Wfa's equity it itself injected, without receiving any remuneration. This means that

(81) As regards the comparison with equity instruments on the financial market submitted by the German Government and WestLB (see later), BdB argues that profit participation certificates (*Genußrechte*) and cumulative perpetual stocks cannot be compared to Wfa's capital. Firstly, they are not accepted as original own funds. (Cumulative perpetual stocks are not even accepted as additional own funds in Germany.) Because it qualifies as original own funds, Wfa's capital allows WestLB to increase further its own funds by raising additional own funds. Secondly, the instruments referred to are limited in time and profit participation certificates lose their additional own funds character two years before maturity. Wfa's capital is, however, at WestLB's disposal for an unlimited period. Thirdly, such instruments normally provide only a limited part of a Bank's own funds and require a considerable share of original own funds. Fourthly, capital market instruments can be traded on the markets, which means that an investor can terminate his investment whenever he wants. The *Land* does not have this opportunity. In return for accepting such a lack of trading possibilities, a private investor would demand a premium of at least 0.5 percentage point on his normal return.

(82) BdB also provided the Commission with data on the equity components and solvency ratios of some large German private banks from 1990 onwards. These data show that, at the beginning of the 1990s, no hybrid original own funds instruments were in fact available to (or at least used by) German banks. It also transpires from that information that these credit institutions generally had solvency ratios well above the minimum requirements of 4 % for original own funds and 8 % for total own funds.

(83) BdB also comments on the covering agreement between the shareholders of WestLB, which stipulates that, internally, Wfa's capital is subordinate in its liability only to the other liable equity capital. Since the expression other liable equity capital also covers additional own funds instruments like profit participation certificates and subordinated loans and is therefore detrimental to their position, it argues that the agreement is a contract at the expense of third parties (*Vertrag zu Lasten Dritter*) and thus void. The risk profile of Wfa's special reserve is therefore said to be higher than that of profit participation certificates and subordinated loans.

(84) For all these reasons, BdB assumes that the remuneration of 0,6 % paid by WestLB does not constitute a market rate. Taking into account WestLB's need to raise liquid funds in order to use Wfa's capital in full and the lack of participation in the accumulated reserves because the *Land's* share in WestLB did not increase, BdB suggests a rate within the range of 14 % to 17 % as correct remuneration. This rate should be paid on the total accepted amount of DEM 4 000 million (EUR 2 050 million).

(ii) Liquidity costs

(85) In its complaint BdB accepted the 'liquidity costs' (described later), so that a reduction of about 7 percentage points should be applied when calculating the appropriate remuneration for the capital. However, it claimed that, because the equity also served to underpin off-balance-sheet business not requiring liquid funds, this figure should in fact be lower.

(86) In its observations on the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, BdB argues that 'liquidity costs' should not be taken into account in calculating the appropriate return on Wfa's capital. These costs are said to have been taken into account already when discounting Wfa's assets to the value of DEM 5 900 million (EUR 3 020 million). Moreover, several banking activities, for example guarantees, do not require any liquidity at all. So, if any costs at all are taken into account, then it should only be a small margin of 2,7 percentage points in order to offset the fact that Wfa's assets are locked up in unprofitable business. BdB submitted an outside expert's opinion on this point.

(87) The 7,5 % figure for refinancing costs claimed by WestLB is also said to be too high in any case. On the basis of an analysis of the average market rates in the different years for the various refinancing instruments and in accordance with WestLB's balance-sheet structure, the actual rate for WestLB's refinancing on the markets is said to be an average of between 6,07 % and 6,54 % for the years 1992 to 1996. BdB also provided the Commission with figures for the refinancing costs of some large German private banks at the time of the transfer, which were considerably lower than the 7,5 % claimed by WestLB as appropriate refinancing costs at an earlier stage of the procedure. Moreover, according to BdB, a distinction must be drawn between figures before tax and figures after tax. Refinancing costs reduced the taxable profit. So, if any refinancing costs are taken into account, only the rates applied after tax should be considered.

(iii) Capital basis for the calculation of the remuneration

(88) As already mentioned, BdB suggests that a rate within the range of 14 % to 17 % should be paid on the total accepted amount of DEM 4 000 million (EUR 2 050 million). However, it claims in its observations that not only this amount, recognised by BAKred as original own funds, but also the excess amount of DEM 1 900 million (EUR 970 million), which cannot be used to underpin business but is nevertheless shown as equity in the balance sheet, benefits WestLB. Rating agencies and investors did not look at the accepted original own funds but at the total equity shown in the balance sheet, as the latter forms the basis for commercial estimates of what is available to cover losses. This amount therefore increases WestLB's credit standing and a remuneration comparable to a guarantee premium should be paid for it.

(iv) Synergy effects

(89) According to BdB, the claimed synergy effects did not constitute the real reason for the transfer. This is said to be apparent from the fact that the law on the transfer justifies the measure on the grounds of the need to strengthen WestLB's competitive position and from the agreement that a remuneration should be paid for the act in money's worth.

(90) Furthermore, BdB questions how synergy effects can be achieved while Wfa's and WestLB's commercial businesses are separated from each other in economic, organisational and personnel terms, as provided for in the relevant legal provisions. If synergies did emerge in Wfa's activities, they would reduce the costs of housing promotion but could not be regarded as remuneration for the *Land* from WestLB.

(b) Tax aspects

(91) BdB points out that Wfa remained exempt from property tax, tax on business capital and corporation tax even after the transfer. Tax exemptions for public-law credit institutions are justified only as long as these institutions are engaged exclusively in promotional activities and thus do not operate in competition with private taxable institutions.

(92) According to BdB, a normal bank increasing its capital would each year have to pay 0,6 % property tax and 0,8 % tax on business capital on this additional capital. WestLB is therefore in a favourable position compared

with other banks. The exemption from corporation tax is said to benefit WestLB indirectly. The waiver of tax income constitutes State aid within the meaning of Article 87(1) of the EC Treaty.

(c) *Waiver of liability*

- (93) Prior to the transfer, Wfa was released from liabilities of DEM 7 100 million (EUR 3 770 million) vis-à-vis the *Land* waived these liabilities without asking for any consideration for this either from Wfa or from WestLB. A market economy investor would have asked for a consideration for such a waiver. The waiver was also a decisive prerequisite for the acceptance by BAKred of original own funds of DEM 4 000 million (EUR 2 500 million). WestLB therefore profited directly from the waiver.

2. Observations by other interested parties

- (94) Besides WestLB and BdB, two other interested parties commented on the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty.

(a) *Association Francaise des Banques*

- (95) *Association française des Banques* argues that the transfer of own funds to WestLB, for which only an insignificant remuneration was sought, and the continuing guarantee for the bank from the *Land* lead to distortions of competition to the detriment of French credit institutions. Since WestLB's owners demanded a return on their capital that was clearly below the normal level, WestLB could offer its services at below cost (dumping). As it benefits from guarantor liability, WestLB has a triple-A rating which allows it to refinance on the markets on very favourable terms.

- (96) These advantages place French banks operating in Germany at a disadvantage. At the same time, WestLB can, under these special conditions, develop its business in France, especially in the sector of municipal finance. Competition within the banking sector is distorted in Germany, France and other Member States.

(b) *British Bankers' Association*

- (97) The British Bankers' Association argues that WestLB is an active competitor against non-German banks within Germany and across the European market. Therefore, any aid granted to WestLB has a distorting effect on

trade within the Community. It calls on the Commission to uphold the principles of the single market and not to exempt publicly owned banks from the competition rules of the Treaty.

3. Observation by WestLB

- (98) Following publication of the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, WestLB submitted as its position a copy of the German Government's observations on the same question and declared itself fully in agreement with that statement. Thus, the arguments of the German Government generally reflect the position of WestLB, which is therefore presented only briefly.

(a) *General observations on the transfer*

- (99) According to WestLB, the market economy investor principle is not applicable to investments in economically sound and profitable enterprises. This is said to have been confirmed by the Court, which had in the past applied that principle only in cases where, at the time of the investment decision, the enterprise in question had already been operating at a loss for a considerable time and was active in a sector characterised by structural overcapacity. It is claimed that there is no basis in case-law for applying the principle to sound and profitable enterprises.

- (100) WestLB submits that, given Wfa's special purpose, its assets are not comparable to normal funds. The transfer to WestLB of the otherwise unusable Wfa assets represents the most commercially sensible use of these assets. By means of the transfer the *Land* had optimised the use of funds earmarked for housing promotion. A private owner would have acted in the same way.

- (101) According to WestLB, an increase in the *Land's* participation following the transfer would be not only unnecessary but also incompatible with the particular risk profile of Wfa's capital. Because of the lack of liquidity, the transfer cannot be compared to other capital injections. Other equity instruments on the market also do not carry voting rights.

- (102) It is claimed that, since the remuneration received by the *Land* was a reasonable price, there was no need to ask for any increase in WestLB's profitability. Furthermore, it was not apparent why a market economy investor would require a certain target profit if he invested in a profitable company. Because WestLB

had made a profit in the past, there was also no need to establish any restructuring plan. Such a plan was required by the Court only in cases of restructuring aid for loss-making enterprises.

(b) *Appropriate remuneration for the capital*

- (103) According to WestLB, the remuneration paid for the capital in question is appropriate. In support of this opinion, WestLB submitted a report from an investment bank which was commissioned by WestLB to assess the remuneration. The expert report compares the risk profile of Wfa's capital with that of other equity instruments on the capital markets and, on the basis of this comparison, identifies a rate within the range of 0,9 % to 1,4 % as appropriate remuneration for Wfa's capital. This compared with costs of about 1,1 % (before tax) for WestLB for the use of Wfa's capital. WestLB stresses that, in order to be used in full, the capital requires additional refinancing costs, which are given in different documents in the range of 7,5 % to 9,3 %.

- (104) WestLB also submits that the figures presented by BdB for the return on equity of German banks are not correct for several reasons. Because of specific stock exchange developments, the investment period used by BdB for the calculation led to particularly high returns. The arithmetical average used by BdB did not produce correct results, as the compound annual growth rate method should be used for such calculations. BdB included in its calculation investment periods which were not relevant for an investment decision in 1992 and, because it took into account all possible holding periods, it counted individual years several times over. The banks used by BdB for computing an average rate of return on equity for large German banks could not be compared to WestLB because of differing core businesses. According to WestLB, the average return on equity of 16,6 % presented by BdB falls to 5,8 % after adjustments for all these factors.

(c) *Synergy effects*

- (105) According to WestLB, the integration of Wfa into WestLB led to considerable cost savings for Wfa. In the first two years Wfa's staff of 588 (staff within the old Wfa and in the housing promotion division of WestLB, the costs of which had to be borne by Wfa before the transfer) were reduced by 53. In the early years the transfer led to annual savings of DEM 13 million (EUR 7 million) for Wfa as a result of synergies. The reduction in staff numbers should continue and annual savings are expected to increase to around DEM 25 million (EUR 13 million) from 1997 onwards. These amounts are said to benefit exclusively the housing

promotion business of the *Land*. Another document refers to a synergy effect of at least DEM 35 million (EUR 18 million) annually.

- (106) Furthermore, in the course of the merger, changing the pension system for Wfa employees cost WestLB DEM [...] (EUR [...]) in payments to the pension institution of the Federal State and the *Länder*. The payments would reduce Wfa's subsequent expenses.

(d) *Synergy effects*

- (107) According to WestLB, Wfa's exemptions from certain taxes correspond to the system of German tax law whereby the taxes in question do not apply to institutions which serve public purposes and are not in competition with tax-paying institutions. WestLB itself is fully liable to all these taxes and does not benefit from the exemptions applicable to Wfa. It also notes that property tax and tax on business capital have not been levied since 1 January 1997 and 1 January 1998 respectively.

(e) *Waiver of liability*

- (108) As WestLB points out the waiver of the liabilities in question was made before the transfer and subsequent valuation of Wfa's assets. The value of DEM 4 000 million (EUR 2 050 million) therefore reflects the situation without liabilities. Since the remuneration is based on this value, WestLB does not receive any advantage from the waiver.

IV. COMMENTS FROM THE GERMAN GOVERNMENT

- (109) The German Government submits that the transaction does not include any elements of State aid for WestLB within the meaning of the EC Treaty. The *Land* receives an appropriate remuneration which corresponds to the terms of the market. Nor does the transaction constitute State aid for the other shareholders of WestLB as the preservation of the shareholder structure after Wfa's transfer is justified by the appropriate remuneration paid by WestLB. Furthermore, the tax exemptions for Wfa did not include elements of State aid for WestLB, as they did not affect the commercial business of the bank.

- (110) In the opinion of the German Government, the Commission may examine the case only on the basis of the circumstances obtaining at the time of the investment decision, i.e. at the end of 1991. Only these circumstances could have been the basis for the *Land's* investment decision. Subsequent questions and

developments such as the acceptance of own funds by BAKred or the yearly valuation and integration of Wfa's assets and liabilities into WestLB's accounts fall outside the scope of the Commission's investigation.

of WestLB. Because this internal agreement does not affect external legal liability, BAKred accepted the special reserve as original own funds amounting to DEM 4 000 million (EUR 2 050 million) on 30 December 1992.

(111) According to the German Government, plans to integrate Wfa into WestLB date back to the 1970s and the 1980s and were prompted by the view that housing promotion could be made more efficient. Before the transfer, the procedure for receiving a housing loan was very complicated as both Wfa and WestLB were involved, alongside the relevant public authorities. Within WestLB a special housing promotion department was set up, with the costs being borne by Wfa. This structure led to duplication of posts and files and other inefficiencies. Since the transfer, the beneficiaries of housing loans have to deal with only one party instead of two.

1. Market economy investor principle

(115) The German Government notes that the *Land* was in no way obliged to consider privatisation as an alternative to the transfer. Privatisation would have allowed WestLB to approach the capital markets in order to raise the necessary equity. The *Land* was not obliged to open up WestLB to private investors. Such an argument would infringe Article 295 of the EC Treaty.

(112) The Federal Government states further that WestLB could also have met the new solvency criteria by raising additional own funds but that, with a view to securing the long-term functioning of the bank, it seemed reasonable to increase the original own funds. All this shows that the prime reason for the transfer was not to increase WestLB's equity but to achieve potential synergy effects and improve housing promotion procedures. The change in solvency rules merely triggered the process.

(116) An increase in the total return on WestLB's equity is said to be unnecessary, as measures to increase the return are required only if the State invests in loss-making companies. The German Government claims that the Court applied the market economy investor principle in the past only to State interventions in loss-making companies and sectors characterised by structural overcapacity. It cannot be inferred from case-law that the Commission may examine State investments in sound and profitable public enterprises in order to determine whether they generate at least an average return. The State may take into account long-term strategic considerations and enjoys a certain latitude for entrepreneurial decisions within which the Commission is not allowed to examine such decisions. Therefore, the Commission may not require a certain minimum return as long as it can be assumed that the enterprises in question will not be loss-making in the long run. The concept of average returns necessarily implies that the profitability of many enterprises is below the average in their industry. Furthermore, it is not clear which enterprises and which periods of time should be used as a basis for computing average returns. The State is not required to be guided only by profitability considerations when taking entrepreneurial decisions. Even a private investor might take other aspects into account. It is part of entrepreneurial freedom to continue to operate enterprises with a below-average return and to inject additional capital into them. The limit for the State is reached only when such behaviour can no longer be economically justified under the private-investor test.

(113) The legislative initiative in question already laid down that the resources of the *Land* housing promotion fund would have to remain earmarked, that its substance would have to be secured and that the instruments for housing promotion would have to be maintained. In accordance with these principles, Wfa must be managed by WestLB as an organisationally and economically independent entity which draws up its own annual accounts. In the event of WestLB being wound up, the *Land* has a preferential claim on Wfa's net assets. All of Wfa's income is still given over to housing promotion. Only that part of Wfa's own funds, which it does not itself need to underpin its assets, can be used by WestLB for solvency purposes. The *Land* retains a special influence over Wfa by way of specific supervisory, information and cooperation rights.

(114) Externally, liability in respect of Wfa's special reserve is unlimited. In the event of WestLB's Liquidation or bankruptcy, creditors would have direct access to it. Losses could also be offset against the special reserve without limitations. Internally, however, WestLB's owners have laid down other arrangements regarding the order in which liable capital is called on, with Wfa's capital being ranked after the remaining equity capital

(117) However, the transaction can also be justified on the basis of the market economy investor principle as a measure which would also have been taken by a private owner. By virtue of being earmarked for a special purpose, the injected capital is not comparable with a normal equity injection and the transfer constitutes in commercial terms the most sensible and efficient utilisation of Wfa's capital. The *Land* has optimised the

value of Wfa's assets by the transfer. If Wfa is compared to a private, non-profit-making entity (e.g. a foundation), the private owner of such an entity would have acted in the same way in order to put the assets, which cannot be used for any other purpose, to a commercial use.

(118) According to the German Government, the public purpose of Wfa's assets constitutes a task of general economic interest which, under Article 295 of the EC Treaty, is not subject to Commission supervision. The Member States are free to create such special-purpose assets.

(119) The German Government submits that the way in which an adequate remuneration is paid is of no relevance under the State aid rules. Since the *Land* received an adequate remuneration, an increase in its participation in WestLB was neither necessary nor justified and would in fact have provided the *Land* with an additional economical advantage without additional consideration. Nor would such a redistribution of shares correspond to the special nature of Wfa's assets (lack of liquidity, internal subordinate liability). Equity instruments on the capital markets, which are comparable to Wfa's assets, do not carry voting rights either. Since the agreed remuneration is adequate, the other owners of WestLB receive no additional income which they would not receive under normal market economy conditions and WestLB's attractiveness for other investors is not therefore increased. Moreover, because the shareholder structure of WestLB is fixed and no new (private) shareholders are possible, a remuneration which was hypothetically too low would in fact have no influence on possible private investors. Even if the other shareholders received an advantage, any effect on the savings banks would be too small to be perceptible.

(120) Since the *Land* receives a fixed and adequate remuneration and WestLB was and is a profit-making enterprise which can undoubtedly pay the agreed remuneration, the actual level of WestLB's total return on capital is in fact of no relevance and there was no need for the *Land* to require an increase in the bank's profitability.

2. Appropriate remuneration for the capital

(121) The German Government submits that WestLB pays an appropriate remuneration for the transferred assets. The fact that a remuneration would have to be paid by WestLB for the capital provided has always been regarded by the *Land* as a prerequisite for the transfer. The level of and basis for assessing such remuneration was intensively discussed between the parties involved. Since it was not yet clear in 1991 what amount would be accepted by BAKred as original own funds. Only the principle, and not the actual level of, remuneration was fixed at the time of the transfer. The actual level of 0,6 % was fixed in 1993 after negotiations with the other owners of WestLB⁽²⁵⁾. The German Government did not provide the Commission with any documents explaining how this figure was determined. Instead, it argues that the decisive factor from a State aid point of view is not the considerations on which the rate was based but only the result, which is said to be appropriate. The fixed remuneration was to be paid from distributable profits, i.e. before any dividends were paid. If, owing to a lack of profits, the remuneration was not paid in any one year, there was no right to recovery payments in future years⁽²⁶⁾. The figure of 0,6 % corresponds to pre-tax costs of about 1,1 % for WestLB.

(122) The following table shows the payments made by WestLB to the *Land* as remuneration for the capital transferred:

(123) Table 6: Remuneration paid by WestLB for the transfer of Wfa (data provided by the German authorities)

	(million DEM)					
	1992	1993	1994	1995	1996	1997
Remuneration (before tax)	[...]	[...]	[...]	[...]	[...]	[...]
Payment for pension entitlements of Wfa staff	[...]	[...]	[...]	[...]	[...]	[...]
Total remuneration paid to the <i>Land</i>	[...]	[...]	[...]	[...]	[...]	[...]

⁽²⁵⁾ The 0,6 % rate was laid down in a protocol note to the covering agreement dated 11 November 1993.

⁽²⁶⁾ The German Government has explained that there was an agreement between the owners that such recovery payments should be made but that there was no corresponding legal obligation on WestLB.

(124) The German Government presented studies by an external consultancy that had been commissioned by WestLB to assess what would have been an adequate remuneration in 1991 for a capital investment with the same risk profile as Wfa's assets. These expert opinions examine the external and internal risk exposure of the capital and the conditions governing the remuneration payments, comparing these features to various equity instruments found on the international capital markets, in order to determine an appropriate remuneration. This comparison is explained in the following section. The studies arrive at a spread of between 0,9 % and 1,4 % as an appropriate remuneration. Since the pre-tax costs for WestLB of the 0,6 % remuneration rate amount to 1,1 %, this rate is regarded as adequate. In addition to this direct remuneration, the synergy effects arising from the transfer have to be taken into account (see later).

(a) *Comparison with other equity instruments*

(125) The studies state that the return on an equity instrument is determined by risk profile. The higher the risk, the higher the risk premium, i.e. the interest difference which has to be paid in relation to secure government bonds. In analysing the risk profile, three elements are particularly important: the arrangements for current interest payments, the investor's position in the event of current losses and his position in the event of liquidation or bankruptcy. The studies describe various features⁽²⁷⁾ of several equity capital instruments on the market (ordinary shares, dormant holdings, profit participation certificates, perpetual preferred shares, trust preferred securities and subordinated bonds) and compare them to Wfa's capital. According to the studies, Wfa's capital can best be compared to profit participation certificates, perpetual preferred stock and dormant holdings⁽²⁸⁾. Of the instruments mentioned above, trust preferred securities and perpetual preferred shares are not accepted in Germany. According to the studies, at the end of 1991 the following capital instruments qualifying as original own funds were available in Germany: ordinary shares, preferred shares (Vorzugsaktien) and dormant holdings (*stille Beteiligungen*).

(126) The studies stress that Wfa's assets would be available for WestLB's creditors in the event of bankruptcy of WestLB (liability function — *Haftungsfunktion*). At the same time WestLB can offset losses without limitations against Wfa's special reserve (loss compensation

function — *Verlustausgleichsfunktion*). The internal agreements and the earmarking of Wfa's assets are of no relevance in this connection. However, internally the special reserve is subordinate in its liability to the other equity of WestLB and this internal situation would be decisive for the decision of an investor.

(127) As regards the loss compensation function, Wfa's special reserve can be compared to perpetual preferred shares. However, since it would be used, in parallel with profit participation certificates (which are additional own funds), only once, WestLB's other original own funds had been exhausted and since some of the profit participation certificates would already have been used in parallel, it is less risky than the profit participation certificates. The same applies to dormant holdings.

(128) As regards the liability function, the special reserve would be used after the other original own funds but before dormant holdings, profit participation certificates and other additional own funds. Wfa's special reserve is therefore said to have a higher risk level than profit participation certificates and dormant holdings. Once again it can be compared in terms of its risk to perpetual preferred shares. However, according to the studies, because of the extremely low probability of a bankruptcy of WestLB, this risk can in fact be disregarded and an investor would heavily discount the corresponding risk costs.

(129) In the case of Wfa's capital, interest payments would be made from distributable profit and have priority over dividends. If the profit is not sufficient, no remuneration is paid. This arrangement corresponds in principle to that of perpetual preferred stock. Profit participation certificates are less risky because missed interest payments would be deferred and paid on a cumulative basis in later years. For dormant holdings too, cumulative repayments are possible. In the case of Wfa's capital, the risk of non-payment is limited to the risk premium (because of the liquidity costs; see later) whereas, in the case of the other two instruments, the full coupon (i.e. risk-free return plus risk margin) is at risk. Therefore, as regards interest payments, the risk of Wfa's capital is slightly lower than that of the other three instruments.

