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Rt Hon Lord Mandelson
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Dept for Business, Innovation and Skills
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BY EMAIL AND POST

26 March 2010

Dear Secretary of State

**Complaint to DG Competition:
State Aid to Guaranteed Export Finance Corporation Plc (GEFCO) and
Breaches by ECGD of Council Directive 98/29/EC and the World Trade Organisation's
Agreement on Subsidies and Countervailing Measures**

We write to inform you that we have today submitted a formal complaint to DG Competition in respect of the aid that the Department for Business, Innovation and Skills (BIS), the Export Credits Guarantee Department (ECGD) and HM Treasury provide to Guaranteed Export Finance Corporation Plc (GEFCO) in the form of "support arrangements". A copy of the Complaint is attached.

We believe that the arrangements conflict with the UK Government's obligations under Articles 107¹ and 108² of the Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), and with the EU's legally-binding rules on export credit support, as set out in Council Directive 98/29/EC³ and Annex 1 of the World Trade Organisation's Agreement on Subsidies and Countervailing Measures (ASCM).⁴

The Facts

The facts are as follows:

1. GEFCO is a profit-making Special Purpose Vehicle (SPV) whose prime purpose is to refinance loans supported or guaranteed by ECGD. It is registered and domiciled in the UK (company no: 01980873).
2. For tax purposes, GEFCO is treated as an investment company.
3. GEFCO was set up by Lloyds Bank and ECGD in January 1986. However, in 1989, it was restructured so that ECGD had no (legal) control over the company.
4. Prior to 1999, GEFCO raised money on the capital markets by issuing ECGD-guaranteed bonds. In 1999, however, the UK Office of National Statistics ruled that the bonds should be counted as part of the UK Government's debt. Since GEFCO did not have sufficient funds to pay the bond principals on maturity, ECGD loaned the company £263 million to cover the shortfall.
5. Since 1999, GEFCO's refinancing activities have been largely funded directly by ECGD via a loan facility that was originally set at £1 billion under an agreement dated 9 July 1999. Subsequently the size of the facility was increased to £4.8 billion.
6. Since 1999, ECGD has received at least £3,740,424,000 from Treasury to fund its direct funding of GEFCO.
7. GEFCO has also been the beneficiary of an ongoing, unconditional and irrevocable guarantee by the Secretary of State for the Department of Business, Innovation and Skills (BIS) and his/her predecessors, acting through the UK Export Credits Guarantee Department (ECGD), to cover all "borrowing, loan stock and derivative liabilities". Over the past decade, ECGD's annual exposure under such guarantees has frequently exceeded billions of pounds sterling.
8. Inter alia, BIS/ECGD continues to guarantee GEFCO's overdraft with Lloyds Banking Group Plc; any losses arising from cross currency swaps and other loans and derivative trades which GEFCO has entered into in order to refinance ECGD's export credit loans; and any adverse fluctuation in the fair value of GEFCO's assets.
9. GEFCO does not appear to pay any premium for the guarantees it receives.
10. As a direct result of the guarantees provided by BIS and its predecessors, and ECGD, GEFCO's 2009 "Directors' Report and Financial Statement" records that:
 - GEFCO's credit risk exposure has been reduced from a potential maximum of £822.9 million to zero.
 - No financial assets have been pledged as collateral against GEFCO's credit risk liabilities.
 - GEFCO's market risk exposure (including its exposure to interest rate and currency rate fluctuations) has been reduced to a level that has no net impact.
11. ECGD's guarantees have also had the effect of enabling GEFCO to raise cheaper funds in the money market.
12. GEFCO's borrowing and lending count as part of those of central government in national accounts.
13. GEFCO's accounts are not, however, consolidated with ECGD's, despite ECGD guaranteeing all of GEFCO's liabilities.

