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Karl SOUKUP
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Directorate-General Competition
European Commission
B-1049 Brussels
BELGIUM

27 October 2010

Your ref: COMP D3-D5/KK/AP/mj D(2010) 664

Dear Mr Soukup

Ref: CP 80/2010: Complaint against the UK export credit scheme

Thank you for letter of 1 October 2010.

As we understand it, DG Competition has concluded that there are insufficient grounds to pursue its investigation of our Complaint that the financial support provided by the UK Treasury through the Export Credits Guarantee Department (ECGD) to the Guaranteed Export Finance Corporation (GEFCO) constitutes unlawful state aid. The

financial support is for refinancing ECGD's loss-making Fixed Rate Export Finance (FREF) scheme provided to UK exporters.

As we understand it, DG Competition has taken this view because:

- GEFCO and ECGD cannot be considered separately and both act in the State's interest;
- GEFCO cannot be considered "an undertaking", which is a prerequisite for the application of the EU State aid rules, since its activities are limited to supporting ECGD; and
- GEFCO's transactions with ECGD do not confer any advantage to either GEFCO or its shareholders.

1. We respectfully submit that none of the above grounds are in fact correct.
2. We would also point out that DG Competition has not ruled, or apparently considered, another part of our Complaint, namely whether or not the UK is in breach of Article 108.3 of the Treaty on the Functioning of the European Union.¹ We can find no public record 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. We note that the UK Representation to the EU [hereafter "the UK"] does not deny providing such state support to GEFCO but, on the contrary, acknowledges doing so.²
3. We would further argue that it is premature for DG Competition to close its investigation of the Complaint since we are still in correspondence with DG Trade, which is considering those aspects of the Complaint that relate to alleged breaches of Council Directive 98/29/EC and the World Trade Organisation's Agreement on Subsidies and Countervailing Measures. As you will be aware, we have argued that any breaches of these legally-binding rules and agreements would automatically render the state support, which the UK admits to providing GEFCO, illegal under EU state aid rules. We therefore contend that the investigations by DG Competition and DG Trade must be considered together.

4. This letter sets out in more detail our arguments in response to your letter. For ease of reference, where relevant, we have quoted extracts from your response first, with our response below.

RESPONSE TO DG COMPETITION'S GROUNDS FOR DISCONTINUING ITS INVESTIGATION

A. GEFCO and ECGD cannot be considered separately and both act in the State's interest

“On the basis of the information provided by the UK authorities as regards the State aid aspects of the measure, I note that the activity of GEFCO cannot be analysed in separation from ECGD. Both entities perform the activities in the State's interest.”

5. We agree that the activities of GEFCO and ECGD, at least in respect of the refinancing of ECGD's Fixed Rate Export Finance (FREF) loans, cannot be considered separately.
6. However, even if GEFCO's business was indeed performed solely “in the state's interest”, which we would question (*see below*, paras 9ff), such an arrangement would be permitted only if it were compliant with the World Trade Organisation (WTO)'s Agreement on Subsidies and Countervailing Measures (ASCM), to which both the UK and the EU are parties. This is a consideration that DG Competition does not appear to have taken into account when reaching its decision to discontinue its investigation.
 - 6.1. As noted in our Complaint, the ASCM prohibits governments from making payments to a funding mechanism, or entrusting or directing a private body to carry out one or more of the type of functions “*which would normally be vested in the government*” and where “*the practice, in no real sense, differs from practices normally followed by governments.*”³
 - 6.2. The UK does not deny providing State support to GEFCO: on the contrary, it acknowledges doing so.⁴ However, it argues that such support is legitimate because the ECGD is forbidden under UK law from borrowing on the private market whereas GEFCO is not, enabling GEFCO to refinance FREF loans

more cheaply than would be the case if the refinancing was undertaken by ECGD itself. In effect, according to the UK, GEFCO is carrying out a function that could not be performed by the ECGD.⁵