⁽²⁷⁾ The following features are described: country of issue and issuer, treatment of the instrument by banking regulators, typical maturity, treatment in the event of bankruptcy/liquidation and for loss absorption, whether it is callable, whether it is possible to defer interest/dividend payments and whether a cumulative deferral is possible.

⁽²⁸⁾ Wfa's capital is compared in one version only to profit participation certificates and perpetual preferred stock and in another to all three instruments

(130) The studies conclude that the risk premium for Wfa's special reserve should be below that for profit participation certificates and dormant holdings as well as below that for perpetual preferred shares. A historical margin before tax of between 1,0 % and 1,2 % is quoted for profit participation certificates, one of between 1,1 %

and 1,5 % for dormant holdings and one of between 1,5 % and 2,0 % for perpetual preferred shares⁽²⁹⁾ (The historical risk margin for ordinary shares is given as between 2,8 % and 3,3 %⁽³⁰⁾). For Wfa's special reserve a remuneration of 1,1 % is calculated for the years 1993 to 1996⁽³¹⁾. For 1992 a rate of 255 % is quoted⁽³²⁾. Synergy effects should also be taken into account. The studies conclude that the remuneration paid by WestLB was too high in 1992 and appropriate in the years 1993 to 1996.

(b) Liquidity costs

(131) A cash injection increases own funds and provides liquidity. This liquidity can be reinvested and earn interest for which the investor would demand a remuneration. The transfer increases WestLB's own funds but does not provide liquidity. Wfa's capital is locked up in the housing promotion business. Unlike what happens with a cash injection, WestLB cannot reinvest the liquidity but has to raise liquidity on the capital market to achieve the same result. This results in additional interest expenses. Because of this lack of liquidity, the *Land* can, as shown by the expert opinions provided, demand a remuneration corresponding only to the risk margin, i.e. the difference between the total return on an investment and the return on a corresponding government bond.

(132) Furthermore, it is stated that practically all risk-related assets-side banking business requires some liquidity, for example swap contracts, forward contracts and derivatives. Only guarantees and sureties do not require liquidity, but the corresponding transactions are not shown in the credit institution's balance sheet.

⁽²⁹⁾ Data from the American and British markets were used for perpetual preferred shares, as these instruments are not available in Germany.

⁽³⁰⁾ The study uses the capital asset pricing model to calculate these rates. This model starts with a risk-free interest rate (here that of German Government bonds with a remaining period to maturity of 10 years, i.e. 8,26 % at the end of 1991) and adds to this a risk premium for equity which is derived from historical market data (here 3,0 % to 4,0 %); this figure is adjusted by a factor reflecting the systematic risk of the respective enterprises in comparison with the total market (here 0,77 %, derived from the market performance of two German banks, BHF-Bank and IKB).

⁽³¹⁾ This is based on the rate of 0,6 %, a corporation tax rate of 46 % until 1993 and 42 % thereafter, plus a solidarity surcharge rate of 3,75 % in 1992, 0 % in 1993 and 7,5 % thereafter.

⁽³²⁾ This is based, firstly, on the fact that the special reserve was accepted by BAKred only on 30 December 1992, resulting in a figure for usable capital (for calculation purposes) of only DEM [...] (EUR [...]), and, secondly, on the payment in 1992 by WestLB of DEM [...] (EUR [...]) for future pension entitlements of Wfa staff, which is taken as remuneration paid by WestLB to the *Land* in that year.

(133) The relevant refinancing costs which have to be taken into account should be based on the return of long-term (i.e. ten-year) risk-free German Government bonds. The secondary market rate of such bonds at the end of 1991 was 8,26 %. The actual average refinancing costs of WestLB in November 1991 stood at [...] %.

(c) Capital basis for the calculation of the remuneration

(134) According to a protocol note to the covering agreement, the remuneration has to be paid on the annual average portion of Wfa's special reserve used by WestLB to underpin its own business. The first payment was to be made in 1993. However, in reality WestLB pays the remuneration not on the amount used but on the amount usable, i.e. the portion not needed to underpin Wfa's own business.

(135) The remainder of the special reserve, i.e. the part needed for Wfa's own business plus the sum of DEM 1 900 million (EUR 970 million) entered as equity in WestLB's balance sheet but not accepted by BAKred, is of no economic use to WestLB because it cannot be used to underpin additional risk-bearing assets. The balance-sheet entry of DEM 1 900 million (EUR 970 million) is only the result of a difference in valuation. Since rating agencies and experienced investors look only at the accepted amount, the DEM 1 900 million (EUR 970 million) is of no economic relevance for WestLB. No private investor could demand remuneration for it on the market because the bank would always have alternative possibilities to raise equity capital on the market that would be accepted as original own funds (e.g. normal cash injection).

(136) According to the Federal Government, Wfa's assets and liabilities would be newly discounted each year in order to be entered in WestLB's balance sheet at their actual value. Since repayments and interest would be granted again as new long-term, lower-interest housing loans, it is possible that the nominal amount of Wfa's assets would increase while the discounted value and the risk-adjusted amount would decrease.

(d) Synergy effects

(137) According to the German Government, the *Land* expected synergies from the transfer amounting to more than DEM 30 million (EUR 15 million) annually in the longer term. These were to come from a simplification of housing promotion procedures, for example the elimination of duplication of activities, easier and faster

communication and less need for coordination. Since the transfer, Wfa needs fewer staff and saves on compensation payments for work carried out in the past by WestLB's housing promotion department for Wfa. It is claimed that the *Land's* expectations were indeed fulfilled and that, from a management point of view, the merger of Wfa with WestLB was the only way to achieve these synergy effects. Furthermore, the way in which synergies are achieved falls within the economic freedom of the *Land*, as protected by Article 295 of the EC Treaty.

capital and property tax have not been levied since 1997 and 1998 respectively, as the Federal Constitutional Court ruled that they were anti-constitutional.

4. Waiver of liability

- (138) The German Government also points out that in 1992 WestLB paid DEM [...] (EUR [...]) to cover existing and future pension entitlements of Wfa employees, which reduced the future costs of Wfa. These payments are depreciated in WestLB's accounts over a period of 15 years by DEM [...] (EUR [...]) annually.

- (141) According to the German Government, the waiver of liability serves to avoid a situation where the *Land* housing promotion fund is constantly reduced because of the liability created each year. The waiver does not reduce the *Land's* assets because, in the event of Wfa's liquidation, the housing promotion fund would be correspondingly higher. Since the liability of Wfa which has been waived would have fallen due only in the event of such liquidation, the waiver does not change the *Land's* overall economic position. In fact, the *Land* is only waiving a liability against itself.

3. Tax exemptions

- (139) Wfa's exemption from property tax (*Vermögenssteuer*), tax on business capital (*Gewerbekapitalsteuer*) and corporation tax (*Körperschaftsteuer*) is provided for in the German tax system. Wfa and other public-law entities are exempt because they do not compete with taxable financial institutions but are used by the State to pursue certain objectives. Because of the tax savings, the State has to provide fewer funds for Wfa's activities. WestLB is fully taxed on its income (and thus also on the commercial activities underpinned by Wfa's capital) and does not receive any financial advantage from Wfa's exemption because the amount accepted as original own funds is not increased as a result. Even if the tax exemption were to lead to an increase in accepted capital, WestLB would not benefit as it would then have to pay an adequate remuneration on any additional amount.

- (142) The waiver was taken into account in the valuation of Wfa's equity capital by BAKred and on this basis WestLB is paying an adequate remuneration. The waiver therefore produces no financial benefit for WestLB.

5. Observations on the comments from interested parties

- (140) As regards property tax and tax on business capital, an asset can be subject to such taxation only once and is taxed where it is directly used. Since Wfa's assets are exempt regarding their primary use, i.e. housing promotion, they cannot be subject to taxation when put to an additional, secondary use. That would be contrary to the system underlying German tax law. The same applies to the integration of a private tax-exempt entity into a private bank. Since these exemptions do not provide WestLB with an unpaid-for advantage, they do not constitute State aid. Furthermore, tax on business

- (143) As to the comments of the two bankers' associations, the German Government remarks that the general accusations made are not substantiated by facts or any actual cases of complaints by credit institutions against WestLB's operation on the markets. The question of *Anstaltslast* and *Gewährträgerhaftung* raised by one of the associations is not linked to the present case and should be considered separately.

- (144) As to the comments by BdB, the German Government stresses that the transfer of Wfa was no ad hoc solution but the result of long-term strategic considerations, in particular the increase in Wfa's efficiency. The case-law of the Court contains no ruling whereby investment by the State in a sound and profitable enterprise has been regarded as State aid. The case referred to by BdB concerns companies which were loss-making. In view of the fact that WestLB has been a profitable enterprise since its formation, the market economy investor principle is not applicable. The German Government believes that this is confirmed by the case-law of the Court, where that principle is never applied to sound and profitable enterprises. Moreover, a private investor not only looks at the return but takes other, strategic

considerations into account. In the case of rescue and restructuring aid, other considerations have to be weighed up than in the case of a capital injection into a profitable enterprise. Investments by the State cannot be assessed simply by looking at the average return in a given sector. Otherwise, State investment in a bank with a below-average return would constitute State aid even though at the same time private investors were in fact investing in that enterprise. An investor is guided by prospects rather than sectoral averages.

(145) The State aid rules allow an examination only of the terms of the asset transfer, not of the particularities of Wfa's assets, which are protected by Article 295 of the EC Treaty. As the special nature of Wfa's assets is protected by that Article, the capital transferred cannot be compared to a normal liquid capital injection. A private-law foundation could be used in the same way as Wfa without any effect on the use of its revenues for its special purpose.

(146) Regarding the risk profile of Wfa's capital, a distinction must be drawn between the role of the *Land* as the owner of WestLB and as an investor in Wfa's special reserve. As an investor in Wfa, the *Land* bears a lower risk because of the internal subordination agreement between WestLB's shareholders. The risk borne by the *Land* as an investor in Wfa is limited to the assets transferred and is not higher, as claimed by the BdB.

(147) The German Government submits that the return calculations provided by BdB (and taken from an outside expert's opinion) are incorrect and supports this view with reference to another study commissioned by WestLB. According to this study, the main errors are the wrong calculation method (arithmetical average instead of compound annual growth rate) and the use of irrelevant investment periods. After adjustment for these errors, the return of 16,86 % before tax for large private banks in Germany comes down to 7,0 %. Furthermore, the five German private banks taken into consideration cannot be compared to WestLB because of their differing business emphasis. Taking banks which are comparable, the return on equity falls to 5,8 %. Furthermore, the study for BdB is said to use a representative reference period from 1982 to 1992,

which includes two periods when the market rose. Shortening the reference period would thus further lower the return figures.

(148) As to the liquidity aspect, the German Government rejects BdB's argument that, on account of a lack of liquidity, no refinancing costs would arise because the discounting of Wfa's assets already took that liquidity cost into account. It states that this discount is in no way connected to the liquidity aspect but is the result of the low- or non-yielding character of Wfa's assets and liabilities. It also rejects BdB's argument that, if any refinancing costs are accepted, only a small rate or 2,7 % before tax is justified. The expert opinion submitted by BdB in this connection is said to be wrong because it confuses in an inadmissible manner the revenues of the bank with the revenues of an external investor. Furthermore, the BdB study looks at gross revenues whereas net revenues should be compared, and it applies an interest rate that is much too low (6,35 %) instead of the rate on long-term Federal bonds at the end of 1991 (8,26 %). The German Government submitted its own study produced by an outside consultancy.

(149) The synergies were said to arise only within Wfa, and not within WestLB, as the duplication of work and existence of parallel departments could be eliminated (transfer of the former housing division of WestLB). These effects were therefore entirely independent of the separation between Wfa and WestLB in economic, organisational and personnel terms. They led to a reduction in the capital grants by the *Land* to Wfa and were the direct result of the transfer of Wfa to WestLB.

(150) The difference between Wfa's special reserve shown in the balance sheet and the amount accepted by BAKred was clearly communicated to the outside world. According to the German authorities, creditors do not assign a liability function to the part not accepted for solvency purposes. Since only the part which can be used by WestLB to underpin its business is of economic use to the bank, the *Land* cannot ask for remuneration in respect of the excess amount.

(151) The waiver of the liability was taken into account in the valuation of Wfa's assets by BAKred, and it is on this basis that WestLB pays the remuneration. Furthermore, the overall economic position of the *Land* is not affected by the waiver and the tax exemption does not yield any benefit for WestLB.

V. ASSESSMENT OF THE MEASURE

- (152) The first step in appraising the measure under the State aid rules of the EC Treaty is to assess whether it constitutes State aid within the meaning of Article 87(1) of the Treaty.

1. State resources and favourable treatment of a certain undertaking

- (153) As described earlier, Wfa was a public-law institution owned entirely by the *Land* of North Rhine-Westphalia and with the task of promoting housing by granting low-interest or non-interest-bearing loans. The *Land* guaranteed its total liabilities under *Anstaltslast* and *Gewährträgerhaftung*. Wfa's main source of financing, the *Land* housing promotion fund, had been created by annual cash injections from the *Land* budget and by interest income from housing loans.

- (154) If State assets of this kind, which have a commercial value, are transferred to an enterprise without sufficient remuneration being paid, it is clear that State resources within the meaning of Article 87(1) of the EC Treaty are involved.

- (155) In order to verify whether the transfer of State resources to a public enterprise favours the latter and is therefore liable to constitute State aid within the meaning of Article 87(1) of the EC Treaty, the Commission applies the market economy investor principle. This principle has been accepted (and developed) by the Court in a number of cases. The assessment under that principle will be made at point V.3 below. If State aid is involved, WestLB, i.e. a certain undertaking within the meaning of Article 87(1) of the EC Treaty, will clearly have been favoured.

2. Distortion of competition and effect on trade between Member States

- (156) As a result of the liberalisation of financial services and the integration of financial markets, banking within the Community has become increasingly sensitive to distortions of competition. This development is intensifying in the wake of economic and monetary union, which is dismantling the remaining obstacles to competition in the financial services markets.

- (157) In its 1997 annual report, WestLB defines itself as a universally and internationally active commercial bank, a central bank for the savings banks and the bank of the *Land* and its municipalities. It describes itself as a

European banking group within the wholesale banking sector with activities in important financial and economic centres around the world. Its presence abroad is concentrated in Europe, where it has subsidiaries, branches and representative offices in all major countries. WestLB is present in over 35 countries worldwide.

- (158) Therefore, despite its name, tradition and legally stipulated tasks, WestLB is not at all a local or regional bank. Its presence in Europe and on international markets has already been described at point II.1. In 1997 the group's foreign business contributed 48 % of non-consolidated revenues. According to the 1997 annual report, the bank's growth in that year can be attributed mainly to the expansion of its foreign business.

- (159) These facts clearly show that WestLB offers its banking services in competition with other European banks outside Germany and, since banks from other European countries are active in Germany, inside Germany. This has been confirmed by the observations of the bankers' associations of two Member States. It is clear, therefore, that aid given to WestLB distorts competition and affects trade between Member States.

- (160) It should also be recalled that there is a very close link between the equity of a credit institution and its banking activities. Only on the basis of sufficient accepted equity capital can a bank operate and expand its commercial operations. As the State measure provided WestLB with such equity capital for solvency purposes, it directly influenced the bank's business possibilities.

3. Market economy investor principle

- (161) In deciding whether elements of State aid are involved in a financial measure taken by a public owner of an enterprise, the Commission applies the market economy investor principle. This principle has been applied by the Commission in many cases and has been accepted and developed by the Court in several decisions⁽³³⁾. It allows the Commission to bear in mind the specific circumstances of each case, for example to take into account certain strategies of a holding company or group of companies or to distinguish between the short- and long-term interests of an investor. The market economy investor principle will also be applied to the case at hand.

⁽³³⁾ See, for example, Cases C-303/88 *Italy v Commission* [1991] ECR I-1433 and C-305/89 *Italy v Commission* [1991] ECR I-1603.

- (162) According to the principle, no State aid is involved if funds are made available on terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market economy conditions⁽³⁴⁾. In particular, a financial measure must be considered unacceptable to a market economy investor if the financial position of the company is such that a normal return (in dividends and capital gains) cannot be expected within a reasonable period of time⁽³⁵⁾.
- (163) The Commission has, of course, to base its appraisal of a particular case on the data available to the investor at the time he took his decision on the financial measure in question. The transfer of Wfa was decided in 1991 by the relevant public bodies. The Commission has therefore to assess the transaction on the basis of the data available and economic and market circumstances obtaining at that time. The data in this decision that relate to later years are used only to show the effects of the transfer on WestLB's situation and in no way to justify or question the transaction after the event.
- (164) The German Government reminded the Commission to examine the case purely on the basis of the situation at the time of the transfer decision, i.e. the end of 1991, and not to take later developments into account. Such a view might imply that the Commission cannot take into account either the fact that only DEM 4 000 million (EUR 2 050 million) of original own funds instead of the requested DEM 5 900 million (EUR 3 020 million) was accepted by BAKred or the fact that a remuneration of 0,6 % was agreed in 1993. However, at the time of the transfer, although the value of Wfa agreed by the Land and WestLB was DEM 5 900 million (EUR 3 020 million), no level of remuneration was fixed. The Commission therefore considers it appropriate, when assessing the operation, also to take into account the situation prevailing when the parties finally fixed the remuneration.
- (165) The Commission does not agree with the German Government and WestLB that the market economy investor principle is not applicable to sound and profitable firms and that this is supported by case-law. The fact that the principle has in the past been applied mainly to firms in difficulty in no way restricts its application to this category of firm.
- (166) Restructuring aid for firms may be granted only in cases where a restructuring plan restores the firm's viability, i.e. leads to a 'normal' rate of return that allows the aided firm to continue by its own efforts, because this 'normal' market rate of return is acceptable to a market economy investor. In cases where such matters have been brought before the Court, it has never called into question the fact that the Commission required not only a break-even situation or a token return but also a full normal market rate.
- (167) There is no provision to the effect that, if a company makes a profit, this rules out *a priori* the possibility that the provision of capital contains elements of State aid. Even if a company is profitable, a market economy investor might refrain from injecting (further) capital if he could not expect an appropriate return on his capital contribution (in the form of dividends or an increased value of the investment). Should the company not show the appropriate expected return at the time of the investment, a market economy investor would call for measures to increase the return. Therefore, the market economy investor principle is applicable in the same way to all public enterprises whether profitable or loss-making.
- (168) The adequacy of the likely return on capital depends in turn on what a market economy investor can expect from similar investments with a similar exposure to risk. It is evident that a constantly underperforming enterprise showing no signs of recovery is not viable in the long term. New investors would decline to meet the company's demand for further capital and existing investors would eventually disinvest, even accepting a loss, if necessary, in order to redirect their capital to more profitable investments. Thus, in a communication to the Member States on the application of the State aid rules to public undertakings, the Commission states that, when comparing the actions of the State with those of a market economy investor, 'in particular when a company is not making a loss', it will evaluate the financial position of the company at the time an additional capital injection is proposed⁽³⁶⁾.
- (169) It should also be borne in mind that 'sound and profitable firms' cannot be equated with firms which do not make a loss. A firm which generates only small profits or generates neither profits nor losses cannot in

⁽³⁴⁾ Commission communication to the Member States: Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ C 307, 13.11.1993, p. 3, point 11). While this communication deals explicitly with the manufacturing sector, the principle can undoubtedly be applied in the same way to all other sectors. As regards financial services, this has been confirmed by a number of Commission decisions, e.g. in the cases *Crédits Lyonnais* (OJ L 221, 8.8.1998, p. 28). and *GAN* (OJ L 78, 16.3.1998, p. 1).

⁽³⁵⁾ Public authorities' holdings in company capital — Commission Position (Bull. 9 — 1984, pp. 93-95).

⁽³⁶⁾ OJ C 307, 13.11.1993, p. 3, point 37.

fact be regarded as sound and profitable. It is certainly difficult to determine 'average profitability', as this is dependent on a number of factors, for example the level of risk in the industry in which the firm operates. However, firms which, over a certain period, generated a profit lower than that generated by firms with a similar risk structure would, as mentioned, be eliminated from the market in the long run. The position taken by the German Government and WestLB would lead to a situation where the State could invest in firms operating with an annual profit of EUR 1, regardless of the State aid rules in the Treaty.

equal to that from comparable investments. Otherwise, the company will not be able to find the necessary funds and will therefore not be viable in the long run.

(170) It is clearly not the Commission's task to initiate procedures systematically and immediately if a public enterprise shows below-average profitability. Even private firms may from time to time have lower-than-average profitability. (The existence of an average logically implies deviations in both directions.) However, in such circumstances a normal firm operating on the market would try to increase its profitability and carry out restructuring and other measures in order to prevent this situation from becoming chronic. Market investors would expect appropriate measures to be taken in this respect.

(172) According to WestLB, the question of whether the bank generated average profits in the years before the transfer can in principle remain unanswered if a fixed and appropriate remuneration is agreed and profitability is sufficient to maintain this remuneration in the long run. This view can be accepted in principle. However, it should also be borne in mind that viability in the long run depend on the company achieving an average rate of return on its equity capital.

(173) With respect to the probable behaviour of a market economy investor, it is of no relevance that other banks also had to raise additional capital as a consequence of the stricter rules of the Solvency Ratio Directive. The Directive does not impose any obligation on banks to raise additional capital. It merely stipulates a minimum ratio of capital to risk-adjusted assets, i.e. it establishes a legal presumption of what is necessary for a bank's viability. In other words, under certain conditions a market economy investor might have urged his bank to restructure its risks in order to comply with the new solvency rules instead of increasing the bank's capital. Such a step would directly reduce the bank's volume of business and hence its market presence.

(171) Furthermore, as already indicated above, a distinction must be drawn between existing and new investments because the starting points for the investment decision in question are different, but not the basic principle. In the case of an existing investment, the investor might be more willing to accept a lower (or even negative) return in the short run if he expects the situation to improve. Certainly, an investor might also increase his investment in a firm with low profitability. However, he would not do so unless he expected an improvement in the situation and a reasonable return in the long term. If, on the other hand, he expects the combination of risk and return to be poorer than in comparable firms, he will consider terminating his investment. In the case of a new investment, the investor may be less willing to accept lower profitability from the very outset⁽³⁷⁾. However, as already stated, the principles are the same in all decision-making situations: the return expected from the investment in the long run (taking into account the risk and other factors) must at least be

(174) If a public shareholder decides that a capital injection is an appropriate way for the bank to meet the capital requirements, the question is whether the particular circumstances under which the capital is provided would be acceptable to a market economy investor. If a capital measure is needed to meet the solvency requirements, a market economy investor might be willing to carry out this measure in order to preserve the value of investments already made. But he would insist on receiving an appropriate return on the newly injected capital. It is likely that a market economy investor would expect a higher return on a capital investment in a bank whose capital resources are depleted and which is in urgent need of new capital because this circumstance exposes him to higher risk.

⁽³⁷⁾ It cannot be said that investments are made only in profitable companies on the market. High-risk investments, e.g. in innovative or new technology companies, are quite common. However, in these cases too the investor invests his capital on the expectation that the start-up losses and the risks involved can subsequently be offset by high profits. Even in the case of such investments, the benchmark is the expected long-term return.