Grounds for the Complaint

Under the Act of Parliament that governs the ECGD (The Export and Investment Guarantees Act 1991), the Secretary of State responsible for ECGD is empowered to “make any arrangements which, in his opinion, are in the interests of the proper financial management of the ECGD portfolio”.⁵ The Secretary of State would therefore be entitled to enter into an agreement with GEFCO whereby GEFCO undertakes the refinancing of ECGD’s export credit loans.

Such arrangements, however, must comply with EU laws governing subsidies.

In addition to the State Aid rules⁶ laid down in the Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), the UK is also legally bound by the export subsidy provisions laid down in Council Directive 98/29/EC⁷ and in the World Trade Organisation (WTO)’s Agreement on Subsidies and Countervailing Measures (ASCM), to which both the UK and the EU are parties.⁸ The latter require that the premiums charged by ECGD are adequate to cover the long-term operating costs and losses of its programmes.⁹

Contravention of Article 107 and 108 of the Treaty on the Function of the European Union

We contend that the guarantees and loans which ECGD provides GEFCO (as detailed above) contravene:

1. *Article 107.1 of the Treaty on the Functioning of the European Union*¹⁰ (previously *Article 87.1 of the Treaty establishing the European Community*),¹¹ in that the aid granted “distorts or threatens to distort competition by favouring certain undertakings”.

More specifically, the loans and guarantees provided by ECGD to GEFCO

- a) have not been offered or made available to other undertakings, thereby giving GEFCO a competitive advantage in the market for refinancing ECGD’s export credit loans, amounting to an effective monopoly;
 - b) permits GEFCO to access capital at rates that are below market rates, giving GEFCO a competitive advantage over other undertakings operating in the capital markets;
 - c) permits GEFCO to employ all of its capital, without the need to set aside assets as collateral against credit, interest rate, currency and other market risks, again giving GEFCO a competitive advantage over other undertakings operating in the capital markets;
 - d) do not fall within any of the categories of aid, as listed in Articles 107.2 (a) to (c)¹² and 107.3 (a) to (d)¹³ of the Treaty on the Functioning of the European Union, which would make them compatible with the rules of the Common Market.
2. *Article 108.3 of the Treaty on the Functioning of the European Union*,¹⁴ in that we can find no record on the European Commission’s archive of competition cases (<http://ec.europa.eu/competition/eojade/isef/index.cfm>) of the UK Government having informed the Commission of its intention to provide GEFCO with guarantees and loans through ECGD, either prior to the introduction of the aid or subsequently, nor of the Commission sanctioning the aid.

Contravention of Council Directive 98/29/EC and the WTO's Agreement on Subsidies and Countervailing Measures (ASCM)

The Complainants also contend that ECGD's use of GEFCO circumvents and subverts the UK's obligations under the subsidy provisions of both Council Directive 98/29/EC and the ASCM.

The ASCM outlaws subsidies, which it defines, inter alia, as a financial contribution by a government or any public body within the territory of a Member where:

- government support involves “a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees)”¹⁵
- “a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions . . . which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.”¹⁶

The support granted to GEFCO thus constitutes an illegal subsidy within the terms of the ASCM, in that:

- ECGD has been directly transferring funds to GEFCO; *and*
- the refinancing of official export credit loans would normally be vested in governments.

In addition, Article 3 of Council Directive 98/29/EC and Annex 1 of the ASCM (both of which are binding on EU Member States and enforceable by the European Commission) outlaw the provision by official export credit agencies of export credit insurance programmes (which would include ECGD's FREF scheme) where premium rates are inadequate to cover the long-term operating costs and losses of the programmes.¹⁷ The intention is to prevent export credit agencies from unfairly achieving a competitive advantage for their national exporters by subsidising their exports.

To comply with this break-even requirement, the premiums charged by ECGD for its FREF scheme must therefore cover the costs of any refinancing of FREF loans, whether undertaken directly by ECGD or by GEFCO with ECGD support, since such refinancing is integral to the operation of the FREF programme. Indeed, the intention of the break-even requirement would clearly be undermined if ECGD were to hide or otherwise effect a reduction in its reported losses and operating costs.

