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Briefing note

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EU Accession and State aid risks

The recent judgment of the EU General Court in *Budapesti Erőmű* highlights the risks of entering into investments through long term contractual arrangements in EU accession countries and accession candidates. Even if EU State aid laws do not apply at the time of entering into the contract, the European Commission can still challenge the arrangement post-accession, and order repayment of amounts it deems to be in excess of the market rate.

An Accession Aggression

In the early-1990s, Hungary's electricity generation infrastructure was in desperate need of modernisation.

To encourage the significant capital investments required, Hungary entered into long term power purchase agreements ("PPAs") with a number of Hungarian State-owned generators, under which MVM - the wholly-owned State company with a monopoly on power supply at the wholesale level – contracted to buy fixed quantities of electricity at fixed prices.

As a result of these PPAs, various foreign companies made substantial and long term investments in the generating companies in the mid 1990s. This was well before Hungary's accession to the EU in 2004 and its signature of the Accession Treaty in 2003, but, importantly, it was after Hungary's "Europe Agreement" had entered into force (in 1994) and after Hungary had submitted its application for accession to the EU (also in 1994). The "Europe Agreement" was one of the legal steps on the route to accession, which imposed obligations on Hungary to harmonise its domestic competition rules with those of the EU.

After Hungary's accession to the EU in 2004, the European Commission took issue with these long term agreements, arguing that the State wholesaler would not have entered into them at the date of accession and that they therefore gave overly preferential rates and terms to the (then privatised) generators.

The Commission required the Hungarian State to terminate the elements of aid in the PPAs, which in effect led to their cancellation. It took the view that EU law and the provisions of Hungary's Accession Treaty allowed it to do so, even though the PPAs were entered into before Hungary had formally agreed to accede to the EU.

The Commission also required the generators to pay back to the Hungarian government amounts that were deemed (according to a controversial formula) to be in excess of the market rate, from the date of Hungary's accession to the EU in 2004. It paid little heed to arguments that the investors would simply not have invested in the original State-owned generating companies or subsequently in new generation capacity in Hungary without the long term price arrangements contained in the contracts.

Key issues

- If a contract is entered into in a country in which EU State aid laws are not in force, can it later be challenged if that country joins the EU?
- What are the consequences of such a challenge?
- How can investors protect themselves against these risks?

The General Court Judgment

The General Court's judgment of 13 February 2012 (*Budapesti Erőmű*, Cases T‑80/06 and T‑182/09) came down entirely on the Commission's side. It seems that the general obligations in a Europe Agreement to align an accession candidate's competition policies with those of the EU is enough, in the Court's eyes, to put companies and foreign investors on alert that their dealings with candidate country governments and their State-owned companies must comply with EU State aid rules, even

if those rules do not yet apply, and indeed may never do so.

Risks for Investors

The judgment of the Court is relevant to all arrangements entered into prior to a country's accession, that continue to exist post-accession, in the following countries:

- countries that have acceded to the EU in recent years, i.e. Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia;
- countries that have already formally agreed to accede, i.e. Croatia;
- "candidate" countries, i.e. Macedonia, Montenegro and Turkey; and
- "potential candidate" countries, i.e. Albania, Bosnia and Herzegovina, Serbia and Kosovo.

Companies whose arrangements are challenged by the Commission can find themselves in a very unfortunate position, not just because they face potentially large and indeterminate State aid liabilities and the cancellation of their contractual arrangements, but also because their procedural rights are unusually limited.

This is because State aid laws impose legal obligations on EU governments, not companies (so, in the case of Budapesti Erőmű, it was the Hungarian government that had breached the State aid laws, not the generators or the investors). Infringement proceedings therefore take place between the European Commission and the government in question, with the "beneficiary" company that is facing the repayment obligation being treated as a third party, and largely reliant on the government to defend its case.

Clearly, if the consequences for a government of losing the case are that it will have to require the beneficiary company to pay it a large amount of money, it may not always share the beneficiary's enthusiasm for a vigorous defence.

Accession Protection

Businesses looking to enter into arrangements involving a government or State-owned company of a country that will or may accede to the EU in the future – as well as those considering the purchase of a business that has the benefit of such arrangements - should consider the following steps to identify and take into account potential future State aid risks:

- Consider whether there is a possibility that the arrangements to be entered into will continue after that country's future accession to the EU. If so, explore options for getting (or at least precisely defining and quantifying) all promised contractual benefits before accession, and/or for contracting only up to accession.
- If the arrangements will continue post-accession, consider seeking legal advice as to whether the arrangements might be viewed as conferring State aid, now or in the future. This can be a complex technical assessment.
- If there is a potential future State aid liability, assess carefully whether that impacts on the viability or desirability of the investment. There may be limited scope for including contractual mechanisms to require a government or State-owned company to compensate an investor for State aid losses. For example, if a government pays out against a State aid warranty, that payment itself risks being viewed as State aid, and therefore subject to recoupment.
- If possible, secure an assurance from the government in question that it will take whatever steps necessary to ensure that the arrangements are deemed, upon accession, to be "existing aid". Qualification as existing aid provides a good (but not absolute) degree of protection against subsequent interference by the European Commission. This can usually be achieved by incorporation into a list of State aid measures contained in the relevant accession treaty (when signed), or by submitting the arrangement for State aid approval by the national regulator, subject to the Commission raising no objections.

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