(175) In the light of the market economy investor principle, the key question is whether such an investor would have supplied WestLB with capital that had the specific characteristics of Wfa's assets and under the same conditions, especially in view of the probable return on the investment. This question will be examined below.

(a) *Article 295 of the EC Treaty*

(176) The German Government argues that the *Land* of North Rhine-Westphalia was not obliged to consider privatising WestLB in order to increase the latter's equity, that the *Land* was in principle free to transfer Wfa to WestLB in order to achieve synergies and that the *Land* was not obliged under Community law to consider the transfer of Wfa to a private credit institution. This argument can be accepted. The German Government also claims that Wfa's public remit constitutes a task of general economic interest and that Wfa is therefore not subject to supervision by the Commission under Article 295.

(177) As long as public entities carry out only public tasks and do not compete with commercial enterprises, the competition rules do not apply to them. The situation changes when there are implications for competition. Article 86(2) of the EC Treaty deals with situations where it might be necessary to deviate from the competition rules in order to ensure the provision of services of general economic interest. It is discussed at point V.6. On the other hand, Article 295 of the EC Treaty protects the national systems of property ownership but this cannot justify any infringement of the Treaty's competition rules.

(178) The German authorities and WestLB claim that, because of the constraints imposed by the special purpose assigned to Wfa's assets, as laid down by the housing promotion law, the only possible profitable use of these resources was to transfer them to a similar public-law entity. Thus, the transfer represented the most commercially sensible use of the assets in question. It is therefore argued that any remuneration for the transfer, i.e. any additional return on Wfa's capital, is sufficient to justify the transfer in view of the market economy investor principle. This argument cannot be accepted. It may be true that Wfa's transfer to WestLB, which subsequently allowed WestLB to use part of Wfa's capital for solvency purposes, was the most commercially sensible use. Member States are free to use public funds for public sovereign purposes, demanding no or low profits in return. The Commission does not question the right of the Member States to create special-purpose funds in order to fulfil tasks of general economic interest. However, as soon as such public funds and assets are used for commercial competitive activities, they must be subject to normal market economy rules. This means that, as soon as the State decides to assign public-purpose assets to a commercial use, it should seek a remuneration corresponding to market terms.

(b) *Specific nature of the measure*

(179) In carrying out the above transfer operation in response to WestLB's need to expand its original own funds, the *Land* authorities chose a method of increasing capital

that had very special features. The general idea was to merge a non-profit credit institution pursuing a particular task (Wfa) with a normal commercial bank operating under conditions of competition, with the aim of utilising surplus capital (from the point of view of the solvency rules) within the non-profit institution for the purposes of the entity exposed to competition. At the same time, the assets transferred remained earmarked for their original purpose. Consequently, the approach of an entity within an entity was chosen, with Wfa's assets constituting an independent and closed circuit in which profits generated by Wfa accrue to and are retained by that institution only.

(180) The Commission is not aware of any precedents for a capital increase involving such an 'imperfect' merger in so far as this might be relevant from a State aid point of view. In its opinion, however, if a mechanism like the one at issue is chosen by a Member State, a thorough analysis of its financial and economic impact on the competitive part of the entity is imperative so as to ensure that non-transparent mechanisms are not used to circumvent the Treaty's State aid rules. It is necessary to assess whether and to what extent the integration carried out is economically advantageous to the competitive divisions of WestLB despite the creation of 'closed circuits'.

(181) It should be pointed out here that the complexity of the case and the lack of directly comparable transactions on the free market makes this judgment a rather difficult one. Therefore, the Commission devoted a considerable amount of time to gathering information and analysing the case. Furthermore, it arranged for an outside expert to deliver an opinion on the transaction and on the remuneration that can be regarded as corresponding to market terms. Only on the basis of all the data available and after a careful examination has the Commission finally drawn its conclusions and come to the present decision.

(c) *No change in ownership structure*

(182) When injecting equity capital into a bank, a market economy investor requires an appropriate share in the bank's profits. One way of ensuring such participation is a corresponding change in the structure of ownership, giving him an appropriate share in the bank's dividends and in a possible increase in its disclosed and non-disclosed value as a result of its enhanced earning capacities. Therefore, one way of ensuring an adequate return on the capital provided would have been to increase the *Land's* participation in WestLB accordingly, provided that the bank's overall profitability corresponds to the normal rate of return that a market economy

investor would expect from his investment. This would have avoided the discussion of whether the 0,6 % rate of remuneration is appropriate. However, this course was not adopted by the *Land*.

(183) According to the German authorities, a redistribution of shares in WestLB was not possible because of the specific nature of the transaction, especially the closed-circuit arrangement and the *Land's* prerogative (only valid internally) as regards the net assets of Wfa in the event of the liquidation of WestLB, which was agreed by WestLB's shareholders.

(184) In this case, however, the *Land* should have demanded appropriate remuneration in another form for the transfer, in accordance with the market economy investor principle. Otherwise, if the *Land* forgoes a remuneration which the market normally demands, it is not behaving like a market economy investor and is thereby granting an advantage to WestLB which constitutes State aid.

(d) *Capital basis for the calculation of the remuneration*

(185) The German Government and WestLB submit that only the part of the accepted original own funds which can be used by WestLB to underpin its commercial business has an economic value for the bank, with the result that a remuneration can be demanded by the *Land* in respect of this part only. BdB claims that the whole amount of DEM 5 900 million (EUR 3 020 million) is at risk and therefore a remuneration should be paid on that amount. The level of this remuneration should be different for the accepted original own funds of DEM 4 000 million (EUR 2 050 million) and the remaining amount of DEM 1 900 million (EUR 970 million).

(186) The Commission's consultants based their assessment on the assumption that, at the time of the transfer, the value of Wfa was established by the *Land* and WestLB at DEM 5 900 million (EUR 3 020 million) and that a market economy investor would therefore in principle seek a remuneration in respect of that figure, regardless of any later developments such as acceptance of the capital (or only part of it) as original own funds by BAKred. The only decisive factors for the fixing of a remuneration for a capital investment are the circumstances obtaining at the time of the investment decision, and not subsequent events. However, the Commission's consultants also accept that the transaction would have taken a different course if normal commercial practice had been followed.

(187) In the Commission's view, the sequence of steps in which the transfer was carried out could in fact point to an equal remuneration for the whole capital shown in

WestLB's balance sheet. The transfer was first decided and carried out, and then BAKred was requested to accept Wfa's special reserve as original own funds and the remuneration was fixed only close on two years after the transfer decision. However, under normal market conditions, no bank would have agreed to include Wfa in its balance sheet for the sum of DEM 5 900 million (EUR 3 020 million) and to pay a uniform remuneration on that amount before first checking whether that amount would also be accepted as original own funds by the supervisory authority. Furthermore, as is also stressed by the Commission's outside experts, a rational investor would certainly not behave in this way, i.e. consent to a substantial capital injection, without first agreeing on an appropriate remuneration mechanism. However, in the Commission's view, the sequence of events can be explained by the special circumstances of the case. The *Land* had long-term financial relations with the bank and was its main owner. There were only a small number of shareholders (all of them public), which means in practice less need for transparency and openness compared with a company that has a large number of ('outside') shareholders or is listed on the stock exchange. These special circumstances made it possible to decide on the transfer while leaving the decision on the final remuneration open until it was established that Wfa's capital could actually be used for commercial banking purposes.

(188) For the purpose of establishing an appropriate remuneration, a distinction should be made between the different parts of Wfa's special reserve according to their use to WestLB. An amount of DEM 5 900 million (EUR 3 020 million) was entered as equity on WestLB's balance sheet. An amount of DEM 4 000 million (EUR 2 050 million) was accepted by BAKred as original own funds. Of these amounts only DEM 2 500 million (EUR 1 280 million) allows WestLB to expand its activities and should be the primary basis of a remuneration for the *Land*. The remaining DEM 1 500 million (EUR 770 million) of the accepted original own funds is shown in the balance sheet but is needed to underpin Wfa's housing promotion business. An amount of DEM 1 900 million (EUR 970 million) is shown in the balance sheet but not accepted as own funds for solvency purposes. Therefore, the amount shown in WestLB's balance sheet but not usable by WestLB to expand its commercial business totals DEM 3 400 million (EUR 1 740 million).

(189) However, equity is necessary not only for supervisory reasons. The amount of equity shown in the balance sheet is also an indication for the bank's lenders of its soundness and thus influences the conditions under which the bank is able to raise outside funds. Contrary to the arguments of the German Government and WestLB, creditors and rating agencies look not only at accepted own funds but also at the overall economic and financial situation of the bank. Accepted own funds form only part of such an analysis of the bank's credit standing. An amount of DEM 5 900 million (EUR 3 020

million) was set by the *Land* and WestLB as a probable value which could be achieved in the event of Wfa being sold to a third party. If this assessment had not been reasonable, WestLB auditors would not have allowed it to stand in the balance sheet. The amount of DEM 4 000 million (EUR 2 050 million) accepted by BAKred reflects the supervisory body's very cautious approach in its valuation. It should be borne in mind that the valuation made for BAKred also gives a spread of between DEM 4 000 million (EUR 2 050 million) and DEM 5 400 million (EUR 2 760 million). Thus, the total amount of DEM 5 900 million (EUR 3 020 million) would be viewed by a potential creditor as security for his monies and would increase the credit standing of WestLB. This positive effect of the transfer on the bank's creditworthiness was also stated in the valuation of Wfa made for WestLB in 1992. Since the amount of DEM 3 400 million (EUR 1 740 million) cannot be used to expand business but improves the bank's appearance in the eyes of creditors, its economic function may be compared in that respect to at least that of a guarantee even if it is shown as equity in the balance sheet.

- (190) Since the amount of DEM 3 400 million (EUR 1 740 million) is also of economic use to WestLB, a market economy investor would have asked for a remuneration to be paid on it. Certainly, the level of this remuneration will be lower than that for the DEM 2 500 million (EUR 1 280 million), which is of greater use to WestLB since it can also be used under the solvency rules as own funds to expand its commercial business.

(e) *Appropriate remuneration for the capital*

- (191) Investments of differing economic quality require differing returns. In analysing an investment's acceptability to an investor acting under normal market conditions, it is important therefore to bear in mind the special economic nature of the financial measure in question and the value of the capital provided for WestLB.
- (192) The complainant originally claimed that the transaction at issue constituted a State guarantee by the *Land* for WestLB's debt. But WestLB shows the transferred assets as equity capital in its accounts and BAKred accepted an amount of DEM 4 000 million (EUR 2 050 million) as original own funds within the meaning of the Own Funds Directive, of which DEM 2 500 million (EUR 1 280 million) can be used by WestLB to underpin its commercial business. Consequently, a coherent appraisal of the financial measure in the light of Article 87(1) of the EC Treaty calls for its principal classification as capital injection and for appropriate remuneration to be paid. The very same financial measure cannot be

regarded as a capital injection under banking supervisory rules and as a guarantee under the Treaty's State aid rules. This principal classification does not, however, rule out the possibility that the Commission might, because of its particularities, liken part of that equity which cannot be used by WestLB in the same way as 'normal' equity to a guarantee for the purpose of calculating an appropriate remuneration.

(i) *Comparison with other equity instruments*

- (193) The German Government claims that, since no direct comparison with other transactions is possible, the appropriate remuneration for the capital provided should be established by comparing the transfer with various equity instruments on the markets. To this end, it submitted outside studies the findings of which are given above and which conclude that Wfa's capital can best be likened to profit participation certificates, perpetual preferred stock and dormant holdings.
- (194) In the Commission's opinion, it is in fact difficult to liken Wfa's transfer to any instrument available on the market because of its special nature. The transfer might resemble certain instruments in some respects, but there are also enough differences compared with each instrument to assign only a limited value to this comparison. Moreover, the studies submitted by the German Government are not really comprehensive as they leave out several relevant instruments such as non-voting shares.
- (195) It should be borne in mind that the instruments used for the comparison by the German authorities normally provide a bank with only a very limited part of own funds. They are additional instruments, supplementing the 'basic equity capital', which consists mainly of share capital and open reserves. By contrast, Wfa's capital boosted WestLB's own funds for solvency purposes from DEM 5 090 million (EUR 2 600 million) to DEM 9 090 million (EUR 4 650 million), i.e. by 80 %. Even if one takes account only of the increase of DEM 2 500 million (EUR 1 280 million) usable by WestLB to underpin its commercial business, this still represents an increase of 50 %. Hybrid instruments were usually issued up to a maximum level of 20 %. It would not have been possible to increase WestLB's capital in the same way, and on a permanent basis, by one of the instruments compared⁽³⁸⁾.

⁽³⁸⁾ This point is also stressed by the Commission's outside experts, who criticise the fact that the studies submitted by the German authorities omit any reference to the size of the transaction and compare the transfer to what are (in terms of size) marginal instruments. According to those experts, Wfa's capital should therefore be compared instead to original own funds instruments like non-voting shares.

- (196) In 1998 the Basle Committee underlined the *de facto* subordinate character of hybrid equity instruments, including those which are in principle accepted as original own funds (at least by some national authorities). It decided that such instruments ('lower tier-1 capital') should in future be allowed only up to a level of 15 % of core capital, i.e. up to 0,6 percentage points of the 4 % core capital requirement. Of course, this decision — taken in 1998 — cannot influence the original assessment of Wfa's transfer and the remuneration to be demanded. However, it confirms the need for credit institutions to have a solid base of core capital in order to make use of hybrid equity instruments. For banking supervisory purposes, Wfa's capital does not constitute 'hybrid' capital but 'basic' own funds. It should also be noted that in the past rating agencies pressed for some sort of 'voluntary restriction' to be applied regarding the share of equity from hybrid instruments, which they monitored closely. The reaction of the Basle Committee also reflects the concerns of the supervisory authorities and the 'market', i.e. the financial community, with regard to the gradual development of such instruments.
- (197) In this connection, it should also be stressed that the relatively wide range of hybrid equity instruments now available to credit institutions in several countries for use as original own funds and additional own funds did not exist in Germany back in 1991, when the transfer of Wfa was decided, or in 1993, when WestLB had to comply with new, stricter capital requirements. Some of these instruments were developed in the meantime, while others already existed but were not accepted in Germany. In practice, the main instruments which were available and used were profit participation certificates and subordinated loans (both of which are additional own funds, the latter being accepted only since 1993). It is therefore inappropriate to compare Wfa's capital to such hybrid instruments, most of which have developed in the meantime and some of which are available only in other countries. The German Government itself (indirectly) rejects such a comparison, claiming that the Commission must examine the case on the basis of the facts available at the time of the decision at the end of 1991.
- (198) The German Government's studies claim that, in the case of WestLB, the likelihood of bankruptcy is so low that it could in fact be practically disregarded. However, if this argument were followed strictly, it would mean that an investor should not require any top-up on the rate of return on risk-free government bonds when investing in companies considered as safe investments. This certainly does not correspond to market reality. Even though the risk of bankruptcy might be low in the case of a particular investment, it is taken into account by a market economy investor, who will demand a significant top-up for such investment in banks, as in the case of any other 'safe' equity investment.
- (199) As to the two instruments which, as the closest benchmarks, play the central role in the German authorities' comparison, namely perpetual preferred shares and profit participation certificates, a number of specific points should be stressed. Perpetual preferred shares constitute original own funds (core capital) in some countries but are still not accepted in Germany. Profit participation certificates constitute only additional own funds, whereas Wfa's capital qualifies as original own funds. The latter is therefore of much greater use to WestLB because it can be used to raise additional own funds (such as profit participation certificates) up to the same amount in order to increase the bank's own funds. Moreover, if profitable years followed loss-making ones, profit participation certificates would be replenished before Wfa's capital. In addition, Wfa's capital is available to WestLB without any time limitation, while profit participation certificates are usually issued for a period of ten years. It is also worth recalling the enormous, atypical size of the capital injection and the fact that the ranking in the event of losses must be seen in this context. Since the share of Wfa's capital is rather large, it will be used relatively quickly when major losses occur.
- (200) For all these reasons, the Commission believes that, because of the peculiarities of Wfa's capital, the comparison with hybrid equity instruments submitted by the German Government is not a suitable way to determine the appropriate remuneration to be paid for Wfa's capital⁽³⁹⁾.
- (201) As to the relationship between Wfa's capital and other equity instruments, BdB claims that the subordination agreement in the covering agreement between WestLB's shareholders is void because it encroaches on the rights of third parties by laying down that, in the event of losses at WestLB that this agreement covers only the relationship between Wfa's special reserve and the other original own funds provided by shareholders, i.e. in
- ⁽³⁹⁾ The outside study drawn up for it supports the Commission's view and comments on various individual assessments in the study submitted by the German Government. For example, it sheds a different light on the 'coupon effect' by stating that, in the event of ongoing losses or liquidation, the whole capital and not only part of it would be lost. The study also points to two subjective elements of the study submitted by the German Government: market data are said to be used selectively and in some places are simply replaced by data from the authors' own experience, without this being stated explicitly.

practice nominal capital and reserves, but that there was no intention to make Wfa's capital subordinate to additional own funds like profit participation certificates and subordinated loans.

an additional burden on WestLB because of the special nature of the capital transferred. Overall, the Commission accepts that WestLB incurs additional 'liquidity costs' to the extent of 'refinancing costs minus tax'.

(ii) Liquidity costs

(202) The arguments of the German Government and WestLB regarding the liquidity costs can in principle be accepted. A 'normal' capital injection into a bank supplies it both with liquidity and with an own funds base which it requires for supervisory reasons to expand its activities. In order to use the capital in full, i.e. to expand its 100 % risk-adjusted assets by a factor of 12,5 (i.e. 100 divided by a solvency ratio of 8) of the capital provided, the bank must refinance itself on the financial markets 11,5 times over. Put simply, the difference between 12,5 times the interest received and 11,5 times the interest paid minus other costs of the bank (e.g. administration) gives the profit on the equity⁽⁴⁰⁾. Since Wfa's capital does not provide WestLB with initial liquidity because the assets transferred and all the income of Wfa remain earmarked by law for housing promotion, WestLB faces additional funding costs equal to the amount of the capital if it is to raise the necessary funds on the financial markets to take full advantage of the business opened up by the additional capital, i.e. to expand risk-adjusted assets by 12,5 times the capital amount (or to maintain existing assets at that level)⁽⁴¹⁾. Because of these extra costs, which do not arise in the case of normal equity capital, the appropriate remuneration must be reduced accordingly. A market economy investor could not expect to be remunerated in the same way as for a cash injection.

(203) However, in the Commission's view and contrary to the opinion of WestLB and the German Government, the entire refinancing interest rate does not have to be taken into account. Refinancing costs constitute operating expenses and therefore reduce taxable income. This means that the bank's net result is not reduced by the amount of additional interest expenses incurred. These expenses are offset in part by reduced corporation tax. Only the net costs should be taken into account as

(204) As regards the actual interest rate to be used for the calculation, the parties agree that the long-term risk-free rate (10-year German Government bonds) at the end of 1991 was 8,26 %. Two 30-year German Government bonds issued in 1986 had secondary market yields of 7,8 % and 7,6 % at the time. WestLB claims that its actual refinancing costs on the basis of its financial structure at the time of the transfer were about [...] %. In the course of the investigation, refinancing rates of 7,0 % and 7,5 % were suggested by WestLB and the German Government in several documents and at several meetings⁽⁴²⁾. Given these rates and assuming that WestLB raised long-term funds to offset the lack of liquidity in Wfa's original own funds (also available in the long term), it is reasonable to take the government bond rate of 8,26 % as an appropriate rate. The studies submitted by the German Government on the level of remuneration also quote this figure as an appropriate long-term refinancing rate. Applying German tax rates, this gives a rate for net refinancing costs of 4,2 %⁽⁴³⁾. In any event, no refinancing costs higher than those of the private banks can be accepted, as WestLB with its triple-A rating should normally pay lower-than-average interest rates.

(205) It should also be pointed out that, in its complaint, BdB accepted the arguments of the German Government and WestLB and assumed that, in calculating the appropriate remuneration, a reduction corresponding to the amount of WestLB's refinancing costs must be made. It was only later, as part of the formal consultations, that BdB challenged this argument. The Commission, however, believes that the 'closed circuit' in the use of Wfa revenues, as asserted by the German Government, presents liquidity spilling over into WestLB's commercial activities

⁽⁴⁰⁾ Of course, in reality the situation is much more complex because of off-balance-sheet items, different risk weightings of assets or zero-risk items etc. However, the principal reasoning holds.

⁽⁴¹⁾ The situation does not change if one takes into account the possibility of raising additional own funds up to the same amount of original own funds (a factor of 25 instead of 12,5 for original own funds).

⁽⁴²⁾ In the decision to initiate the procedure laid down in Article 88(2) of the Treaty, the Commission provisionally indicated a rate of 7 % on the basis of information submitted at that time by WestLB.

⁽⁴³⁾ According to documents provided by the German Government, the corporation tax rate was 46 % in 1992, plus a solidarity surcharge of 3,75 %, i.e. 49,75 % in total. This gives net refinancing costs of 4,15 %. The overall tax rate fell to 46 % in 1993 and has stood at 49,5 % since 1994, giving net refinancing costs of 4,46 % and 4,17 % respectively. The 4,2 % rate is therefore justified not only for 1992 but also as an average.

- (iii) Appropriate remuneration for the amount of DEM 2 500 million (EUR 1 280 million)

(206) In theory, there are no doubt different ways of calculating the appropriate remuneration for the equity capital provided. The German Government and WestLB suggest using the capital asset pricing model in order to calculate only the risk premium for Wfa's special reserve, while simply disregarding the risk-free base rate because of the liquidity costs. BdB and the Commission's outside experts argue that the basis should be the normal rate of return on investment in the banking sector adjusted for a number of specific features of the transaction.

(207) The capital asset pricing model was in fact developed for the purpose of pricing shares held in a portfolio of a well-diversified investor. By contrast, the investment decision in question was a one-off decision and did not involve one particular stock within a diversified portfolio. Furthermore, it is also questionable whether the two banks used by WestLB's consultants to arrive at a beta factor for WestLB are really the best choice, as WestLB is much more complex and more internationally oriented. However, in principle, the two approaches should lead to similar conclusions.

(208) As has also been pointed out in the documents submitted by the German Government, even experienced investors normally use data from past years as a basis for their assessment of likely returns in the future. However, it should be stressed that, in principle, a market economy investor bases his decisions on the expected return and not on past performance.

(209) The Commission has taken into consideration, alongside its own experience, several statements and studies by investment banks and consultancies regarding actual and expected returns on equity and investments, as well as the statements submitted by the different parties involved in the case. On the basis of this information, its own relevant experience, market statistics and decisions taken in the past on capital provided by the State⁽⁴⁴⁾, the Commission assumes an expected

minimum remuneration of 12 % after tax⁽⁴⁵⁾ for this type of equity investment at the time of the transfer⁽⁴⁶⁾. It should again be recalled that historical average returns are only one factor in an investor's investment decision. In fact, investors use as a guide the expected future rate of return. By so doing, they are in fact not only aiming for an average return but also endeavouring to achieve an even better return while taking into account the risk of the investment. In practice, companies therefore have to convince investors that they will at least be able to generate average returns on the equity injected. If a company cannot satisfy these expectations of at least average returns, the investor will consider investing in another company with better prospects. The *Land* obviously did not explore such other possibilities. In any case, such investment decisions and assessments by investors cannot be challenged by using retrospective market data on the actual performance of the markets since the time of the relevant decision.