ECGD's activities in relation to GEFCO breach both Council Directive 98/29/EC and the ASCM in that:

- ECGD does not consolidate its accounts with those of GEFCO.¹⁸ The operating costs attendant on GEFCO's refinancing activities are thus removed from ECGD's balance sheet. As a result, ECGD's accounts do not reflect its true operating costs.
- The mechanisms used by ECGD to refinance loans through GEFCO obscure the true extent of the losses incurred by ECGD. When a refinanced loan goes into default, the default is covered by an additional loan – known as a WIGG – to GEFCO from ECGD. The WIGG does not appear to be accounted for separately by either GEFCO or ECGD but is lumped in with other borrowings received. As a result, it is difficult to assess how

much of the money voted to ECGD for GEFCO is for refinancing and how much for writing off bad debt. The full extent of ECGD's losses is thus hidden.

More specifically, the Complainants contend that ECGD is currently in breach of:

1. Annex 1 paragraph "k" of the ASCM, in that ECGD's failure to consolidate its accounts with those of GEFCO removes the greater part of the operating costs of refinancing ECGD's loans from ECGD's balance sheet, contravening the break-even requirement of the ASCM by distorting ECGD's (true) operating costs.
2. Annex 1 paragraph "k" of the ASCM, in that the accounting of the WIGGs used by ECGD to pay for defaults on loans being refinanced by GEFCO obscures the losses incurred by ECGD on its export credit programmes, contravening the break-even requirement of the ASCM by distorting ECGD's (true) losses.
3. Council Directive 98/29/EC, "Chapter II: Premium", para 3, in that ECGD's failure to consolidate its accounts with those of GEFCO removes the greater part of the operating costs of refinancing ECGD's loans from ECGD's balance sheet, contravening the break-even requirement of the Directive by distorting ECGD's (true) operating costs.
4. Council Directive 98/29/EC, "Chapter II: Premium", para 3, in that the accounting of the WIGGs used by ECGD to pay for defaults on loans being refinanced by GEFCO obscures the losses incurred by ECGD on its export credit programmes, contravening the break-even requirement of the Directive by distorting ECGD's (true) losses.

GEFCO's Ownership

Finally we would take this opportunity to draw your attention to the fact that the ownership of GEFCO has (for a number of years) been wrongly attributed in ECGD's Annual Resource Accounts. The correct ownership details are provided in the Complaint.

Yours Sincerely

A handwritten signature in blue ink, reading "Nicholas Hildyard", enclosed in a light blue rectangular box.

Nicholas Hildyard
The Corner House

A handwritten signature in black ink, reading "Ann Feltham".

Ann Feltham
Campaign Against Arms Trade

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- ¹ Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 107.1, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>.
- ² Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 108.3, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>.
- ³ “Council Directive 98/29/EC of 7 May 1998 on harmonisation of the main provisions concerning export credit insurance for transactions with medium and long-term cover”, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:148:0022:0032:EN:PDF>.
- ⁴ The ASCM is an international treaty to which both the European Community (EC) and the UK are parties. It therefore automatically forms a part of UK law in accordance with constitutional principles and section 1(2) of the European Communities Act 1972. The Commission can enforce its provisions against a Member State in the same way it enforces other aspects of EC law. The ASCM came into force in 1995.
- ⁵ Export and Investment Guarantees Act 1991, Article 3.1, http://195.99.1.70/acts/acts1991/Ukpga_19910067_en_1.htm.
- ⁶ Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 107.1, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>.
- ⁷ “Council Directive 98/29/EC of 7 May 1998 on harmonisation of the main provisions concerning export credit insurance for transactions with medium and long-term cover”, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:148:0022:0032:EN:PDF>.
- ⁸ World Trade Organisation, “Agreement on Subsidies and Countervailing Measures” (ASCM), http://www.wto.org/english/docs_e/legal_e/24-scm.pdf.
- ⁹ Council Directive 98/29/EC, “Chapter II: Premium”, para 3, requires, *inter alia*, that “*the premium charged for export credit insurance shall correspond to the risk (country, sovereign, public and/or private risk) covered, adequately reflect the scope and the quality of the cover granted, [and] not be inadequate to cover long-term operating costs and losses*” The ASCM (Annex 1, “Illustrative List Export Subsidies”) contain the same requirements at paragraph k.
- ¹⁰ Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 107.1, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>. “Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market”. See also: “Treaty establishing the European Community (consolidated text)”, Official Journal C 325 of 24 December 2002, Article 87.1, http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf; Treaty of Rome, Section 3 (Aids Granted by State), Article 92.1, <http://www.eurotreaties.com/rometreaty.pdf>.
- ¹¹ The Treaty of Lisbon, which came into force on 1 December 2009, amended the European Union's two core treaties, the Treaty on European Union and the Treaty establishing the European Community. The latter was renamed the Treaty on the Functioning of the European Union. In addition, several Protocols and Declarations are attached to the Treaty. See: http://europa.eu/lisbon_treaty/full_text/index_en.htm.
- ¹² Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 107.2, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>. “The following shall be compatible with the common market: (a) aid having a social character, granted to individual consumers, provided that such aid is