(210) However, three features of the transaction in question are crucial for fixing the appropriate remuneration and have thus to be taken into account accordingly: firstly, the fact that the transfer constitutes a very substantial investment in a company with a significant capital shortage, low profits and no restructuring plan; secondly, the absence of new shares and associated voting rights; thirdly, the fact that it is a permanent investment in unquoted stock (i.e. with no exit possibility).

(211) The size of the amount transferred and its decisive effect on WestLB from the point of view of solvency regulations has already been mentioned. WestLB was making a profit in 1991 but was underperforming when compared with other banks. On this basis, a market economy investor would have demanded a

⁽⁴⁴⁾ The same rate was used by the Commission in its decision on State aid for the French bank *Crédit Lyonnais*, where it stated that the relevant rate must be 'the rate that the capital markets would have used in order to assess the return on their contribution. According to estimates made by a number of experts, including *Crédit Lyonnais*, the appropriate rate of return for capital invested in a bank is of the order of 12 %' (OJ L 308, 21.12.1995, p. 92, Section 6.3).

⁽⁴⁵⁾ It is worth pointing out that, in principle, investors primarily look at net returns when comparing investments.

⁽⁴⁶⁾ This assessment is borne out by the study by the Commission's outside experts, who assume a rate of between 12 % and 13 % after tax as a minimum remuneration for equity at the time of the transaction. They add that investors were likely at that time to have had higher expectations (by around 1 percentage point) because of the European convergence process.

significant premium for an injection of capital as large in relative and absolute terms as Wfa's assets⁽⁴⁷⁾.

(212) Following the transfer of Wfa, the *Land* has been exposed to a higher risk in the event of WestLB becoming insolvent. On the other hand, the transfer of Wfa did not provide the *Land* with additional voting rights. By forgoing voting rights, the investor renounces a say in decisions taken by the bank's board. To compensate for this acceptance of a higher risk without a corresponding increase in influence over the company, a normal market economy investor would demand a higher remuneration (even if the potential risk were cushioned by internal agreements with the other shareholders). The situation can be compared to non-voting shares, which normally pay higher dividends than ordinary shares. A market economy investor would demand compensation to offset the renunciation of influence⁽⁴⁸⁾.

(213) Normally, an investor can at any time sell any of the various equity instruments mentioned earlier on the markets and thereby end his investment. The special circumstances of Wfa's transfer do not give the *Land* such an opportunity. This statement does not challenge the public purpose of housing promotion pursued by the *Land* and the earmarking of Wfa's assets for this purpose. However, even if the *Land* wanted to remove the housing promotion division from WestLB, for example because it considered that the public task in question could be fulfilled more efficiently by another arrangement, it could not do so. In fact, the *Land* is forgoing at least part of its right of disposal over the housing promotion fund. Because of the tied nature of the investment, a market economy investor in the same situation would demand an increase in the remuneration.

(214) In the case of shares, the remuneration depends directly on the performance of the company and is expressed mainly in the form of dividends and a share in the increased value of the company. The *Land* receives a fixed remuneration the level of which should reflect these two aspects of remuneration for 'normal' equity injections. It could be argued that the fact that the *Land*

receives a fixed remuneration instead of one directly linked to WestLB's performance constitutes an advantage which justifies a reduction in the rate of the remuneration. Whether such a fixed rate actually constitutes an advantage as compared with a variable, profit-linked rate depends on the company's performance. If the performance is poor, a fixed rate benefits the investor but, if the performance is above expectations, it places him at a disadvantage. However, subsequent developments cannot be used to judge the investment decision, which was based on certain expectations on the part of the investor about the bank's future performance. It should also be borne in mind that, in the event of losses, no remuneration is paid at all and a decision on cumulative recovery payments is a matter for WestLB. In that respect too, the fixed nature of the rate does not benefit the investor. In aggregate, the Commission believes that the rate of remuneration should not be changed for this reason.

(215) The Commission is of the opinion that, because of the particularities of the transaction discussed above, a market economy investor would have demanded a premium on top of the normal market return on the capital provided. It regards a premium of 1,5 percentage points as the minimum reasonable rate⁽⁴⁹⁾.

(216) On the basis of the above considerations, the Commission concludes that an appropriate remuneration for the investment in question would be 9,3 %, namely, a 12 % normal return on equity plus a premium of 1,5 percentage points for the particularities of the transaction minus 4,2 percentage points on account of the financing costs resulting from the transferred assets' lack of liquidity for WestLB.

(217) It should also be mentioned that the remuneration of equity injected is normally a matter to be agreed between the company and the investor. However, in the case at hand, the level of the remuneration to be paid by WestLB was obviously agreed on between WestLB's shareholders, which seems unusual. It should not depend on what the other shareholders are willing to accept but on the risk for the *Land* and the usability for WestLB. The German Government moreover did not provide any documents about the negotiations on the remuneration or the way in which the level was calculated. It is certainly right in claiming that only the result, i.e. the level of the remuneration, is decisive for the Commission's assessment under the State aid rules,

⁽⁴⁷⁾ The study by the Commission's consultants provides an example of a loss-making bank in the United States which suffered from a serious capital shortage and put together a robust restructuring plan. In order to attract an investor, it had to grant a considerable one-off discount on the quoted share price. Certainly, the case is not directly comparable to the one at issue (and the discount applied only once, at the time of the injection), but it shows that, where large amounts of capital are urgently needed, an investor asks for a premium.

⁽⁴⁸⁾ The principle that non-voting shares should yield a preferential dividend above the normal level has been established by the Commission in past decisions (see, for example, the Commission's letter to Belgium dated 25 July 1984 regarding the firm Sidmar).

⁽⁴⁹⁾ The study by the Commission's outside experts stresses that a market economy investor would expect a premium to be paid for each of these special circumstances and proposes for all three aspects together a premium of 1 to 2 percentage points.

and not the way in which this result was achieved. However, in the Commission's view, the way in which the remuneration was fixed and the considerations that played a part in that respect can certainly provide pointers to the extent to which the *Land* behaved like a market economy investor.

a guarantee. A market economy investor would demand an appropriate remuneration in return for exposing himself to a risk of this sort.

(218) Furthermore, it was agreed between the shareholders of WestLB that the remuneration should be fixed only once WestLB's financial results for 1992 onwards were available. In the Commission's view, the bank's financial result should not in fact be of any relevance in determining the level of the fixed remuneration, which should be based not on the profits actually generated by WestLB but on the risk for the *Land* and the potential benefits of the transfer for the bank. A market economy investor would not be prepared to accept a lower level of remuneration because the results of the company in question were poor. This agreement does not therefore suggest behavior corresponding to that of an investor acting under normal market economy conditions.

(219) During the Commission's preliminary investigations, negotiations took place between the complainant and WestLB with a view to finding a solution, i.e. to establish on a common basis a remuneration regarded as being in line with the market, without recourse to the procedure laid down in Article 88(2) of the EC Treaty. These negotiations were not successful. During them, however, WestLB proposed that, in the event of its liquidation, the *Land* should be granted the right to receive, in addition to the existing fixed remuneration of 0,6 %, an adequate consideration for the increase in value of WestLB due to the additional business made possible by the transfer of Wfa, i.e. the *Land* would be given an additional share in WestLB's open and hidden reserves. This fact suggests that the value to WestLB of the transferred capital actually exceeded the agreed remuneration. However, no such share in the break-up value was agreed. Nor would a market economy investor accept such a hypothetical remuneration since, in the case of a perpetual company like WestLB, he would never be able to cash it; it would thus have no value.

(iv) Appropriate remuneration for the amount of DEM 3 400 million (EUR 1 740 million)

(220) As already mentioned, the equity of DEM 3 400 million (EUR 1 740 million) is also of material value to WestLB and its economic function may be compared to that of

(221) In its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, the Commission quoted a rate of 0,3 % as having been indicated by the German Government as the appropriate commission on a bank guarantee (*Avalprovision*) for a bank like WestLB. However, two factors in particular must be taken into account here. Firstly, the amount of DEM 3 400 million (EUR 1 740 million) exceeds what is normally covered by such bank guarantees. Secondly, bank guarantees are normally associated with certain transactions and limited in time. By contrast, Wfa's special reserve is at WestLB's disposal without any time limit. These two factors require an increase in the premium to about 0,5 % to 0,6 %. Guarantee premiums normally count as operating expenses and therefore reduce taxable profit, but the remuneration for Wfa's capital is paid to the *Land* from after-tax profits, so the rate must be adapted accordingly. In view of all this, the Commission is of the opinion that a rate of 0,3 % after tax is a correct remuneration for this kind of capital.

(v) Synergy effects

(222) The German authorities claim that the real reason for the transfer was to achieve potential synergies and not to increase WestLB's equity. It might well be true that a discussion on the efficiency of housing promotion had already begun in the 1970s. However, despite this lengthy debate, the transfer did not take place until 1991, when WestLB's capital requirements forced its public owners to take such action. It is clear from the documents — especially the relevant material on the Transfer Law, such as the grounds of the Law and the minutes of the parliamentary debates — that the actual purpose of the transfer was to provide WestLB with the equity base needed to comply with the new solvency rules. Synergy effects were seen as a positive side-effect but were certainly not the main driving force behind the transaction at the time.

(223) The German authorities and WestLB claim that the *Land* is not only receiving a payment of 0,6 % on the amount of DEM 2 500 million (EUR 1 280 million) but also benefiting from synergy effects worth about DEM 30 million (EUR 15 million) annually as a result of the transfer and integration of Wfa and WestLB's takeover of Wfa's pension obligations totalling DEM 33 million (EUR 17 million). The cost savings from synergies arise from the merger of Wfa with the former housing

[illegible]

	(million DEM)						
	1992	1993	1994	1995	1996	1997	1998
Total remuneration in line with market conditions	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Actual remuneration (after tax)	[...]	[...]	[...]	[...]	[...]	[...]	[...]
Aid element	-14,2	228,5	254,5	273,8	278,8	279,1	279,2

4. Tax exemptions

(233) As stated in the Commission decision to initiate the procedure laid down in Article 88(2) to the EC Treaty, State aid may be involved if a particular enterprise is exempt from taxes whereas its competitors are subject to normal taxation. If the construction of an 'entity within an entity' involves a non-profit, tax-exempt entity, steps have to be taken to ensure that the economic effects of tax privileges are strictly limited to the non-profit entity and do not spill over to the enterprise in the competitive sector.

(234) WestLB is subject to neither property tax (*Vermögenssteuer*) nor tax on business capital (*Gewerbekapitalsteuer*) on the transferred capital. Furthermore, the profit from Wfa's activities exempt from corporation tax (*Körperschaftsteuer*) after the transfer. According to the German Government, these tax provisions are not intended to favour and do not favour WestLB over other taxable persons.

(235) Profits accruing within WestLB's competitive business as a result of the use of Wfa's capital for solvency calculations are taxed normally. Only profits in the housing promotion sector are exempt from tax. Similarly, the exemptions from taxes on business capital and on property are limited to the housing promotion business. It is not the Commission's task to decide whether the German tax laws regarding exemptions for non-profit-oriented activities have been infringed, but only to assess the measure under the State aid rules of the Treaty.

(236) The exemption from property tax, tax on business capital and corporation tax enjoyed by Wfa within WestLB boosts Wfa's profits (or reduces its losses), reduces the potential need for the *Land* to inject additional funds into housing promotion and could subsequently increase Wfa's net assets. Since Wfa needs only a certain part of this (enlarged) capital base as original own funds for its own business, the part available to WestLB to underpin its competitive activities might also increase over time. However, if this share increases, the basis for the remuneration to be

paid to the *Land* will also increase. If this remuneration is fixed at an appropriate level, there will be no distortion of competition in favour of WestLB as a result of the tax exemptions for the housing promotion business. According to the above calculations, an appropriate level would be 9,3 % and 0,3 % respectively.

5. Waiver of liability

(237) The German Government argues that the waiver of liability does not adversely affect the *Land's* financial position and does not constitute any competitive advantage for Wfa or WestLB. Following the transfer, Wfa's assets (the *Land* housing promotion fund) are not reduced each year by this liability, so that higher proceeds are possible in the event of Wfa being wound up, with such higher proceeds accruing to the *Land*. The German authorities also state that, without the waiver, BAKred would not have accepted DEM 4 000 million (EUR 2 050 million) as original own funds of Wfa.

(238) The Commission accepts the argument of the German authorities that the *Land's* economic position has in principle not been changed by the waiver. Redemptions and interest for the debts in question had to be paid by the *Land* in any event. The waiver of liability increases Wfa's current value and its potential break-up value. The waiver of a debt of a public enterprise by its public owner could in principle constitute State aid. Here, however, the entity in question is not engaged in commercial activities.

(239) It should be noted though that, as a result of the transfer, the *Land* lost the latitude it enjoyed to change its housing promotion policy and to put Wfa into liquidation. Since Wfa's capital functions as equity of WestLB, this capital cannot simply be withdrawn by the *Land*. This fact was taken into account by the Commission when considering the appropriate level of remuneration for the transfer.

(240) The waiver has certainly increased Wfa's value. However, since the remuneration to be paid by WestLB is based on the valuation of Wfa after the waiver, i.e.

taking into account this increase in its value, the waiver does not constitute an advantage for WestLB if the remuneration is in line with the market.

exemption clause are not met. WestLB is not described as an undertaking in difficulty whose viability must be restored with the support of State aid.

6. Compatibility of the measure with the EC Treaty

- (241) On the basis of all these considerations, it can be stated that all the criteria laid down in Article 87(1) of the EC Treaty are met and the transfer of Wfa therefore involves State aid within the meaning of that Article. On this basis, an assessment must be made as to whether that aid can be considered compatible with the common market. It should be pointed out that the German Government did not invoke any exemption clause of the Treaty with regard to possible State aid elements in connection with the transfer of Wfa.
- (242) None of the exemption clauses of Article 87(2) of the EC Treaty are applicable. The aid is not of a social character, is not granted to individual consumers, does not make good the damage caused by natural disasters or exceptional occurrences, and does not compensate for economic disadvantages caused by the division of Germany.
- (243) Given that the aid has no regional objective — it is designed neither to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment nor to facilitate the development of certain economic areas — neither Article 87(3)(a) nor (c) of the EC Treaty, as regards the latter's regional aspect, is applicable. Nor does the aid promote the execution of an important project of common European interest. The aid not aimed either at promoting culture or heritage conservation.
- (244) Since the economic survival of WestLB was not at stake when the measure took place, there is no need to consider whether the collapse of a single large credit institution like WestLB could lead to a general banking crisis in Germany, which might possibly justify aid to remedy a serious disturbance in the German economy under Article 87(3)(b) of the EC Treaty.
- (245) Under Article 87(3)(c) of the EC Treaty, aid may be found compatible with the common market if it facilitates the development of certain economic activities. This might in principle also apply to restructuring aid in the banking sector. However, in the case at hand the conditions for the application of this

- (246) Article 86(2) of the EC Treaty, which allows exemptions from the State aid rules of the Treaty under certain conditions, is in principle also applicable to the financial services sector. This has been confirmed by the Commission in its report on Services of general economic interest in the banking sector⁽⁵⁰⁾. However, it is clear that the transfer was effected in order to enable WestLB to comply with the new own funds requirements and with no regard to any services of general economic interest. Furthermore, the German Government did not claim that the transfer of Wfa was designed to indemnify WestLB for the provision of certain services of general economic interest. Therefore, this exemption clause does not apply either in the case at hand.
- (247) Since no exemption from the principle of the ban on State aid pursuant to Article 87(1) of the EC Treaty applies, the aid in question cannot be found compatible with the Treaty.

VI. CONCLUSIONS

- (248) The Commission finds that Germany has unlawfully implemented the aid in question in breach of Article 88(3) of the EC Treaty. This aid is therefore illegal.
- (249) The aid cannot be found compatible under either Article 87(2) or (3) or under any other provision of the Treaty. The aid is therefore declared incompatible with the common market and must be discontinued and the aid element of the measure illegally put into effect must be recovered by the German Government,

HAS ADOPTED THIS DECISION:

Article 1

The State aid which Germany has implemented for Westdeutsche Landesbank Girozentrale in the years 1992 to 1998, amounting to DEM 1 579,7 million (EUR 807,7 million), is incompatible with the common market.

⁽⁵⁰⁾ This report was presented to the Ecofin Council on 23 November 1998 but has not been published. It can be obtained from the Competition Directorate-General of the Commission and can also be found on the Commission's website.

Article 2

1. Germany shall take all necessary measures to discontinue and recover from the beneficiary the aid referred to in Article 1 and unlawfully made available to the beneficiary.

2. Recovery shall be effected in accordance with the procedures of national law. The aid to be recovered shall include interest from the date on which it was at the disposal of the beneficiary until the date of its recovery. Interest shall be calculated on the basis of the reference rate used for calculating the grant equivalent of regional aid.

Article 3

Germany shall inform the Commission, within two months of notification of this decision, of the measures taken to comply with it.

Article 4

This decision is addressed to the Federal Republic of Germany.

Done at Brussels, 8 July 1999.

For the Commission

Monika WULF-MATHIES

Member of the Commission

COMMISSION DECISION**of 20 July 1999****on State aid to be granted by Germany to CBW Chemie GmbH, Bitterfeld-Wolfen***(notified under document number C(1999) 3272)***(Only the German text is authentic)****(Text with EEA relevance)***(2000/393/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 provisions cited above⁽¹⁾ and having regard to their comments,

Whereas:

I. PROCEDURE

- | | |
|-------------------|---|
| 21 March 1997 | Germany informed the Commission, in accordance with Article 88(3) of the EC Treaty, of the privatisation of the firm CBW Chemie GmbH Bitterfeld-Wolfen (CBW). The case was registered on 25 March 1997 as State aid N 238/97. |
| 18 April 1997 | The Commission asked Germany to supply additional information (reference D/51861). |
| 23 May 1997 | Germany supplied additional information (letter registered as received on 27 May 1997 under reference A/34120). |
| 18 August 1997 | The Commission informed Germany by letter SG(97) D/7102 of its decision to initiate formal proceedings in the case. The decision was also published in the <i>Official Journal of the European Communities</i> ⁽¹⁾ . |
| 2 September 1997 | Germany replied (letter registered as received on 2 September 1997 under reference A/37005). |
| 12 September 1997 | The Commission sent a further letter to Germany (reference D/54167). |
| 29 September 1997 | Germany replied (letter registered as received on 30 September 1997 under reference A/37729). |
| 5 January 1998 | Comments were submitted by interested party Fischer & Limberger (registered as received on 12 January 1998 under reference A/30208). |
| 16 January 1998 | Comments were submitted by interested party Fischer & Limberger, represented by Schön, Nolte, Finkelnburg & Clemm (registered as received on 16 January 1998 under reference A/30379). |

⁽¹⁾ OJ C 383, 17.12.1997, p. 4.

11 February 1998	The Commission forwarded the comments received to Germany (reference D/50622).
23 February 1998	A letter was sent by Fischer & Limberger to the Commission (registered as received on 23 February 1998 under reference A/31489).
11 March 1998	A letter was sent by CBW to the Commission (registered as received on 11 March 1998 under reference A/32032).
24 April 1998	A letter was sent by Fischer & Limberger to the Commission (registered as received on 27 April 1998 under reference A/33271).
5 June 1998	A letter was sent by Fischer & Limberger to the Commission (registered as received on 8 June 1998 under reference A/34297).
11 June 1998	A letter was sent by Fischer & Limberger to the Commission (registered as received on 11 June 1998 under reference A/34439).
15 June 1998	The Commission asked Germany a number of questions (reference D/52467).
27 July 1998	Germany replied (letter registered as received on 28 July 1998 under reference A/35874).
12 November 1998	Talks were held between representatives of the Commission and Germany in Berlin.
8 December 1998	Germany supplied additional information (registered as received on 4 January 1999 under reference A/30043).
2 February 1999	A letter was sent by Mr Thieme to Mr Van Miert, Member of the Commission (registered as received on 8 February 1999 under reference A/000542), to which Mr Van Miert replied by letter of 24 February 1999 (reference D/508350386).

II. GENERAL DESCRIPTION

1. Reasons for initiating formal proceedings

After examining the notification and the additional information supplied by Germany, the Commission decided to initiate formal proceedings under Article 88(3) of the EC Treaty for the following reasons:

- (a) doubts as to the firm's viability: the data contained in the notification gave rise to doubts concerning the firm's ability to remain in business since a positive result was not expected before 2005;
- (b) insufficient contribution by the investor: the originally proposed share of 3,5 % of the costs of restructuring was insufficient;
- (c) distortion of competition: the incomplete nature of the information supplied by the German authorities gave rise to doubts concerning possible overcapacity on the relevant market.

2. The recipient of aid

In 1990, the former Chemiekombinat Bitterfeld-Wolfen, situated at Bitterfeld (Saxony-Anhalt), was transformed into Chemie AG. When the attempts by the Treuhandanstalt (THA) to privatise the entire firm failed owing to a lack of interested buyers, Chemie AG was split up into a number of divisions. This resulted in the creation of Chemie GmbH Bitterfeld-Wolfen (formerly CBW), a firm active in the manufacture of various primary chemical products for the dye and pharmaceutical industry.

Under a contract of 13 March 1997, six divisions of CBW, subsequently known as CBW Chemie GmbH, Bitterfeld-Wolfen (CBW), were taken over by Mr Bräutigam and Mr Riemann (B & R) for a total of DEM 1 million. On top of this was a variable price component that was determined on the basis of the annual cash-flow trend. With 246 employees and a turnover of DEM 74 million in 1997, CBW meets the definition of a small and medium-sized enterprise (SME).

3. Financial measures

Under the privatisation contract, the costs break/down among the individual providers of funds as follows:

BvS

(in million DEM)

Aid measure	Amount
Investment aid	46,100
Various grants (disposal of chemical residues, infrastructure measures)	11,240
Payment of the costs of disposing of chemical residues from the period before 1 July 1990	1,280
Payment to offset negative cash flow	9,000
Total	67,620

Land of Saxony-Anhalt

(in million DEM)

Aid measure	Amount
Investment aid under the joint Federal Government/Länder scheme ⁽¹⁾	28,800
Total	28,800

⁽¹⁾ The measures provided for under the joint Federal Government/Länder scheme for improving regional economic structures constitute regional investment aid within the meaning of Article 87(1) of the EC Treaty and were approved under Article 87(3)(a) (25th framework plan, cf. aid case C 37/96 (ex N 186/96), (OJ C 35, 4.2.1997)).

Investors

(in million DEM)

Aid measure	Amount
Purchase price	1,000
Taking-over of the liabilities	8,857
Capital increase	1,000
Guarantee	2,000
Operating loan	2,000
Investment loan	8,000
Total	22,857

Under a contract dated 13 March 1997, the shares of the former CBW were sold to B & R for an immediate price of DEM 1 million. The additional variable component of the purchase price is to be

calculated on the basis of the expected cash flow in the period 2000 to 2004 (up to 50 % of annual cash flow, payable each September of the year following the year in question). Since the initiation of proceedings, Germany has informed the Commission that the value of this price component is now as much as DEM 20 million given the firm's significantly improved position⁽²⁾. In addition, the investor has taken over CBW's liabilities of DEM 8,857 million, an amount which falls due for payment on 30 June 2005.

Under the purchase contract, the investor is also required to increase CBW's capital by DEM 1 million; it is also assuming liability for dormant equity holdings of DEM 2 million.

Private credit institutions, including [...] (*), granted the firm two loans guaranteed by the investor and totalling DEM 10 million. A DEM 2 million operating loan on 30 June 1998 and carrying interest at 8,25 % per annum and a DEM 8 million investment loan over two years at an interest rate of 5,75 %. The original intention was to cover these loans by 80 % guarantees from the *Land* of Saxony-Anhalt but, as the Commission learned from Germany in the course of the proceedings, the banks have since waived the need for public guarantees because of the firm's improved position.

III. COMMENTS FROM INTERESTED PARTIES

After initiation of the formal proceedings, a group which was also interested in buying CBW, Fisher & Limberger (F & L), expressed doubts as to whether B & R had in fact submitted the best aid.

IV. COMMENTS FROM GERMANY

The Commission passed these remarks on to Germany and gave the German authorities the opportunity to comment on them. Germany responded by letter of 23 March 1998, supplying further details on the choice of investor, the tender procedure and the current position of the firm.

V. ASSESSMENT OF THE AID

1. Existence of aid within the meaning of Article 87(1) of the EC Treaty

(a) *Aid in connection with the privatisation of firms*

Privatisation measures do not contain any element of State aid if the following conditions are met⁽³⁾:

- a competitive tender must be held that is open to all comers, transparent and not conditional on the performance of other acts,
- the company must be sold to the highest bidder, and
- bidders must be given enough time and information to carry out a proper valuation of the assets as the basis for their bid.

If these conditions are not met, the measures in question must be notified so that any payments made in connection with the privatisation can be assessed in the light of the prohibition of aid laid down in Article 87(1) of the EC Treaty.

In its letter of 5 January 1998, the group F & L alleged that it had been discriminated against in the tender procedure. The Commission therefore has doubts as to whether the tender procedure was correctly implemented.

(*) Business secret.

⁽²⁾ This information was supplied by the BvS at a meeting on 12 November 1998.

⁽³⁾ See 23rd report on competition policy (1993), point 402 et seq.

(i) Sequence of events in the privatisation process

In mid-1995 the firm KPMG carried out an international call for tenders for the purchase of nine operating divisions of the former CBW. Of the firms and persons which notified their interest, there were, alongside six tenders for the privatisation of individual divisions, three potential groups of investors:

- Mr Bräutigam and Mr Riemann (B & R),
- the group Fischer & Limberger (F & L),
- a consortium⁽⁴⁾.

According to the assessment made by KPMG and the management committee⁽⁵⁾ (*Leitungsausschuß*) at a meeting held on 22 August 1995, only B & R and F & L had submitted realistic tenders for all of the divisions to be sold off. The consortium's tender was rejected because of the exorbitant amount of public money it would require. A series of tenders for the separate privatisation of individual divisions were also deemed too costly.

The total costs associated with the original tenders for the takeover of the nine divisions compare as follows:

(in million DEM)

Total costs	
B & R	140,6
F & L	212,0
Individual privatisations	Total of 178,7

At the end of 1995 the BvS decided to reduce the number of divisions to be privatised from nine to six because the examination of tenders had revealed that the privatisation of three of the divisions would not be profitable. From March 1996 onwards, discussions on the takeover were held only with B & R and F & L.

In April 1996 F & L complained for the first time to the BvS that B & R had a competitive advantage because Mr Bräutigam had previously worked as a consultant in the chemicals department of the THA. He had therefore been able, in drawing up the 1996 management buy-out plan, to make use of expert reports financed using THA/BvS funds. These allegations had been examined at a meeting of the management committee in July 1996 but could not be substantiated. The management committee rejected any accusation of improper conduct on the part of the BvS because KPMG had made all relevant reports available to F & L and had answered all of the latter's requests for additional information. Moreover, the BvS had submitted to the Commission the report of the public prosecutor's office in Halle on the basis of which an investigation had been launched, following allegations of fraud under Section 263 of the Criminal Code, in respect of members of the BvS Chemicals Working Group and of the management committee. This investigation was closed on 18 September 1998 owing to lack of evidence.

In the view of the management committee, as expressed at its meeting of 18 August 1996, B & R and F & L had submitted two comparable tenders. B & R's tender envisaged a slightly higher (by amount DEM 4 million) public contribution. It seemed more interesting from the point of view of its approach but also involved higher risks up to 2000.

On 17 September 1996 the board of directors of the BvS decided, after examining both plans on the basis of the data in the table below, to continue negotiations first with B & R and then, if these did not lead to a satisfactory outcome, with F & L. Before concluding a privatisation contract with B & R, the board of directors also requested some additional information.

⁽⁴⁾ This was made up of four partners; Buch Umwelttechnik GmbH, Manifattura Chemica Italiana, Mr H. Schmidt and a fourth unknown firm.

⁽⁵⁾ An independent body set up by the competent ministry to evaluate the plans submitted. The BvS is not bound by the Committee's decisions but will normally follow them.

	B & R plan (1997)	B & R plan (August 1996)	F & L plan (August 1996)
Total cost 1997 to 2000 (in million DEM)	309,9	309,9	361,5
Number of employees,	254	254	203
of which subject to penalties	190	190	184
Total investment,	84,9	95,2	99,9
of which subject to penalties (in million DEM)	84,9	84,2	99,9
BvS contribution (in million DEM)	55,1	56,4	39,1
Land contribution (joint Federal Government/Länder scheme; in million DEM)	28,8	28,8	42,3
Public contribution (BvS and Land in million DEM)	83,9	85,2	81,4
Contribution by investor	3,0	0,3	20,0
(excluding purchase price; in million DEM)	8,857 (2005)	(proposal)	(proposal)
Purchase price (in million DEM)	1,0 + variable component		n.a.

According to the information supplied during the formal proceedings, the BvS decided in favour of the B & R plan for the following reasons:

- It had serious doubts concerning the financial plan and, in particular, the solvency of F & L. In spite of repeated requests, most recently by letter of 19 July 1996, it had still not received any details from the group concerning its financial contribution. Given that the group's combined nominal capital was DEM 16,8 million, it did not seem realistic that it could put up finance of DEM 20 million [...]. Despite its requests for information, the group had consistently refused to provide a consolidated financial statement. Although the group had, on several occasions, declared its readiness to provide data on the business activities of the individual firms within it, the BvS did not at any time receive such information.
- As far as the public contribution was concerned, the BvS doubted whether F & L would receive funds from the Land of Saxony-Anhalt covering 42 % of its investment costs. According to the information supplied by the Land authorities, this calculation seemed unrealistic because of uncertainty concerning the group's SME status⁽⁶⁾ F & L did not manage to dispel these doubts. By contrast, the plan of B & R, whose SME status was not in doubt and which envisaged aid equivalent to 33 % of the investment costs, seemed plausible.
- A further reason for the BvS's decision was the strategic approach of the B & R plan, which involved introducing made-to-order production and the concentration on 'toll-processing' as a means of securing the firm's long-term viability. This seemed more intelligent and forward-looking to the BvS than the F & L plan, which envisaged merely an increase in turnover on the basis of existing products, most of which were at the end of their useful life. The analysis of the relevant market also showed that large chemical companies such as BASF and Hoechst were increasingly farming out their production activities and obtaining chemical products which they no longer produced themselves

⁽⁶⁾ Classification as an SME is important because it is associated with a certain ceiling below which investment costs can be granted in the form of regional aid under the joint Federal Government/Länder scheme for improving regional economic structures.

from other producers. B & R's plan took account of this trend in that CBW would be transformed into a firm producing chemical products to order for these large companies. The products in question would be top of the range so that a net value added could be achieved⁽⁷⁾. Central to F & L's plans, by contrast, was cooperation with partners such as [...]. Enquiries had revealed, however, that these companies were interested in maintaining only certain areas of activity (e.g. in the case of [...], camposan) or production units (e.g. in the case of [...], the pilot plant).

(ii) *Assessment*

The doubts concerning the tender procedure and the choice of investor were not confirmed as the proceedings progressed. KPMG was responsible for arranging the call for tenders. The BvS selected the investor on the basis of quantitative and qualitative criteria.

B & R's plan required a slightly higher public contribution than that of F & L. As is clear from the above table, the BvS and the *Land* would have to put up a total of DEM 81,3 million under F & L's 1996 plan, while B & R required public funds of DEM 85,2 million initially and, in fact, of only DEM 83,9 million when the contract was concluded.

Nevertheless, the BvS decided in favour of B & R's plan because it appeared more viable in view of the investor's solvency. F & L did not manage to dispel the BvS's doubts about its financial strength and DEM status. Since the BvS wishes at all costs to avoid a situation in which a privatised firm requires further aid and 'contract management' is necessary after privatisation, the criterion of the solvency of the investor has always played an important role in the selection of buyers. In view of the minor difference between the public contributions envisaged by B & R and F & L, the Commission is able to support the BvS's arguments. In addition, in selecting B & R, the BvS opted for the more modern plan, under which CBW would introduce made-to-order production (toll-processing). The Commission therefore accepts that, following an open and transparent tender procedure which was not conditional on the performance of other acts, the firm was sold to the highest bidder and that privatisation therefore took place in accordance with the relevant rules⁽⁸⁾.

It must nevertheless be examined whether liquidation might not have been less costly than the sale of the firm. When the THA was still in operation, the Commission took the view that the liquidation of a given firm should be considered as an economic alternative to privatisation⁽⁹⁾. If the costs of liquidation are lower than the costs arising on the sale of a firm, the process of privatisation is deemed to include elements of State aid. In the case in hand, the costs of liquidation would be in the region of DEM 54 million; the net cash value is DEM 46,303 million.

The Commission has been unable to verify the costs of liquidation estimated by Germany. The estimated value might, in view of the State's social responsibility (continuation of contractual obligations), be higher than the corresponding cost of winding up a private firm. A private provider of capital would not need to bear this burden because it would prefer insolvency to liquidation. This is reason enough for deeming privatisation to constitute a process which includes elements of State aid.

Germany has complied with its obligation under Article 88(3) of the EC Treaty to inform the Commission of the financial measures being taken in favour of CBW.

(b) *Individual aid measures*

It cannot be ruled out that the measures taken in support of the firm active on the relevant market distort trade between the Member States.

⁽⁷⁾ A significant growth factor is the global success of firms which manufacture generic products for the pharmaceutical industry and agriculture, two sectors in which the main producers are increasingly buying their active substances from outside.

⁽⁸⁾ See footnote 3.

⁽⁹⁾ Commission decisions on the activities of the THA in Cases NN 108/91 (letter of 26 September 1991, SG(91) D/17825), E 15/92 (letter of 8 December 1992, SG(92) D/17613) and N 768/94 (letter of 1 November 1995, SG(95) D/1062)..

The measure taken by the *Land* of Saxony-Anhalt under the joint Federal Government/*Länder* scheme for improving regional economic structures constitutes State aid within the meaning of Article 87(1) of the EC Treaty. However, it has been implemented under and in accordance with an aid scheme notified to and approved by the Commission.

The measure taken by the BvS, which is to be deemed to constitute State aid within the meaning of Article 87(1) of the EC Treaty and the value of which can be put at DEM 66,34 million, must be assessed in the light of the possible application of Article 87(3)(c) of the EC Treaty and of the Community guidelines on State aid for rescuing and restructuring firms in difficulty⁽¹⁰⁾. The amount of DEM 1,28 million allocated for the disposal of chemical residues from the period before 1 July 1990 (a 'burden' inherited from the days of German Democratic Republic) does not constitute State aid. Under the 1991 Treuhand arrangements⁽¹¹⁾, the Commission already took the view that funds provided to cover the cost of disposing of such burdens could not be classified as State aid because neither the firm nor the investor could be made responsible for them since they fell solely within the responsibility of the former political regime.

2. Derogation under Article 87(3) of the EC Treaty

The Commission must examine whether the aid in question may be deemed compatible with the common market in accordance with Article 87(3).

Article 87(2) cannot be applied in this case because of the nature of the measures involved. Moreover, Germany has not claimed that the conditions for such a derogation are met.

The Commission must therefore consider whether a derogation under Article 87(3)(c) might be applicable. Under that provision, aid to facilitate the development of certain economic activities or of certain economic areas may be considered compatible with the common market where such aid does not adversely affect trading conditions to an extent contrary to the common interest. Moreover, CBW is situated in an area in which there is serious underemployment and the standard of living is abnormally low.

However, the main purpose of the aid in this case is not to promote regional development but rather to rescue a firm. It must therefore be regarded as ad hoc aid designed to help a firm in difficulty operating in an ailing economic sector to restore its viability. Such aid may be deemed compatible with the common market if it meets the conditions of the Community guidelines on State aid for rescuing and restructuring firms in difficulty.

(a) Restoration of viability

(i) Assumption of the worst-case scenario

When drawing up their restructuring plan, the investors worked on the basis of extremely cautious estimates.

The worst-case scenario covers two aspects: B & R estimated certain cost elements at a very high level. For example, its plan provides for very high depreciation over a period of not more than 10 years. However, the periods of depreciation usually applied in business are based on the actual useful life of plant, which, in the case of the chemical industry, is 15 years. Staff costs were also estimated at a high level by both investors. Even if the number of employees increases as planned, the estimated increase in staff costs seems excessive.

Furthermore, the restructuring plan does not contain certain aspects relating to the firm's strategic approach which were envisaged in B & R's original plan. The central component of that plan was the merger of the six divisions into one economic entity, with the resultant synergistic effects allowing costs to be drastically cut. At the same time, introducing made-to-order production and the concentration on toll-processing technology within CBW would lead to better utilisation of production capacities and

⁽¹⁰⁾ OJ C 368, 23.12.1994, p. 12.

⁽¹¹⁾ See aid NN 108/91 (letter of 26 September 1991, SG(91) D/17825).

improved productivity. However, B & R's business plan does not allow for the synergistic effects resulting from the merger or for the introduction of made-to-order production (toll-processing) because the investor was unable, in 1996, to predict when the restructuring measures would produce their effect.

(ii) Plausibility of the worst-case scenario

The plan was nevertheless deemed plausible by KPMG and the management committee. On the basis of the information received in the course of the proceedings, the Commission is able to support the BvS's arguments.

- In order to be able to assess the plausibility of the restructuring plan, it must first be stated that the assumptions made are based on the annual cash flow. In order for the firm to be deemed viable under the terms of the guidelines, the cash flow must normally be enough to cover not only current activities but also maintenance and reinvestment measures.

However, in order for CBW to be classified as viable, its cash flow need not cover such maintenance and reinvestment measures precisely because its maintenance costs are already included in the firm's planning at an amount of DEM 4 million per annum. Moreover, in view of the considerable investment carried out between 1997 and 1999 for the firm's extensive reorganisation, reinvestment will not be necessary until CBW has further stabilised.

Consequently, cash flow is not required to cover maintenance and reinvestment measures in this case. CBW's cash flow should be positive from 1999 onwards⁽¹²⁾. This means that operating costs would be covered and that the firm will be in a position to finance itself.

- In the restructuring plan presented by the investor, a series of cost items have been set at a very high level. Take, for example, depreciation, which is particularly high because of the depreciation period of not more than 10 years. However, for the purpose of establishing whether the plan is viable, a depreciation period must be applied which corresponds to the actual useful life of plant. Assuming, that, from 1997 to 1999, a total of DEM 83,3 million was invested in plant and that no replacement investment will be necessary until 2005 or later, the depreciation costs are in fact lower (60 %) than set out in the plan. On that basis, the firm would show a positive result from as early as 2001.
- A number of elements of B & R's original plan are not adequately taken into account in the restructuring plan itself. Nevertheless, the BvS did take account, in assessing the plan's viability, of the synergistic effects and of the introduction of made-to-order production and toll-processing, which should lead to lower costs and higher productivity.

(iii) The firm's current position

In the course of the proceedings, Germany has submitted updated data which suggest that a positive operating result can be expected from 2000:

(in million DEM)

Data submitted with the notification						
	1997	1998	1999	2000	2001	2002
Turnover	[...]	[...]	[...]	[...]	[...]	[...]
Operating result	[...]	[...]	[...]	[...]	[...]	[...]
Gross cash flow	[...]	[...]	[...]	[...]	[...]	[...]

⁽¹²⁾ The original plan forecast negative cash flow for 1997 and 1998 that was to be offset by the abovementioned DEM 9 million payment.

(in million DEM)

Data received by the Commission in the course of the proceedings						
	1997	1998	1999	2000	2001	2002
Turnover	[...]	[...]	[...]	[...]	[...]	[...]
Variable costs	[...]	[...]	[...]	[...]	[...]	[...]
Fixed costs	[...]	[...]	[...]	[...]	[...]	[...]
Depreciation	[...]	[...]	[...]	[...]	[...]	[...]
Staff costs	[...]	[...]	[...]	[...]	[...]	[...]
Operating result	[...]	[...]	[...]	[...]	[...]	[...]
Gross cash flow	[...]	[...]	[...]	[...]	[...]	[...]

As the table shows, CBW's financial position has improved considerably. Its turnover in 1997 was much higher than forecast, namely a 30 % increase in relation to the worst-case scenario on which the notification was based.

The data supplied in the course of the proceedings are realistic for the following reasons:

- the improved position is attributable to the initial restructuring measures undertaken in 1997 and 1998 and involving the firm's marketing strategy, the merger of the research units into one analysis centre, the introduction of the ISO 9001 standard and the use of IT systems,
- according to the German authorities, CBW has gained a good reputation among the chemical industry's main players (strategic customers are [...]). Solely on the basis of this newly acquired reputation, the firm is obtaining firm and potential orders for the next three years and more. The merger of six divisions into one entity and the introduction of made-to-order production have been highly successful,
- the progress made in the wake of restructuring has, without doubt, been bolstered in 1997 by favourable trends on the world market.

All of these factors throw a positive light on the restoration of the firm's viability and on the arguments of BvS, which when proceedings were initiated in 1997, were greeted with scepticism. The situation in which CBW finds itself today confirms the BvS's earlier assessment concerning the restoration of the firm's viability.

(b) *Avoidance of undue distortions of competition*

The doubts expressed when the proceedings were initiated concerning overcapacity on the relevant market have not been confirmed by third parties. The Commission does not have any information on the capacity situation on the market for any of CBW's products, with the exception of anilin 310. It would appear that there are some problems with regard to this product⁽¹³⁾. However, in view of the fact that CBW is an SME situated in a region eligible for assistance under Article 87(3)(a) of the EC Treaty, the Commission is not so strict in demanding capacity reductions. That apart, the trend on the chemicals market is very positive, particularly as far as products for the pharmaceutical industry are concerned. For the rest, anilin accounts for only 10 % of total production. The Commission therefore takes the view that no reduction of capacities is necessary in this case.

⁽¹³⁾ CBW is made up of six divisions: Anilin, Azo-Ost, Camposan, nitro-chloro-benzole distillation, pharmaceuticals and the pilot plant.

(c) *Proportionality of the aid*

Even if account is taken of the fact that this case involves a management buy-out, the financial contribution originally envisaged by the investor (some 3,5 %) was inadequate. However, Germany has informed the Commission in the course of the proceedings that, in view of the firm's progress, the (private) credit institutions have waived the need for State guarantees on *Land* loans of more than DEM 10 million in total. This waiver means that the investor's contribution has increased to DEM 22,857 million⁽¹⁴⁾. This constitutes some 19 % of the overall finance and is deemed appropriate given that this case involves a management buy-out. To this should be added a variable purchase-price component estimated, on the basis of the firm's much improved situation, at some DEM 20 million⁽¹⁵⁾.

Against the background of the firm's improved position, it has been incumbent on the Commission to examine whether the aid intensity has been limited to the strict minimum needed to enable restructuring to be undertaken. The aid granted by the BvS includes a payment to offset the negative cash flow originally forecast for 1997 and 1998 (DEM 9 million). However, Germany informed the Commission in the course of the proceedings that the cash flow for 1997 was in fact [...], with a similar figure being estimated for 1998⁽¹⁶⁾. Given this much improved cash-flow situation, the proposed cash-flow offset does, in the Commission's view, indeed exceed the minimum needed to enable restructuring to be undertaken. For this reason, it has to be deemed incompatible with the common market.

VI. CONCLUSION

The amount of DEM 28,8 million made available by the *Land* of Saxony-Anhalt under the joint Federal Government/*Länder* scheme for improving regional economic structures constitutes State aid within the meaning of Article 87(1) of the EC Treaty. It was, however, granted in its entirety under and in accordance with aid schemes notified to and approved by the Commission.

The measures by the BvS which are to be deemed to constitute State aid within the meaning of Article 87(1) of the EC Treaty and amount of DEM 66,34 million have been examined in the light of the Community guidelines on State aid for rescuing and restructuring firms in difficulty in order to determine whether Article 87(3)(c) is applicable. The amount of DEM 1,28 million granted for the disposal of chemical residues from the period before 1 July 1990 does not constitute State aid⁽¹⁷⁾.

Doubts concerning the choice of investor have not been confirmed in the course of the proceedings. The firm KPMG was responsible for the call for tenders. The rescue plan submitted by B & R provided for a slightly higher public contribution than that of F & L, but the BvS chose the B & R plan because it considered it to be more viable in view of the investor's solvency. The group F & L did not succeed in dispelling the BvS's doubts concerning its planned financial arrangements. The solvency criterion was always a key factor for the BvS when it came to selecting a particular buyer. In view of the insignificant difference between the respective amounts of aid envisaged by B & R and F & L, the Commission accepts the reasons put forward by the BvS for its decision. Moreover, in choosing B & R, the BvS opted for the more modern plan because it involves introducing made-to-order production (toll-processing).

The serious doubts expressed when the proceedings were initiated as to whether the firm's viability could be restored were dispelled by the information supplied in the course of the proceedings. The fundamentals of the restructuring plan were deemed viable by the BvS despite its extremely cautious assumptions. The

⁽¹⁴⁾ This is made up of the purchase price of DEM 1 million, the taking-over of the hive-off vehicle's liabilities of DEM 8,857 million, a DEM 3 million capital increase and the granting of an investment and operating loan totalling DEM 10 million. The loans are included in the investor's contribution because they are no longer guaranteed by the *Land*.

⁽¹⁵⁾ According to information supplied by the BvS at talks on 12 November 1998.

⁽¹⁶⁾ It should be pointed out that the privatisation contract provides for the reimbursement of the cash-flow offset up to an amount of DEM 6,4 million if there is no negative cash flow.

⁽¹⁷⁾ Commission decision on the activities of the Treuhandanstalt in Case NN 108/91 (letter of 26 September 1991, SG(91) D/17825).

Commission supports this assessment. Since positive cash-flow results were anticipated as from 1999, with the firm's operating costs thus being covered, the firm should, in principle, be able to finance itself. The BvS's expectations concerning the restoration of CBW's viability are borne out by the firm's current position following the positive cash flow in 1997.

The investor's share of the total costs of restructuring is estimated by the Commission at 19,1 %. To this should be added a variable purchase-price component. Consequently, since this case involved a management buy-out, the investor's contribution is deemed adequate.