granted without discrimination related to the origin of the products concerned; (b) aid to make good the damage caused by natural disasters or exceptional occurrences; (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.”

- ¹³ Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 107.3 (a) to (c), Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>. “The following may be considered to be compatible with the common market: (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; (b) aid 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; (c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest. However, the aids granted to shipbuilding as of 1 January 1957 shall, in so far as they serve only to compensate for the absence of customs protection, be progressively reduced under the same conditions as apply to the elimination of customs duties, subject to the provisions of this Treaty concerning common commercial policy towards third countries; (d) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.” See also: “Treaty establishing the European Community (consolidated text)”, Official Journal C 325 of 24 December 2002, Article 87. 3 (a) to (c), http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf; Treaty of Rome, Section 3 (Aids Granted by State), Article 92. 3 (a) to (c), <http://www.eurotreaties.com/rometreaty.pdf>.
- ¹⁴ Title VII Common Rules on Competition, Taxation and Approximation of Laws, Section 2 Aids granted by States, Article 108.3, Treaty on the Functioning of the European Union (formerly Treaty establishing European Community), “Consolidated version of the Treaty on European Union and the Treaty on the Functioning of the European Union”, Official Journal C115 of 9 May 2008, <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>. “The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 107, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.” See also: “Treaty establishing the European Community (consolidated text)”, Official Journal C 325 of 24 December 2002, Article 88.3, http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf; Treaty of Rome, Section 3 (Aids Granted by State), Article 93.3, <http://www.eurotreaties.com/rometreaty.pdf>.
- ¹⁵ World Trade Organisation, Agreement on Subsidies and Countervailing Measures, Part 1: General Provisions, Article 1.1 (a) (1) (i), http://www.wto.org/english/docs_e/legal_e/24-scm.pdf.
- ¹⁶ World Trade Organisation, Agreement on Subsidies and Countervailing Measures, Part 1: General Provisions, Article 1.1 (a) (1) (iv), http://www.wto.org/english/docs_e/legal_e/24-scm.pdf.
- ¹⁷ Council Directive 98/29/EC, “Chapter II: Premium”, para 3, requires, *inter alia*, that “*the premium charged for export credit insurance shall correspond to the risk (country, sovereign, public and/or private risk) covered, adequately reflect the scope and the quality of the cover granted, [and] not be inadequate to cover long-term operating costs and losses*” The ASCM (Annex 1, “Illustrative List Export Subsidies”) contain the same requirements at paragraph k.
- ¹⁸ ECGD, Resource Accounts 2008-09, Note 10, page 52, and note 37, p.108, <http://www.ecgd.gov.uk/ecgd-resource-accounts-2008-09.pdf>. See also: Hansard, Column 118W, 26 October 2009, “Guaranteed Export Finance Corporation”, <http://services.parliament.uk/hansard/Commons/ByDate/20091026/writtenanswers/part019.html>