The firm's current position is much better than expected in the original plan. In view of the positive gross cash flow for 1997 [...] and the similarly positive result for 1998, the Commission takes the view that the DEM 9 million payment to offset negative cash flow exceed the minimum needed for the firm's restructuring and is therefore incompatible with the common market,

HAS ADOPTED THIS DECISION:

Article 1

1. The measures amounting to DEM 1,28 million which Germany intends to take in order to dispose of the burdens of the firm Chemie GmbH Bitterfeld-Wolfen (CBW) inherited from before 1 July 1990 do not constitute State aid within the meaning of Article 87(1) of the EC Treaty.
2. The State aid totalling DEM 57,34 million which Germany intends to grant to CBW in the form of an investment grant of DEM 46,1 million and the payment of the costs of demolition works and infrastructure totalling DEM 11,24 million is compatible with the common market.
3. The State aid of DEM 9 million which Germany intends to grant to CBW in the form of a payment to offset negative cash flow is incompatible with the common market. This aid may therefore not be granted.

Article 2

Germany shall inform the Commission within two months of the notification of this decision of the measures it has taken to comply with it.

Article 3

This Decision is addressed to the Federal Republic of Germany.

Done at Brussels, 20 July 1999.

For the Commission

Mario MONTI

Member of the Commission

COMMISSION DECISION**of 25 November 1999****on aid to firms in Venice and Chioggia by way of relief from social security contributions under
Laws Nos 30/1997 and 206/1995***(notified under document number C(1999)4268)***(Only the Italian text is authentic)****(Text with EEA relevance)****(2000/394/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 Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty⁽¹⁾ and in particular Article 14 thereof,

Having called on interested parties to submit their comments⁽²⁾ pursuant to the provisions cited above and having regard to their comments,

Whereas:

I**PROCEDURE**

- (1) By letter dated 10 June 1997, the Italian authorities communicated the text of Article 27 of Decree-Law No 669 of 31 December 1996, converted into Law No 30 of 28 February 1997 containing provisions on the reduction of and exemption from social security contributions. This was done pursuant to Article 5 of Commission Decision 95/455/EC on the arrangements for reducing the social security contributions paid by firms in the Mezzogiorno⁽³⁾. That Article requires the Italian Government to notify the Commission of the measures adopted for implementing the plan for the progressive dismantling, laid down by the same Decision, of the scheme for the reduction of social security contributions benefiting firms in Sicily, Calabria, Sardinia, Basilicata, Apulia, Molise and Abruzzi.
- (2) Examination of the provisions shows that, apart from implementing the said dismantling plan, they extend the scope of the relief from social security contributions to the cities of Venice and Chioggia. The Commission asked for further information by letter dated 1 July

1997. Since no reply was received, a reminder was sent by letter dated 28 August 1997.

- (3) Since the Italian authorities failed to provide further information, the Commission notified Italy by letter dated 17 December 1997 of its decision to initiate the procedure laid down in Article 88(2) (formerly Article 93(2) of the EC Treaty regarding the aid provided for by Article 27 of Law No 30/1997 and Article 5a of Decree-Law No 96 of 29 March 1995, converted into Law No 206/1995 to which the said Article refers. These provisions extend to Venice and Chioggia the scope of the reduction of and exemption from social security contributions for the Mezzogiorno.
- (4) In the course of the proceedings an interested party, the Comitato Venezia vuole vivere (Venice wants to live committee – hereinafter ‘the Committee’) submitted comments by letter dated 17 March 1998, in the form of a memorandum and a study carried out by COSES (Consorzio per la ricerca e la formazione – Association for research and training) on the particular difficulties faced by firms operating in the lagoon of Venice and not experienced by companies based on the mainland.
- (5) The comments were forwarded to Italy.
- (6) By letter dated 23 January 1999 the Italian authorities notified their comments regarding:
- (a) National Institute of Social Insurance (INPS) tables listing the types of reduction in social security contributions granted, the number and size of the recipient firms, the number of employees involved and amounts broken down by sector and year,
- (b) their position regarding the nature of the measures and the compatibility of the aid which is the subject of the proceedings,
- (c) their position regarding the recovery of any aid considered incompatible.

⁽¹⁾ OJ L 83, 27.3.1999, p. 1.

⁽²⁾ OJ C 51, 18.2.1998, p. 9.

⁽³⁾ OJ L 265, 8.11.1995, p. 23.

- (7) The Venice authorities also submitted their comments by letter, explaining that municipal companies also received aid under the scheme and stating that the companies in question provided public services of general interest. For this reason they requested that the relief from social security contributions granted to the municipal companies in Venice and Chioggia be exempted under Article 86(2) (formerly Article 90(2)). The Commission forwarded these comments to Italy.
- (8) By letter of 10 June 1999 the Italian authorities informed the Commission that they fully supported the Venice authorities' view that the Article 86(2) exemption should apply to the reductions in social security contributions for the municipal companies in Venice and Chioggia.
- (9) By decision of 23 June 1999, as the Commission considered that Italy had failed to provide all the necessary information to enable it to assess whether the measures concerning the municipal companies of Venice and Chioggia could be exempted under Article 86(2) of the Treaty, it gave Italy notice to provide it with all such documentation, information and data as are necessary to enable it to examine the compatibility of the reductions with the common market.
- (10) The Italian authorities replied by letter of 27 July 1999.
- (11) A meeting was held with the Italian authorities in Brussels on 12 October 1999.
- (12) No other Member State or third party submitted comments.

II

DESCRIPTION OF THE AID

- (13) The aid provided for under Article 5a of Law No 206/1995 and Article 27 of Law No 30/1997 concerns:
- (a) reductions in social security contributions under Article 1 of the Decree of the Minister of Labour of 5 August 1994 (which was the subject of Decision 95/455/EC) for companies situated in Venice and Chioggia;
- (b) exemption from social security contributions under Article 2 of the Decree of 5 August 1994 for net job creation in companies in Venice and Chioggia.

The data supplied by INPS can be summarised in the table below:

1995 to 1997 — annual average

	General reduction (Article 1 of Ministerial Decree of 5 August 1994)	Exemption for net job creation (Article 2 of Ministerial Decree of 5 August 1994)
Amount of aid	ITL 73 billion (EUR 37,7 million)	ITL 567 million (EUR 292 831)
Number of firms assisted	1 645	165

- (14) The Italian authorities stated that they had suspended the scheme with effect from 1 December 1997.
- (15) INPS indicated that exemptions from social security contributions for net job creation were granted for one year for the net jobs created within the company in relation to a reference period (the 30 November prior to the exemption period). The company is not allowed to have laid off staff and the employees taken on must have been unemployed. According to the Italian authorities, average annual aid per employee amounts to EUR 300.
- (16) When the Commission initiated the procedure under Article 88(2) of the Treaty, it observed that the reduction of social security contributions for existing jobs constituted *prima facie* operating aid. This type of aid can be authorised, under certain conditions, only in regions eligible for exemption under Article 87(3)(a) of the Treaty. The cities of Chioggia and Venice are not eligible for this exemption, since they do not belong to a NUTS level II region with a per capita GDP lower

than 75 % of the Community average⁽⁴⁾. As regards the exemption from social security contributions for new jobs created, the Commission observed that, since it was a question of total exemption and since the Italian Government had not provided any further information for its assessment, it was not in a position to conclude that the amount of aid was proportional to the objective pursued. Moreover, while the city of Chioggia is eligible for regional aid under Article 87(3)(c), the city of Venice is only partly eligible for that derogation. It also expressed doubts regarding the compatibility of the measures with the common market in that, in the areas of Venice not eligible for regional aid, the aid does not appear to be consistent with the guidelines on aid to employment, as it does not appear to be limited to small and medium-sized enterprises (SME) nor intended to encourage firms to take on certain groups of workers experiencing particular difficulties entering or re-entering the labour market.

III

COMMENTS FROM THE INTERESTED PARTIES

A. The question whether the relief from social security contributions constitutes the aid

The Italian authorities's comments

- (17) The Italian authorities pointed out that the reductions were intended to offset the additional costs incurred by firms operating on the lagoon islands and were granted to everyone employed by firms located on the Venetian islands. The additional costs incurred by the firms are:

- (a) increased costs of location as a result of higher purchase prices or rents charged for premises and higher maintenance costs;
- (b) the logistical disadvantage of frequent intermediate reloading in connection with the transport of stocks and goods;
- (c) the increased cost of goods and services because the firms operate in a city which is also a popular tourist resort;

(d) additional costs incurred owing to legal constraints and restrictions designed to safeguard the historical and scenic heritage of the area and special safety regulations;

(e) additional disadvantages deriving from environmental factors (seasonal flooding, fog and tides);

(f) disadvantages caused by the declining and ageing population, which limits the number of firms operating locally.

- (18) The reductions of and exemptions from social security contributions should not be considered aid, since they in no way strengthened the position of the recipient companies. They were rather a method of offsetting the more significant disadvantages faced by companies operating in the lagoon area.

- (19) The Italian authorities referred to the details of the COSES study to demonstrate that the additional costs incurred by Venetian companies were far greater than the benefits they derived from the reduction of and exemption from social security contributions⁽⁵⁾.

- (20) Therefore the companies located in the lagoon area were not viewed as enjoying any advantage over other companies with regard to costs normally incurred. In fact, State involvement was seen as having the effect of partly redressing the competitive balance between companies. Instead of distorting competition, the aid at least partly restored it by enabling the recipient companies to compete with others on a more equal footing.

- (21) Failure to provide this assistance would amount to leaving the city to waste away, as could be seen from the tendency to move to the mainland.

The Committee's comments

- (22) The Committee's observations reiterated the comments already set out but also pointed out that there was no real or potential distortion of competition, as the reductions of and exemptions from social security contributions were a method of compensating for costs incurred by companies operating in the lagoon area.

⁽⁴⁾ See point 1 of the Commission communication on the method for the application of Article 92(3)(a) and (c) to regional aid (OJ C 212, 12.8.1988, p. 2), now replaced by the guidelines on national regional aid (OJ C 74, 10.3.1988, p. 9).

⁽⁵⁾ According to the COSES study, the impact of the relief from social security contributions is equivalent to 2,9 % of turnover, while the impact of the additional costs is the equivalent of 9,5 %.

The cost breakdown was extremely similar to that of the Italian authorities⁽⁶⁾. The measures in question were intended to level the playing field with regard to competition between companies, which was in keeping with the aims of the Treaty. For this reason they were not detrimental to competition and therefore did not fall into the category of aid within the meaning of Article 87(1) of the Treaty.

- (23) The Committee also pointed out a close and inseparable link between the relief in question and the intrinsic added cost of being based in Venice. The measures were intended to promote employment; they were linked to the development of the region. As the measures were simply a form of compensation⁽⁷⁾, the authors of the study concluded that the reductions should not be considered aid within the meaning of Article 87 of the Treaty.

Venice local authorities' comments

- (24) The Venice local authorities pointed out that if the relief from social security contributions were to be regarded as aid, it had to have an impact on intra-Community trade and distort competition.
- (25) The authorities explained that the city of Venice had asked to be included on the list of regions eligible for Structural Fund assistance under Objective 2 in the coming programming period. If the aid were declared incompatible and the funds ordered to be recovered, this would effectively cancel out any benefits deriving from Structural Fund assistance and therefore from the cohesion policy. The fact that the city did not enjoy

Objective 2 status at the time was irrelevant, since the practical situation was no different from that which would obtain from 1 January 2000, the date of the start of the new Structural Funds programming period.

- (26) Examination of the Treaty provisions covering cohesion and competition, they argued, revealed that, constitutionally speaking, cohesion was a higher principle than competition and that those provisions prevailed. It therefore followed that competition legislation, particularly on State aid, was intended to bring about fair competition, not free competition. This could be achieved only by restoring the conditions of freedom to compete.

B. Compatibility of the aid

The Italian authorities' comments

- (27) If the measures were to be considered aid, the Italian authorities requested an exemption under Article 87 (formerly Article 92(3)(a) and (c) of the Treaty, as the measures were intended as part of a regional policy and had little impact on competition or intra-Community trade. The underlying reason for the exemption would be economic cohesion to enable all companies to pursue Community objectives that market forces would not allow them to achieve within a reasonable period of time. Moreover, the Italian authorities cited the case-law of the Court of the Justice of the European Communities in support of their request that the Commission demonstrate the impact of the measures on competition⁽⁸⁾.
- (28) The Italian authorities claimed that the measures prevented out-migration from the city of Venice, the decline of its industrial activities and the transformation of Venice into a living museum devoid of any vitality or potential for development.
- (29) They observed that the various Community guidelines were not suitable to justify the relief in question and argued that the Commission should not apply the principles too rigidly as this would not be in the spirit of the exemptions provided for under the Treaty.
- (30) They recalled that in the Community guidelines on State aid for undertakings in deprived urban areas⁽⁹⁾ the Commission acknowledges that the rules governing regional aid do not reflect the needs of geographically

⁽⁶⁾ The Committee lists the following additional costs:

- (a) logistical and structural costs, including the higher maintenance costs and the expense of adapting the buildings, costs resulting from the need to use warehouses which need to be higher to combat the effects of humidity and tides, higher prices for purchasing or renting property and additional costs as a consequence of architectural limitations and scenic and safety restrictions;
 - (b) operational disadvantages, including the need for transshipments when transporting stocks and goods, the higher cost of goods and services, which is in part a consequence of relatively static tourist demand notwithstanding price increases;
 - (c) higher personnel costs owing to the emoluments paid to employees who agree to work in Venice;
 - (d) commercial disadvantages caused by out-migration and the gradual ageing of the population of Venice, which make it more difficult to have contact with customers and sell products;
 - (e) weather-related disadvantages (seasonal flooding, fog and tides).
- ⁽⁷⁾ The Italian authorities referred to the 'neutral' nature of the measures and cited the case of aid granted to the textile, clothing and leather/footwear industry by France in the form of reductions in social security contributions in connection with reorganising working hours (OJ C 357, 26.11.1996, p. 5).

⁽⁸⁾ Case 296/82 Netherlands and Leuwarder v. Commission [1985] ECR 809.

⁽⁹⁾ OJ C 146, 14.5.1997, p. 6.

limited areas. Therefore the Commission should recognise the regional objectives behind these measures which, in the view of the Italian Government, consisted of preventing out-migration from the city and urban decline caused by companies being forced to relocate on account of the additional costs they had to meet in order to stay in the area.

- (31) These considerations were behind the changes to the method for the application of Article 87(3)(c) to regional aid for northern Europe⁽¹⁰⁾.
- (32) They claimed that the exemption under Article 87(3)(a) and (c) of the Treaty could be applied to these measures for the following reasons:
 - (a) the reductions and exemptions contributed to the long-term development of the islands of the Venice region;
 - (b) it was a matter of Community interest that the islands of the Venice region benefit from the measures; there was a clear link between safeguarding the economy of Venice and the preservation of the city as a place of universal interest as described by Unesco;
 - (c) the measures had no impact on intra-Community trade, as they were a method of offsetting additional burdens faced by Venetian companies and because the Venetian economy served a local market.
- (33) The peculiarity or, rather, uniqueness of Venice's situation should enable the Commission to adopt a flexible attitude when assessing the measures. The island status of the area should provide an additional reason for adopting this approach in the light of Declaration No 30 on the island regions annexed to the Final Act of the Treaty of Amsterdam.
- (34) The Committee believes that, should the measures be considered aid within the meaning of Article 87 of the Treaty, the Commission should exempt them under the provisions of Article 87(3)(a) and (c), as they were regional aid measures, had only a minor impact on intra-Community trade and helped to safeguard Venice's historical and artistic heritage.
- (35) The Committee pointed out that part of the region where the relief applied was entitled to a derogation under Article 87(3)(c).
- (36) The arguments employed by the Italian authorities were reiterated by the Committee to urge the Commission to adopt more flexible criteria when assessing the relief from social security contributions.
- (37) The Committee repeated the particular needs which form the basis for the guidelines on deprived urban areas, pointing out that the Commission had also adopted a flexible approach in connection with the north of the province of Madrid, which was exempted under Article 87(3)(c) although it was part of a NUTS III region and therefore ineligible.
- (38) Furthermore, problems similar to those experienced by Venice had led the Commission to change the rules governing the application of the exemptions under Article 87(3)(c) to the peripheral and sparsely populated regions of northern Europe; island regions should be treated favourably in line with Declaration No 30.
- (39) They argued that the aid in question was proportional, since it was the only way to stem the tide of companies relocating to the mainland.
- (40) The aid granted did not affect trade to an extent that was detrimental to the Community interest. Most of the recipient companies were SMEs and had already received aid under the *de minimis* threshold. Moreover, they were primarily operating locally. Given the problems of operating from the islands, the companies were not very competitive in relation to the outside world but could be affected by competition from outside. Venetian manufacturing destined for export was based on traditional products, such as glass.

The Committee's comments

- (34) The Committee believes that, should the measures be considered aid within the meaning of Article 87 of the Treaty, the Commission should exempt them under the provisions of Article 87(3)(a) and (c), as they were regional aid measures, had only a minor impact on intra-Community trade and helped to safeguard Venice's historical and artistic heritage.
- (35) The Committee pointed out that part of the region where the relief applied was entitled to a derogation under Article 87(3)(c).
- (41) For all of the reasons set out above, the measures should be considered compatible on the basis of the exemption under Article 87(3)(c). The Committee also requested the application of the exemption under Article 87(3)(a), pointing out that to preserve Venice, which had been declared a protected monument by Unesco, steps needed to be taken to revitalise the economy of the city and its firms. Left without an economic and social base, the city would become a museum. The Committee also asked the Commission to present a proposal to the Council to authorise the measures on the basis of the exemption under Article 87(3)(e), given the exceptional nature and urgency of the situation.

⁽¹⁰⁾ OJ C 364, 20.12.1994, p. 8.

Venice local authorities' comments

- (42) For the most part, the local authorities used the same arguments as those set out above to request the application of the exemption under Article 87(3)(a) and (c) of the Treaty. They asked the Government to include Venice among the regions exempted under Article 87(3)(c) of the Treaty, arguing that, without these measures to restore a level playing field for the recipient companies, the additional costs and difficulties involved in operating from the lagoon area would force the firms into decline and lead to their disappearance. Without this assistance untrammelled market forces would not achieve one of the objectives of the exemptions, namely regional development.

C. The municipal companies

- (43) The Venice local authorities confirmed that certain municipal companies had benefited from the relief. They pointed out that these companies were entrusted with the operation of public services of general interest and for this reason could be exempted under Article 86(2), in accordance with rulings of the Court of First Instance of the European Communities⁽¹⁾.
- (44) The Italian authorities agreed wholeheartedly with the comments forwarded by the Venice authorities in support of their request that the relief from social security contributions for the municipal companies in Venice and Chioggia be exempted under Article 86(2).

D. The *de minimis* rule

- (45) The Italian Government and the Venice authorities pointed out that most of the measures in question provided SMEs with assistance far below the threshold set out in the *de minimis* rule⁽¹²⁾.

E. The possibility of a recovery order

- (46) The Italian authorities cited a number of Commission Decisions and Court rulings to illustrate the discretionary nature of recovery. They also cited Decision 95/455/EC, where at point 15 the Commission endorsed the general principle that in special situations with a limited impact

on competition there need be no recourse to recovery if the aid is stopped.

- (47) The Italian authorities listed three Decisions where, for specific reasons, the Commission did not order aid to be recovered. In their view, the specific reasons for not requiring recovery of the aid were that:
- (a) the companies were located in an island region;
 - (b) their activities were local;
 - (c) no third party had expressed an interest in the proceedings;
 - (d) the scheme was stopped on 30 September 1997.

IV

ASSESSMENT

- (48) The measures in question are part of an aid scheme, as provided for by a law concerning all companies in the regions involved. Consequently, and in line with the case-law of the Court of Justice⁽¹³⁾, they cannot be considered ad hoc cases, as claimed by the Committee.

The aid element involved in the scheme

- (49) The Commission takes the view that the measures involved in the scheme constitute state aid within the meaning of Article 87(1) of the Treaty. First of all, they result in a loss of contributions for INPS, which amounts to a use of public funds. Secondly, the assistance was granted to selected companies based in the lagoon area, which do not have to bear costs that they would normally incur. Therefore they enjoy an advantage over competing companies forced to bear the full cost of making social security contributions. Moreover, competition and trade between Member States is affected, in that all companies benefit from reductions in social security contributions, including those operating in areas where there is trade between Member States. In particular, according to the information notified by the Italian authorities, some of the recipient companies operate in sectors of intense trading activity, such as the manufacturing and service sectors.

⁽¹⁾ Case T-106/95 *Fédération française des sociétés d'assurances v. Commission* [1997] ECR II-229.

⁽¹²⁾ Commission notice on the *de minimis* rule for State aid, OJ C 68, 6.3.1996, p. 9.

⁽¹³⁾ Joined Cases C-324/90 and C-342/90 *Germany and Pleuger Worthington v. Commission* [1994] ECR I-1173.

- (50) Although most of the recipient companies are SMEs, and therefore less likely to be active outside the domestic market, the measures distort competition and have an impact on intra-Community trade, not only because part of their production is exported to other Member States, but also because companies located in other Member States have less chance of being able to export their products ⁽¹⁴⁾.
- (51) With regard to the arguments put forward by the Italian authorities and interested third parties to the effect that the measures compensated companies operating in the lagoon area for the additional costs they had to bear, the Commission finds as follows.
- (52) The fact that a measure is of a compensatory nature does not mean that it is not an aid measure within the meaning of Article 87(1) of the Treaty. Article 87(2)(b) defines as compatible 'aid to make good the damage caused by natural disasters ...'. It follows that the notion of aid is not dependent on whether a measure is designed as a form of compensation. In certain cases, however, the compensation aspect may be taken into consideration when assessing compatibility.
- (53) Moreover, it should be borne in mind that the Treaty is not intended to ensure perfect theoretical equality between companies, since companies operate in a real-life context and not in a perfect market where they are all subject to the same conditions.
- (54) Furthermore, the additional costs borne by Venetian companies are calculated in relation to savings that would have been made if the companies had relocated to the mainland, not to average costs borne by companies in the Community. Therefore, the comparison is not made with a typical situation, but with a situation which would favour the companies in question.
- (55) The Commission's assessment in a Decision cited by the Italian authorities that certain aid granted to the textile sector was neutral was based on an examination of average costs in the sector and included the form of aid involved in the measures assessed.
- (56) The Commission points out that, more generally speaking, Article 87 does not distinguish between measures on the basis of cause or aim; it defines them according to their impact on competition ⁽¹⁵⁾.
- (57) The argument presented by the Italian authorities that the measures are neutral because the companies do not export their products cannot be accepted. Trade between Member States is harmed when the opportunities for companies located in other Member States to export their products to any market are reduced ⁽¹⁶⁾.
- (58) The Venice authorities asked the Commission to prove that the measures had an impact on intra-Community trade. The Commission notes that the scheme is designed to favour companies involved in trade between Member States ⁽¹⁷⁾. As this is a scheme and not an ad hoc case, this constitutes sufficient grounds for finding that there is an impact on trade. Moreover, the Commission is not required to demonstrate the actual impact on intra-Community trade in the case of an unnotified scheme, in so far as any other decision would favour Member States which grant aid in violation of the notification requirements to the detriment of States which notify planned aid ⁽¹⁸⁾.
- (59) The claims that, according to the Treaty, cohesion legislation prevails over rules on State aid are in the Commission's view unfounded. The reference in the first indent of Article 2 of the Treaty on European Union (formerly Article B) to cohesion as one of the objectives of the Union must be taken in conjunction with the reference in the fifth indent to the objective of maintaining in full the *acquis communautaire* and building on it. Article 2 also sets the objective of promoting a harmonious and balanced development of economic activities which includes rules on competition and economic and social cohesion. In the list of activities provided for under Article 3 of the Treaty to achieve the purposes set out in Article 2, competition policy is dealt with under Article 3(1)(g) and the strengthening of

⁽¹⁵⁾ Case 173/74 Italy v. Commission [1974] ECR 709.

⁽¹⁶⁾ Case 102/87 France v. Commission [1988] ECR 4067.

⁽¹⁷⁾ Case 248/84 Germany v. Commission [1987] ECR 4013.

⁽¹⁸⁾ Case T-214/95 Het Vlaamse Gewest v. Commission [1998] ECR II-0717.

⁽¹⁴⁾ Case C-102/87 SEB v. Commission [1988] ECR I-4067.

economic and social cohesion under Article 3(1)(j). The Treaty provisions therefore do not bear out the claim that cohesion policy is a higher priority than competition policy.

Lastly, if secondary legislation is taken into consideration, Article 7 of Council Regulation (EEC) No 2052/88 on the tasks of the Structural Funds clearly states that cohesion measures must be in keeping with competition rules⁽¹⁹⁾, which once again refutes any claim of superiority for cohesion policy.

Compatibility of the aid measures provided for by the scheme

(60) Having established that the measures under scrutiny constitute State aid within the meaning of Article 87(1) of the Treaty, the Commission has to examine whether they may be declared compatible with the common market in pursuance of Article 87(2) or (3) of the Treaty.

(61) As regards the aid granted under Article 2 of the Decree of 5 August 1994 in the form of an exemption from social security contributions to promote job creation, the Community guidelines on aid to employment ('the employment guidelines'⁽²⁰⁾), specify that the Commission will be favourably disposed, *inter alia*, towards aid for net job creation if it is reserved for SMEs or regions eligible for regional aid. The guidelines also specify that the Commission will ensure that the aid is proportionate to the aim to be achieved. On the basis of the information supplied by INPS, the Commission can conclude that the measure in question is intended for net job creation within the meaning of the employment guidelines and as approved by Decision 95/455/EC. The amount of around EUR 300 per job created is proportionate to the aim pursued since it is small in relation to the total cost of employing a worker. However, while the city of Chioggia is eligible for regional aid under Article 87(3)(c)⁽²¹⁾, the city of Venice was only partly eligible for that derogation during the period concerned. In the areas of Venice not eligible for regional aid, the aid is compatible with the common market in accordance with the employment guidelines only if it is not limited to SMEs. Accordingly, in line with the first indent of point 21 of the

employment guidelines, the aid is compatible with the common market where it is granted to SMEs. The aid granted to firms which are not SMEs is compatible where they operate in an area eligible for exemption under Article 87(3)(c) of the Treaty.

(62) Outside these two categories, namely SMEs and large firms operating in an area eligible for exemption under Article 87(3)(c) of the Treaty, aid may be exempted where it is granted to firms which have taken on certain groups of workers experiencing particular difficulties entering or re-entering the labour market.

(63) Having due regard to point 23 of the employment guidelines, the above analysis also applies to firms in sensitive sectors since the scheme in question is not limited to one or more sensitive sectors but applies without distinction to all sectors of the economy.

(64) Unlike the measures discussed in point 61, the reductions in social security contributions provided for in Article 1 of the Decree of 5 August 1994 constitute aid to maintain jobs granted in favour of all the employees of firms operating in the lagoon area.

(65) Point 22 of the employment guidelines stated that aid to maintain jobs, which is similar to operating aid, may be authorised only under the following conditions:

- (a) where it is intended to make good damage caused by natural disasters or exceptional occurrences (Article 87(2)(b) of the Treaty);
- (b) where it is granted to firms located in regions eligible for exemption under Article 87(3)(a) of the Treaty;
- (c) where it forms part of a restructuring plan for an ailing firm in accordance with the conditions laid down in the Community guidelines on State aid for rescuing and restructuring firms in difficulty⁽²²⁾.

Since these conditions are not met in the case in point, the reductions in social security contributions provided for in Article 1 of the Decree of 5 August 1994 cannot be regarded as compatible with the common market under the employment guidelines.

⁽¹⁹⁾ OJ L 185, 15.7.1988, p. 9, repealed as of 1 January 2000 by Council Regulation (EC) No 1260/99 (OJ L 161, 26.6.1999, p. 1).

⁽²⁰⁾ OJ C 334, 12.12.1995, p. 4.

⁽²¹⁾ See the Commission decision notified to the Italian Government by letter dated 30 June 1997, concerning, *inter alia*, the list of areas eligible for regional aid.

⁽²²⁾ OJ C 368, 23.12.1994, p. 12.

- (66) All the parties which submitted comments urge the Commission, in view of the special situation of Venice, to refrain from applying the rule referred to in point 65 and to adopt a special derogation for that city. According to the Italian authorities, such a derogation should be based on the regional exemptions provided for in Article 87(3)(a) or (c) of the Treaty, while the interested third parties call for the application, in addition to the latter, of the 'cultural' exemption provided for by Article 87(3)(d) or of a specific derogation that the Commission could propose for adoption by the Council under Article 87(3)(e).

The regional exemptions

- (67) As regards the regional exemption provided for by Article 87(3)(a) of the Treaty, no explanation has been given as to why it should be applied. The arguments put forward by the Italian authorities and interested parties in support of applying a regional exemption to the aid measures under examination are based on the need to avert population decline in Venice and the erosion of its industrial base and prevent it becoming a 'museum city' with no vitality and development potential.
- (68) The Commission would point out first of all that only part of the territory of the city of Venice is included in the list of Italian regions eligible for the regional exemptions. It would also stress that, when the regional aid map was drawn up by Italy on the basis of proposals from the Italian authorities, the city of Venice was not proposed in its entirety as a region in which the derogation provided for in Article 87(3)(c) of the Treaty was to apply.
- (69) The criteria for determining the eligibility of an area for the regional exemptions, the type of aid that can be granted therein and the intensity of such aid were laid down by the Commission in its communication on the method for the application of Article 87(3)(a) and (c) of the Treaty to regional aid⁽²³⁾. Only aid granted in accordance with that method may be regarded as regional aid. In applying Article 87(3)(c), the Commission bases its decisions on a method of assessing the socio-economic situation of a region in both the national and the Community context. This enables it, in the Community interest, to establish whether there is a significant regional imbalance and, if so, to allow the Member State concerned, irrespective of its level of economic development, to implement a national regional aid policy.
- (70) Regional aid is furthermore intended to support productive investment or job creation linked to such investment. Since they are independent of any kind of investment, the measures in question designed to

stimulate job creation cannot be regarded as regional measures.

- (71) In reply to the arguments adduced in support of the claim that the Commission has occasionally used the regional exemption provided for by Article 87(3)(c) of the Treaty in order to apply rules departing from those set out in the communication mentioned in point 69, as in the case of an area in the north of the Province of Madrid, the Commission stresses the following.
- (72) It is not correct to describe State aid to firms in deprived urban areas as regional aid⁽²⁴⁾. The rules laid down by the relevant guidelines refer to Article 87(3)(c) and concern assessment of the compatibility of aid granted by Member States to urban areas 'for which the socio-economic indicators are significantly worse than the average for the cities to which they belong'. Those rules cannot be regarded as exceptions to the rules laid down in the communication mentioned in point 69. Neither can they be applied in the case in point since the conditions governing the eligibility of areas, enterprises and activities are not satisfied⁽²⁵⁾.
- (73) The method for the application of Article 87(3)(c) of the Treaty to regional aid was amended⁽²⁶⁾ when Finland and Sweden joined the Community. The Commission made those changes because the existing Community rules did not adequately reflect the special features of some areas of the Nordic countries (remote northern location of some areas, harsh weather conditions and very long distances), as stated in point 4 of the notice. The Commission's aim was to find a test of eligibility that satisfied two conditions: it had to continue to be of general application, i.e. potentially applicable to any country, and it should not disrupt the organisation of the Community and particularly the system of regional aid currently in force.
- (74) The Commission does not intend to amend the method for the application of Article 87(3)(c) of the Treaty in order to adapt it to the case under examination. The situation in Venice has not changed, and the proposed aid is such as to disrupt the system of aid in force since

⁽²³⁾ See footnote 4.

⁽²⁴⁾ See footnote 9.

⁽²⁵⁾ The conditions for the application of the guidelines in question stipulate, *inter alia*, that the deprived urban area must have a population of between 10 000 and 30 000 and belong to a city or urban agglomeration with at least 100 000 inhabitants. Although the Municipality of Venice had a population of 293 727 in 1997, the historic centre of the city had 68 600 inhabitants and the islands 45 382. These population figures do not allow the guidelines in question to be applied to the area under examination. As far as eligible firms are concerned, the guidelines refer only to small enterprises in accordance with the Community definition. An Annex to guidelines also lists the eligible sectors.

⁽²⁶⁾ See footnote 10.

it is operating aid granted to a region that does not suffer from acute problems of economic and social cohesion. The socio-economic indicators for the areas concerned during the period in question were a per capita GDP equal to 122,3 % and an unemployment rate equal to 70,8 % of the Community average. These figures are not indicative of an abnormally low standard of living or serious underemployment.

(75) The Commission already examined in Decision 95/455/EC the reductions in social security contributions provided for by Article 1 of the Decree of 5 August 1994. In that Decision it found that they constituted operating aid and deemed them compatible with the common market where they were degressive and temporary and granted in a region eligible for the derogation provided for in Article 87(3)(a) of the Treaty. The Venice lagoon does not qualify for that derogation.

(76) As regards the fact that the same aid was already deemed compatible in two regions of the Mezzogiorno eligible for exemption under Article 87(3)(c) ⁽²⁷⁾ the Commission explained in Decision 95/455/EC that that assessment had been made in relation to temporary support measures for firms located in regions that had ceased to be eligible for exemption under Article 87(3)(a) of the Treaty. Those support measures consisted, *inter alia*, of certain forms of operating aid. That approach clearly cannot be taken in the case of Venice and Chioggia, which have never been eligible for that exemption and currently only partly qualify for exemption under Article 87(3)(c).

(77) As regards the exceptional case in which exemptions were allowed in an area in the north of the Province of Madrid, it should be pointed out that, in Decision 93/353/EEC ⁽²⁸⁾, the Commission found that the area in question was not eligible for regional aid. The Spanish national regional aid scheme could therefore be applied in that area only in respect of SMEs, and more specifically SMEs located in areas eligible for Structural Fund assistance, up to 31 December 1993. The intensity of the investment aid was partly reduced and limited to 10 % for medium-sized enterprises, 20 % for small enterprises and 40 % for micro-enterprises. In this case the Commission based its decision on a generally

applicable rule set out in the last paragraph of point 4.1 of the Community guidelines on State aid for small and medium-sized enterprises ⁽²⁹⁾.

(78) As far as the regional development objective of the aid is concerned, the Commission notes that, given their characteristics, the measures are not related to the structural difficulties they seek to overcome. There is no connection between the reductions in social security contributions granted per person employed and transport costs, the costs of purchasing, renting and maintain buildings, and administrative burdens imposed by legal, architectural and scenic constraints and other public restrictions ⁽³⁰⁾.

The cultural exemption

(79) On the subject of the cultural objective of the aid granted in the form of relief from social security contributions in the lagoon area, the Commission points out that the Italian Government has never sought to rely on the exemption provided for by Article 87(3)(d) of the Treaty, having always argued that the measures under examination constitute regional aid and qualify for the regional exemption.

(80) There are two aspects to Article 87(3)(d) of the Treaty, which may be applied in respect of aid to promote culture or heritage conservation.

(81) With regard to heritage conservation, the Italian Government and the Committee include in the list of additional costs which they claim are borne by Venetian firms the extra costs of complying with architectural and scenic constraints. Such costs are not, however, incurred by all firms; it follows that while the relief is granted to all firms, only some of them bear costs linked to heritage conservation. Furthermore, even if the relief were restricted to firms occupying buildings subject to architectural and scenic constraints and therefore actually incurring such additional costs, the advantage deriving from the aid would not be proportional to the costs incurred. The aid could prove insufficient for achieving the objective of heritage conservation where granted to a firm employing few people in relation to the artistic heritage to be preserved or, conversely, excessive where granted to a firm with many employees but limited heritage conservation costs.

⁽²⁷⁾ Although they qualified for Structural Fund assistance under Objective 1, the two regions concerned (Abruzzi and Molise) were no longer eligible for exemption under Article 87(3)(a) since their per capita GDP expressed as a percentage of the Community average (89,85 % for Abruzzi and 78,97 % for Molise) greatly exceeded the threshold for eligibility for exemption under Article 87(3)(a), set at 75 %.

⁽²⁸⁾ OJ L 145, 17.6.1993, p. 25.

⁽²⁹⁾ OJ C 213, 19.8.1992, p. 2.

⁽³⁰⁾ These burdens are furthermore not linked per se to the island status as such of the lagoon and therefore do not constitute structural handicaps of the islands which any guidelines drawn up on the basis of the new Declaration No 30 introduced by the Amsterdam Treaty could take into account.

The derogation cannot therefore be allowed since the method of implementation of the aid does not make it possible to ensure that it is proportional to the objective of heritage conservation.

- (82) As far as the promotion of culture is concerned, the Commission considers that the approach must be based on the generally accepted definition of the term and that the concept cannot be interpreted broadly. The argument put forward by the Committee, namely that promoting the economic activities that constitute the lifeblood of Venice contributes to conservation of the city, which Unesco has designated as belonging to the world cultural heritage, is too superficial and vague in relation to the cultural objectives covered by this derogation.

The exemption provided for by Article 87(3)(e) of the Treaty

- (83) In its conclusions the Committee, in the hope that the aid will be deemed compatible with the common market, calls for application of the exemption provided for by Article 87(3)(e), which reads 'such other categories of aid as may be specified by a decision of the Council acting by a qualified majority on a proposal from the Commission'.
- (84) On the basis of the categories of aid already specified in the exemptions provided for by Article 87(3), the Commission has drawn up the Community guidelines on aid to employment, which constitute an adequate body of rules governing that category of aid. Furthermore, even if the Council were to specify a new category of aid, this would not automatically render aid belonging to such a category compatible with the common market but would still require the Commission to take a decision assessing the compatibility of a specific instance of aid and possibly also to adopt guidelines for the new aid category. Neither could the Commission disregard the relevant and currently applicable rules when assessing aid that has been put into effect unlawfully.

Municipal companies

- (85) In the comments they submitted as an interested party, the Venice local authorities argue that the municipal companies benefiting from the relief are entrusted, by the public authorities, with the operation of a service of general public interest and that the aid is necessary for the performance of the 'particular tasks assigned to them'.
- (86) The Venice local authorities claim that Article 87 of the Treaty consequently does not apply on account of the exemption provided for by Article 86(2). They also argue that some of the firms in question operate in sectors that have not been liberalised and enjoy a monopoly, with the result that the relief granted does not distort competition. These comments were repeated by the Italian authorities in their reply to the Commission's letter of 23 June 1999 giving them notice

to supply all the necessary information and documentation for assessing the aid.

- (87) The Italian authorities state that the firms in question enjoy a monopoly and claim that they qualify for exemption under Article 86(2) of the Treaty. They submitted a list of six municipal companies which they claim are entrusted with the operation of services of general interest. The firms in question provide the following services: scheduled urban and suburban public transport (ACTV); ship's towage in the port of Venice (Panfido SpA); integrated water management (ASPIV); school cleaning, public park maintenance and other welfare services (AMAV); operation of the Venice casino; and conservation of Venice and the lagoon (Consorzio Venezia Nuova).
- (88) For some of these companies the Italian authorities provided accounting data intended to demonstrate that the relief granted served exclusively to offset the additional costs they incurred in carrying out public service tasks.
- (89) The Commission has examined the case of each of these companies individually.
- (90) In the case of the company providing scheduled urban public transport (ACTV), the service, including transport in the lagoon, which given the special situation of Venice can be treated in the same way as scheduled urban public transport, was during the period concerned operated under a monopoly established by law, in a non-liberalised sector. The fact that a sector has not been liberalised is not always a sufficient condition for ruling out any impact on trade. However, in the case in point, since the service is provided locally and there is no scope for potential competition as ACTV has been granted an exclusive right to operate it and the instrument granting that right to ACTV allows the firm to engage only in the activities specified therein, there can be no impact on trade. In view of the foregoing, the relief from social security contributions granted to ACTV cannot be regarded as aid since the conditions for the application of Article 87(1) of the Treaty are not met in the case in point, there being no impact on intra-Community trade. In such circumstances it is not necessary to ascertain whether the exemption provided for by Article 86(2) is applicable.
- (91) As regards the company entrusted with ships' towage in the port of Venice (Panfido SpA), the activity is performed locally and in a non-liberalised sector. Since Panfido has an exclusive right to operate the service and the instrument granting that right allows the firm to

engage only in the activities specified therein, there is no impact on trade. The relief from social security contributions granted to Panfido cannot be regarded as aid since the conditions for the application of Article 87(1) of the Treaty are not met in the case in point, there being no impact on intra-Community trade.

compatible with the common market by virtue of the exemption provided for in Article 87(3)(d) of the Treaty: in the case in point, the institutional role of the Consorzio is to safeguard and preserve the heritage of Venice, and the aid granted in the form of relief from social security contributions in the lagoon therefore has a cultural objective.

(92) In the case of the company responsible for integrated water management (ASPIV), the conditions for application of the exemption provided for by Article 86(2) of the Treaty are met. The activity concerned here is the operation of a service of general economic interest which has been assigned, by means of a formal decision by a public authority, to a non-profit-making public enterprise. The Italian authorities have demonstrated that the relief from social security contributions granted to ASPIV is intended exclusively to offset the additional costs deriving from performance of the specific public service tasks assigned to the firm. The aid granted to ASPIV is therefore compatible with the common market.

Applicability of the other exemptions

(97) The aid under examination does not qualify for any of the other exemptions provided for by Article 87(2) and (3) of the Treaty. It is not intended to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State, and is therefore not eligible for exemption under Article 87(3)(b).

(98) As far as Article 87(2) is concerned, the aid does not meet the conditions laid down in subparagraph (a), which relates to aid of a social character granted to individual consumers, nor of course those laid down in subparagraph (c).

(93) The company providing community services such as the cleaning of schools, maintenance of public parks and other welfare services (AMAV) operates locally and its activities therefore have no impact on intra-Community trade. Accordingly, the relief from social security contributions granted to it does not constitute aid as the conditions for the application of Article 87(1) of the Treaty are not met.

(99) Neither does the aid qualify for exemption under Article 87(2)(b) since the seasonal flooding in Venice cannot be regarded as a natural disaster or an exceptional occurrence.

Recovery of aid which is declared incompatible

(100) The court of Justice has recognised that the Commission is entitled to order a Member State to recover incompatible and unlawful aid⁽³¹⁾.

(94) The Commission regards the operation of the Venice casino as a commercial activity subject to competitive forces and therefore falling within the scope of Article 87 of the Treaty. On the question of the exemption provided for by Article 86(2) of the Treaty, the Commission notes that the activities of the casino cannot be regarded as services of general economic interest since the public authorities have not imposed public service obligations of general interest in respect of those activities.

(101) Regulation (EC) No 659/1999 requires the Commission to recover unlawfully granted aid which is incompatible with the common market.

(95) The general analysis set out in points 61 to 65 consequently applies to the firm in question.

(102) Where the Commission's decision finds that aid has been granted unlawfully and that it is incompatible with the common market, it follows from the case-law of the Court of Justice⁽³²⁾ that recovery is the logical consequence for the purpose of re-establishing the previously existing economic situation.

(96) In the case of Consorzio Venezia Nuova, which looks after the conservation of Venice and the lagoon, the Commission notes that the company was set up for the express purpose of safeguarding the historic, artistic and archaeological heritage of the city of Venice: its object is to carry out, under concession, measures encouraged by the State in that area. The Commission considers that the aid granted to Consorzio Venezia Nuova is

(103) The observations submitted by the Italian authorities in support of their request that the Commission should refrain from ordering recovery of the aid if it were found to be incompatible with the common market are not sufficient to justify disregarding the obligation imposed by Regulation (EC) No 659/1999, deriving from the fact that the aid in question is incompatible with the common market and was granted unlawfully, for the following reasons:

⁽³¹⁾ Case 70/72 Commission v. Germany [1973] ECR 813.

⁽³²⁾ Case C-142/87 Belgium v. Commission [1990] ECR I-959.

- (a) island status is not *per se* a source of structural weakness for a region;
- (b) the local nature of the activities carried on by firms in Venice has not been demonstrated;
- (c) the fact that no interested party submitted observations does not prove that there is no need to re-establish the previously existing economic situation;
- (d) discontinuation of the scheme from 30 November 1997 ensures that the competition rules are re-established, but the fact remains that before that date certain firms enjoyed advantages that must be eliminated.

V

CONCLUSIONS

- (104) The Commission finds that Italy has put into effect, in breach of Article 88(3) of the Treaty, the relief from social security contributions provided for by Article 27 of Law No 30/1997 and Article 5a of Law No 206/1996, which refers to the Decree of 5 August 1994.
- (105) On the basis of the analysis set out in part IV of this Decision, the Commission finds that the aid granted in the form of a total exemption from social security contributions for net job creation by SMEs is compatible with the common market. Where it is granted to firms that do not have the status SMEs, it is compatible if the firms concerned operate in an area eligible for exemption under Article 87(3)(c) of the Treaty. The aid is also compatible where it benefits any types of firm which hire groups of workers experiencing particular difficulties entering or re-entering the labour market.
- (106) The aid provided for by Article 1 of the Decree of 5 August 1994 and the aid provided for by Article 2 thereof and granted to large firms located outside areas eligible for exemption under Article 87(3)(c) of the Treaty is incompatible with the common market.
- (107) For the reasons set out in points 90, 91 and 93, the measures granted in favour of the municipal companies ACTV, Panfido SpA and AMAV are not deemed to constitute aid within the meaning of Article 87(1) of the Treaty.
- (108) For reasons set out in point 92, the aid granted to the municipal company SPIV is compatible with the common market since it qualifies for exemption under Article 86(2) of the Treaty.
- (109) For the reasons set out in point 95, the aid granted to Consorzio Venezia Nuova is compatible with the common market since it qualifies for exemption under Article 87(3)(d) of the Treaty.
- (110) Measures which comply with the *de minimis* rule do not fall within the scope of Article 87 of the Treaty. Under that rule, the total amount of aid granted to firms in accordance with the above provisions must not exceed EUR 100 000 over a three-year period. As stated in the relevant Commission notice⁽³³⁾, the *de minimis* rule does not apply to the industries covered by the ECSC Treaty, to shipbuilding, to transport or to aid towards expenditure in connection with agriculture or fisheries.
- (111) Where aid granted unlawfully is found to be incompatible with the common market, the Commission requires the Member State concerned to recover it from the beneficiaries⁽³⁴⁾ in order to re-establish the previously existing situation. This applies to the aid found by this Decision to be incompatible with the common market, of which the amount already received will have to be reimbursed by the recipients.
- (112) Repayment is to be made in accordance with the procedures of national law. The amounts to be repaid are to bear interest from the date on which the aid was made available to the beneficiaries until the date on which it is effectively repaid. The interest must be calculated on the basis of the reference rate used to calculate the grant equivalent of regional aid.

HAS ADOPTED THIS DECISION:

Article 1

Except as provided by Articles 3 and 4 of this Decision, the aid which Italy has put into effect in favour of firms located in Venice and Chioggia, in the form of exemption from social security contributions provided for by Laws No 30/1997 and No 206/1995 which refer to Article 2 of the Ministerial Decree of 5 August 1994, is compatible with the common market where it is granted to the following firms:

- (a) SMEs within the meaning of the Community guidelines on State aid for small and medium-sized enterprises;

⁽³³⁾ See footnote 12.

⁽³⁴⁾ See Commission communication in OJ C 318, 24.11.1983, p. 3.

(b) firms that do not comply with that definition but are located in an area eligible for exemption under Article 97(3)(c) of the Treaty;

(c) any other type of firm which hires groups of workers experiencing particular difficulties entering or re-entering the labour market as referred to in the Community guidelines on aid to employment.

Such aid is incompatible with the common market where it is granted to firms which are not SMEs and are located outside areas eligible for exemption under Article 87(3)(c) of the Treaty.

Article 2

Except as provided by Article 3 and 4 of this Decision, the aid which Italy has put into effect in favour of firms located in Venice and Chioggia, in the form of reductions in social security contributions provided for by Article 1 of the Ministerial Decree of 5 August 1994, is incompatible with the common market.

Article 3

The aid measures which Italy has put into effect in four of the companies ASPIV and Consorzio Venezia Nuova are compatible with the common market since they qualify for exemption under Article 86(2) and Article 87(3)(d) of the Treaty respectively.

Article 4

The measures which Italy has put into effect in favour of the companies ACTV, Panfido SpA and AMAV do not constitute aid within the meaning of Article 97 of the Treaty.

Article 5

Italy shall take whatever steps are necessary to recover from the beneficiaries the incompatible aid referred to in the second paragraph of Article 1 and in Article 2 which has unlawfully been made available to them.

Repayment shall be made in accordance with the procedures of Italian law. The amounts to be repaid shall bear interest from the date on which the aid was made available to the beneficiaries until the date on which it is effectively repaid. The interest shall be calculated on the basis of the reference rate used to calculate the grant equivalent of regional aid.

Article 6

Italy shall inform the Commission, within two months of the date of notification of this Decision, of the measures it has taken to comply with it.

Article 7

This Decision is addressed to the Italian Republic.

Done at Brussels, 25 November 1999.

For the Commission

Mario MONTI

Member of the Commission

COMMISSION DECISION**of 22 December 1999****on State aid implemented by Germany in favour of Entstaubungstechnik Magdeburg GmbH***(notified under document number C(1999) 5205)***(Only the German text is authentic)****(Text with EEA relevance)***(2000/395/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 given notice to the parties concerned to submit their comments in accordance with the abovementioned provisions,

Whereas:

1994. At a meeting with the Commission, Germany announced ETM's privatisation. In April 1998 the Commission asked Germany for details of the privatisation. These were provided that same month. It asked for further information in May 1998, and this was furnished by Germany in May and July 1998. Additional questions were put in December 1998, and these were answered in January 1999. In August 1999 a number of final questions were put, to which answers were received in September 1999.

II. DETAILED DESCRIPTION OF THE AID**A.****I. PROCEDURE**

- (1) On 15 March 1995 the Commission initiated a formal investigation procedure in respect of State aid for SKET Schwermaschinenbau Magdeburg GmbH, Magdeburg ('SKET SMM')⁽¹⁾. Since plans were afoot to turn Entstaubungstechnik Magdeburg GmbH, Magdeburg ('ETM') into a subsidiary of SKET SMM, the procedure was extended to include ETM. The procedure was given the number C 16/95.
- (2) On 30 July 1996 procedure C 16/95 was extended to include aid which had been paid out since the decision was taken to initiate the procedure⁽²⁾ and which was not covered by that decision. The potential investors (Oestmann & Borchert Industriebeteiligungen (GbR) abandoned the restructuring plan at the end of 1995. A new plan involving additional aid was subsequently notified.
- (3) On 26 June 1997 in respect of the aid for SKET SMM the Commission adopted a final negative decision, Decision 97/765/EC⁽³⁾. This Decision did not apply to ETM. The procedure concerning ETM was given the number C 16b/95.
- (4) In January and August 1997 Germany informed the Commission of the aid which ETM had received since
- (5) ETM is based in Magdeburg Saxony-Anhalt. In 1997 it employed some 110 people and achieved a turnover of DM 13,4 million. It designs and manufactures advanced air and smoke filtering systems. It has a share of the relevant market as described below of around 1 %
- (6) ETM's current business activity dates back to 1970, when new environmental legislation was introduced in the German Democratic Republic. The firm, retooled to produce filtering systems, was integrated in the air - and refrigeration-technology combine. As a result, in 1989 it was transferred to the Ernst Thälmann heavy machinery combine. As a result, in 1990 it became a subsidiary of SKET AG. In 1992 its shares were transferred to the Treuhandanstalt ('THA'). When the THA was dissolved, the shares passed to the Bundesanstalt für vereinigungsbedingte Sonderaufgaben ('BvS'), in whose hands they remained until the privatisation and their sale to the PKA group. The privatisation occurred in January 1998, when ETM was sold to PKA Umwelttechnik GmbH & Co. Kg., a member of the PKA group.
- (7) The PKA group is based in Germany but operates worldwide in various markets for environmental technologies. the group is made up of small firms active in several different product markets. The products and services on offer include, in particular, the design, construction and sale of plants for the treatment and processing of sludge, refuse and waste, together with the

⁽¹⁾ OJ C 215, 19.8.1995, p. 8, and OJ C 298, 9.10.1996, p. 2.

⁽²⁾ OJ C 298, 9.10.1996, p. 2.

⁽³⁾ OJ L 314, 8.11.1997, p. 20.

recovery of reusable materials and energy. It specialises in the application of pyrolysis⁽⁴⁾ for these purposes. The PKA group, including ETM, has only 220 employees and will achieve a turnover of DEM 50 million in 1999. In the light of the information furnished by Germany, the entire PKA group is an SME according to the criteria laid down in Commission recommendation 96/280/EC of 3 April 1996 concerning the definition of small and medium-sized enterprises.

B.

- (8) The sale of ETM to the PKA group took place on the basis of an open, unconditional and transparent tender procedure. West Merchant Bank, which had been tasked by the BvS with finding an investor, had by 7 June 1997 received 12 bids in response to the invitation to tender, a total of 224 firms worldwide having been approached in the course of the procedure. Negotiations were entered into with four of the bidders, the best offer being selected on the basis of the business plan, job maintenance guarantees and key financial data. The PKA group was the only bidder capable of taking the firm over in the foreseeable future and of taking part in the privatisation using its own resources and hence of sharing the commercial risk. It was also done in a position to present a financing plan and take over the BvS's guarantees.
- (9) The sale price was DEM 1. PKA injected DEM 1 million of capital into the firm. It undertook to invest DEM 2,5 million before 31 December 1999 subject to a 100 % penalty and to continue to employ 65 people for three years subject to a penalty of DEM 36 000 per worker per year. It also undertook to release the BvS from all guarantees (current account credit facility of DEM 2,5 million and counter guarantees for DEM 4,7 million). The BvS waived repayment by ETM of a DEM 7,5 million loan including interest and granted a subsidy of DEM 10 million.

C.

- (10) ETM was a firm in difficulty incurring annual losses⁽⁵⁾. One of its main problems was deficient operating

controls (especially of equipment purchases but also of its marketing and sales operations). The high proportion of bought-in parts and related services thus accounted for some 60 % to 70 % of the value of contracts. With more efficient buying these costs might have been some 10 % to 15 % lower. Another problem was the unsuccessful association with SKET SMM. ETM was to have become a subsidiary of SKET SMM, and SKET SMM and its subsidiaries were to have been privatised. This plan never came to fruition, but the relationship between the troubled conglomerate SKET SMM and ETM damaged the latter's reputation and credibility in the marketplace. ETM's order book suffered as a result. Additional problems arose when trying to establish a 'new technologies' division within the cumbersome and inefficient organisational framework of SKET SMM.

- (11) ETM has undergone continuous restructuring ever since it was founded as a limited company in 1990. Before the firm was acquired by PKA, the THA and later the BvS took the first restructuring measures. After the failure to privatise SKET SMM, the BvS's strategy was to prepare ETM for privatisation as an independent company. Various steps were taken in this direction in 1997. ETM was to concentrate on its core business, namely the design and manufacture of filtering systems, and the 'special construction' division was shut down. The firm reduced its personnel costs. Various production plants were closed. The restructuring plan submitted by the investor in 1998 addressed the operating control problems. In this respect the expertise acquired by the PKA group should stand ETM in good stead. The plan is based on cooperation between ETM and the PKA group, their product ranges and customer bases being complementary. ETM is to become the PKA group's business partner in the air and gas filtration field. A further aspect of the restructuring is the expansion of ETM's production around the PKA group's core products (e.g. gas converters, piping and conduits, silos). This is in the interest of the PKA group, which has no production capacity of its own. It also eliminates the risk of loss of know-how inherent in third-party production. Furthermore, it enables ETM to use underutilised capacity. The restructuring will have been completed in 1999.

⁽⁴⁾ Pyrolysis is an incineration process whereby organic matter is decomposed through the action of intense heat in the absence of oxygen. It typically occurs under pressure and at temperatures above 430 °C. The recovered solid materials can be used, for example, in the construction industry and the recovered gases for power generation.

⁽⁵⁾ For example in 1997 it made a loss of DEM 4,9 million on its normal commercial activities after losing DEM 7,4 million in 1996 under the same heading.

- (12) The total cost of restructuring both from 1996 onwards and during administration by the Treuhandanstalt (with a view to preparing ETM for privatisation) comes to DEM 49,836 million. The costs can be broken down as follows:

TABLE A

(million DEM)

BEFORE PRIVATISATION	
Investments	9,1
Innovation and distribution costs	8,5
Organisation costs (certification, introduction of PVD system) and change over to SAP, ISO 9001	0,95
Concentration, manufacture, engineering and administration	0,5
Liquidity for current operations	11,486
Skilling and training	0,6
<i>Total before privatisation</i>	31,136
AFTER PRIVATISATION	
Liquidity for current operations	2,5
Warranty claims	1,5
Repayment of a credit line	1,5
Social plan expenditure	0,5
Job creation measures (Article 249(h) of the Employment Promotion Act)	0,5
Distribution and innovation costs	1,0
Investments up to the end of 1999	2,5
Capital increase	1,0
Innovation costs	0,5
Counter guarantee	4,7
Current account credit facility	2,5
<i>Total after privatisation</i>	18,700
Total	49,836

- (13) According to the restructuring plan, if the plan is fully implemented there will be a return to viability in 1999. The following table contains the key data concerning the projected return to viability⁽⁶⁾. The figures for 1999 are based on forecasts made at the time of privatisation.

TABLE B

	1997 (actual)	1998 (actual)	1999 (forecast)	2000 (forecast)
Turnover	[...] (*)	[...]	[...]	[...]
Equipment costs	[...]	[...]	[...]	[...]
Personnel costs	[...]	[...]	[...]	[...]
Depreciation	[...]	[...]	[...]	[...]
Operating result	-[...]	-[...]	[...]	[...]
Annual result	-[...]	-[...]	[...]	[...]

(*) Business secret

⁽⁶⁾ The table contains only a selection of key data; the individual columns are not complete from an accounting point of view.

- (14) The projected growth in turnover is reflected in ETM's order book. TEM has benefited from orders from the rest of the PKA group and from the worldwide growth in demand for the PKA group's products. The level of incoming orders for ETM is therefore above average compared with that of other firms active in the same sector in Germany. The interim figures for 1999 confirm that viability is being restored according to plan. The forecasts for 2000 bear out this favourable trend, hence their inclusion in the table despite the fact that the restructuring will have been completed in 1999.

D.

- (15) The package of State-financed measures as notified to the Commission by Germany was worth at the time of privatisation DEM 41,336 million. The measures concerned are as follows:

TABLE C

(million DEM)

Item	Measure	
1.	Loans from the THA/BvS between 1993 and 1995 (DEM 29,142 million, less DEM 11,7 million from the sale of a plot of land in 1995 ⁽¹⁾)	17,442
2.	Loans from BvS in 1996 and 1997	12,200
3.	Investment grants in 1996 and 1997	0,523
4.	Investment allowance	0,442
5.	Research and development grant	0,529
6.	Grants from the BvS in connection with the privatisation and sale of ETM to the PKA group (DEM 10 million, less a grant of DEM 0,5 million for job creation measures)	9,500
7.	Grants from the BvS in connection with the privatisation and sale of ETM to the PKA group for job creation measures	0,500
8.	European Social Fund	0,200
	Total public resources	41,336

⁽¹⁾ Germany states that the sale of the plot of land by ETM involved no element of aid.

- (16) The choice of the PKA group as investor was the result of an open, unconditional invitation to tender, with the award going to the highest bidder. As a result, no further aid element falls to be considered in the context of the privatisation.

- (17) The investor's contribution amounts to DEM 8,5 million and may be broken down as follows:

F.

TABLE D

(million DEM)

Measure	
Grant	1,0
Liability for current account credit facility	2,5
Counter guarantee	4,7
Contribution towards innovation costs	0,3
Total private resources	8,5

E.

- (18) ETM is active in the market for the design and manufacture of industrial air and smoke filtering systems. The relevant geographic market is a worldwide one [...]. The relevant product market is a growth market, although in some geographical areas the growth is no longer as spectacular as it was in the late 1980s and early 1990s. The market outlook remains favourable, however, thanks to the increasing importance of energy savings and the perceived need to protect the environment worldwide, as evidenced by the growing number of environmental protection provisions. In the European Union, the market is expected to expand in Spain, Italy and Greece. According to data supplied by Germany, additional growth is to be expected in the countries of central and eastern Europe as they move closer to the standards set in the Community.

- (19) The market for industrial air and smoke filtering systems is part of the broader market for environmental technologies in which the PKA group also operates, especially where pyrolysis is used. The use of pyrolysis to recover solids and gases lessens the disposal problem compared with other processes by reducing the volume of waste and avoids the problems associated with incineration. The process contributes to a reduction of CO₂ emissions and the gas resulting from the process can be used for energy production. The solid residue, pyrolysis char, can be used for filtering purposes and, if gasified, the gas can also be used in the energy industry and the solid residue in the construction industry. The plants designed by the PKA group will use ETM filters. The Commission has no evidence of overcapacity either in the markets for these types of plant or in the market for environmental technologies in general⁽⁷⁾.

⁽⁷⁾ On the market for recycling and environmental technologies generally, see Panorama of EU industry 1997, Section 19; the only potentially declining market is that for the treatment of chemical solvents.

- (20) The formal investigation procedure provided for in Article 88(2) of the EC Treaty was initiated in respect of the aid for SKET SMM and its subsidiaries. ETM was included in the procedure owing to the intention to transfer the shares in ETM to SKET SMM. The transfer never took place, however, from a legal point of view. Regarding ETM, the main problem in relation to initiating the procedure was the lack of information concerning the restructuring. After ETM's privatisation in January 1998, several problems were identified concerning the restructuring plan then submitted; in particular, the investor's contribution seemed to be on the small side and the total amount of aid was unclear. These matters were resolved with the help of the information subsequently received.

III. ASSESSMENT OF THE MEASURES

A.

- (21) Several of the measures identified in Table A fall within the scope of Article 87(1) of the EC Treaty for the following reasons. ETM is active in a product market extending across Member States, therefore trade between Member States is affected. State financing measures made available to firms in difficulty generally constitute aid because such firms would in all probability not receive any financial assistance from private sources. Aid threatens *per se* to distort competition. The measures identified below⁽⁸⁾ and awarded to ETM are therefore aid within the meaning of Article 87(1) of the EC Treaty which unless one of the exceptions provided for in the Treaty applies is incompatible with the common market.
- (22) The measures identified as Item 1 in Table C amounting to DEM 17,442 million were awarded before 1996 and meet the condition of the relevant Treuhand aid scheme⁽⁹⁾. A subsequent waiver of repayment of the loans does not constitute additional new aid as the loans and guarantees that were granted under the Treuhand scheme benefited firms in particular difficulty and it was not expected at the time of award that the firms would be able to repay them. It was assumed that the aid

⁽⁸⁾ Recital 22.

⁽⁹⁾ As regards the aid granted before 31 December 1994, see the Commission Decisions on the activities of the Treuhandanstalt in Cases NN 108/91 and E 15/92. As regards the aid granted in 1995, see also the Commission Decision in Case N 768/94.

intensity in these cases might be as high as 100 %. The measure identified as Item 7 in Table C is not aid⁽¹⁰⁾. The measure identified as Item 8 in Table C is not aid because it is not from State resources. The DEM 442 000 investment allowance⁽¹¹⁾ (Item 4) is based on a regional aid scheme previously authorised by the Commission and therefore does not need to be reassessed by it. Accordingly, DEM 22,752 million falls to be considered in this Decision.

- (23) Article 87(2) and (3) of the EC Treaty provides for the possibility of exempting aid which falls within the scope of Article 87(1). The only basis for exempting the restructuring aid to ETM, a firm in difficulty, is Article 87(3)(c). In order to meet the requirements for a derogation under this heading, however, the aid must satisfy the criteria set out in the Guidelines on State aid for rescuing and restructuring firms in difficulty (the Guidelines)⁽¹²⁾.
- (24) The Guidelines are not to be applied in their 1999 version⁽¹³⁾ to the aid measures in question because no more aid was granted after the new Guidelines were published.

B.

- (26) To satisfy the criteria set out in the Guidelines, a restructuring plan must restore the long-term viability of

the firm in difficulty within a reasonable timescale and on the basis of realistic assumptions.

- (27) As noted above, ETM is a firm in difficulty⁽¹⁴⁾. It is therefore eligible for restructuring aid.
- (28) The problems faced by ETM and the measures required to address them are outlined above⁽¹⁵⁾. The measures undertaken before privatisation addressed part of them, and the measures undertaken after privatisation address the remainder of the problems including integration into the parent company. ETM's economic performance meets the targets set at the time of privatisation. The investor's commitments have already had an impact on ETM's order inflow, orders worth DEM 7,8 million having been booked by the end of January 1999, which is well above the industry average. For 2000 ETM has received an order for a pyrolysis plant for Chile in addition to orders worth DEM 6 to 8 million. A restoration of viability within a reasonable period therefore seems realistic. The firm accordingly satisfies this criterion.

C.

- (29) A further condition which restructuring aid must satisfy under the Guidelines is that any distortion of competition resulting from the aid may not be undue.
- (30) According to the Guidelines, the aid recipient must, where there is structural overcapacity in the relevant market, permanently reduce its production capacity increase during the restructuring period is not normally allowed.
- (31) As already indicated⁽¹⁶⁾, the Commission has no evidence that the relevant market, the market for environmental technologies, which includes that for the production of air and smoke filtering systems, is in structural overcapacity. In fact this new market appears to be enjoying steady growth. Therefore no permanent capacity reduction by ETM is required. What is more since 1990 ETM has decommissioned part of its production capacity.

- (32) It is also to be noted that, as the major part of the aid was granted in the past, it cannot be used by the privatised ETM for carrying out predatory pricing in the future. Similarly, the risk of misuse of the aid granted in

⁽¹⁰⁾ In State aid Case NN 117/92, financial assistance for environmental protection measures, intended to be at the same time measures for job creation, was considered by the Commission not to be aid within the meaning of Article 87(1) of the EC Treaty.

⁽¹¹⁾ Investment Allowance Act: measures under the Act qualify as regional investment aid under Article 87(1) of the EC Treaty and were authorised by the Commission under the derogation in Article 87(3)(a) (authorised aid scheme N 494/A/95).

⁽¹²⁾ OJ C 368, 23.12.1994, p. 12.

⁽¹³⁾ See Section 7 of the Guidelines (OJ C 288, 9.10.1999, p. 2).

⁽¹⁴⁾ Recital 10.

⁽¹⁵⁾ Recital 10.

⁽¹⁶⁾ Recital 18.

the context of privatisation, around DEM 10 million, is low because it is earmarked for specific items of individual expenditure listed in Table A. Therefore, within the meaning of the Guidelines, there has been no undue distortion of competition.

- (33) The Commission has no indication of overcapacity in either the specific market in which ETM, the immediate aid beneficiary, operates or in the markets in which the rest of the PKA group operates.
- (34) Given the foregoing, and also taking into account both ETM's status as an SME and its small market share, the Commission concludes that the aid measures in favour of ETM will not result in an undue distortion of competition.

D.

- (35) A further condition under the Guidelines for restructuring aid to be acceptable is that the amount and intensity of the aid must be limited to the strict minimum needed to enable restructuring to be undertaken and must be related to the benefits anticipated from the Community's point of view. The investor is also expected to make a significant contribution to the restructuring plan from its own resources.
- (36) The total costs of the restructuring amount to DEM 49,836 million. As indicated above, the sum is restricted to the minimum required for carrying out the restructuring. Of this some DEM 17,442 million is covered by the Treuhand schemes and is not considered for purposes of assessing proportionality. Of the balance, DEM 32,394 million, the investor is contributing some DEM 8,5 million, i.e. around 26 %, and as such it is a significant contribution.
- (37) In view of the foregoing, the Commission concludes that its concerns expressed in the opening of proceedings have been addressed and that the criterion concerning the proportionality of aid is satisfied.

E.

- (38) A further condition of the Guidelines is that a restructuring plan submitted to and accepted by the Commission must be fully implemented and that any obligations laid down by the Commission Decision must be observed. Otherwise, unless the original Decision is amended following a new notification from the Member State, the Commission will take steps to require the recovery of the aid. The restructuring of ETM is practically complete. Moreover, Germany has provided an assurance that all possible measures will be taken to ensure that the plan will be carried out. The

Commission therefore concludes that this heading of the Guidelines is also satisfied.

IV. CONCLUSION

- (39) The Commission finds that Germany has unlawfully implemented the aid measures identified above, contrary to Article 88(3) of the EC Treaty. However, in view of the foregoing⁽¹⁷⁾, the Commission concludes that, in so far as they fulfil the restructuring aid Guidelines, they are compatible with the common market. The Commission has also taken into account the fact the ETM is located in an assisted area within the meaning of Article 87(3)(a) of the EC Treaty,

HAS ADOPTED THIS DECISION:

Article 1

The measures which Germany has implemented in favour of Entstaubungstechnik Magdeburg GmbH ('ETM') and which fall to be considered under this Decision amount to DEM 22,752 million and are compatible with the common market within the meaning of Article 87(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement. The aid concerned comprises:

- (a) a grant by the Bundesanstalt für vereinigungsbedingte Sonderaufgaben (BvS) at the time of privatisation (DEM 9,5 million);
- (b) loans from the BvS in 1996 and 1997 (DEM 12,2 million);
- (c) an R & D grant by the BvS (DEM 529 000);
- (d) investment grants in 1996 and 1997 (DEM 523 000).

Article 2

Germany should submit a report every year on the implementation of the restructuring plan.

Article 3

This Decision is addressed to the Federal Republic of Germany.

Done at Brussels, 22 December 1999.

For the Commission

Mario MONTI

Member of the Commission

⁽¹⁷⁾ Recitals 21 and 22.