- 6.3. But it is clear from the UK's response to this Complaint to DG Competition that GEFCO has long ceased to borrow on the private market, its last bond being issued in 1993⁶ – outside of the period covered by the Complaint. Indeed, on the ECGD's own admission, all borrowings by GEFCO since 1999 have consisted of loans from ECGD, not monies raised on the private market.⁷
 - 6.4. The justification for using GEFCO as a vehicle for refinancing the FREF scheme thus no longer holds, since GEFCO is no longer borrowing on the private market. There is consequently no reason why ECGD could not refinance the FREF loans on its own account.
 - 6.5. We would therefore contend that the arrangement between ECGD and GEFCO has been in breach of the ASCM from at least 1999 onward and consequently in breach of EU state aid rules, precisely because GEFCO has been performing a function that could – and should – be performed by ECGD and which, to our knowledge, is performed by many other export credit agencies without the use of an off balance sheet vehicle such as GEFCO. In effect, the method of refinancing used since 1999 is *“a practice [that], in no real sense, differs from practices normally followed by governments”*.
 - 6.6. Even if, as stated by the UK, ECGD is no longer using GEFCO to refinance new FREF loans, the existing loans held by GEFCO are still being paid off. Their management by GEFCO is therefore still in contravention of WTO rules since ECGD could equally well perform the task. We would contend that ECGD should be required to relinquish GEFCO's management of the loans and that their control be returned to ECGD.
7. The above is not the only alleged breach of the ACSM. As pointed out in our Complaint, the ASCM requires that the premiums charged by ECGD should cover its long-term operating costs and losses (the so-called “break even provision”). If the

arrangement between GEFCO and ECGD leads to a breach of this rule, the State support provided to GEFCO would be illegal.

- 7.1. It remains our contention that the arrangement between ECGD and GEFCO results in the ASCM's break-even provision being circumvented.
- 7.2. We note that the UK's response to DG Competition acknowledges that the operating expenses incurred by GEFCO in the refinancing of ECGD's FREF loans are deducted from any surplus arising from GEFCO's interest income, prior to that surplus being paid to ECGD.⁸ This prior deduction is confirmed in ECGD's Annual Resource Accounts, which state:

“Under the contracts for the refinancing of export credit loans, ECGD has agreed that, at the end of each month GEFCO will deduct from the principal and interest payable to ECGD any expenses incurred by GEFCO in administering the refinanced loans”.⁹

- 7.3. As a result, the costs of operating the FREF refinancing scheme would appear to be removed from ECGD's books.
 - 7.4. Consequently, ECGD is able to circumvent the ASCM by charging lower premiums than would be required if those refinancing costs were included in its own accounts. In effect, GEFCO is not only the acknowledged recipient of state aid but acts as a vehicle that is used to deliver state aid to private companies that benefit from the FREF scheme.
8. We would contend that DG Competition must take account of the above allegations before reaching any decision to discontinue its investigation into our Complaint. We understand that matters relating to the ASCM are the province of DG Trade, which recently initiated a separate investigation. We are still in correspondence with DG Trade on the issues raised and are appealing its decision to terminate its investigation. Until these proceedings are concluded, we would again stress that we believe it premature for DG Competition to make any final decision on the State aid aspects of our Complaint, since the outcome of DG Trade's investigations, should they continue, will have a materially significant bearing on the legality or otherwise of the support given to GEFCO by ECGD, the UK Treasury and the UK Department for Business, Innovation and Skills.

B. GEFCO's status as an "undertaking"

"The fact that GEFCO's role is limited to supporting ECGD in the achievement of its tasks indicates that GEFCO is not an entity engaged in an economic activity defined as offering goods and services in the market. Furthermore, GEFCO is not allowed to carry out any other economic activity for as long as it receives any support from ECGD. Therefore it seems that it cannot be considered as an undertaking, which is a prerequisite for the application of the EU State aid rules."

9. From the available corporate documentation concerning GEFCO, it would appear wholly incorrect to state that GEFCO's activities are limited to supporting ECGD:
 - 9.1. The permitted scope of GEFCO's activities are clearly set out in Paragraph 4 (a-v) of the company's Memorandum and Articles of Association, which, under UK law, set out any restrictions on what the company is allowed to do.
 - 9.2. As you will note, GEFCO's Memorandum and Articles of Association (which we have already sent you but which we are attaching again at Annex 1 for ease of reference) do *not* limit GEFCO to supporting ECGD. On the contrary, the objects of the company are extremely widely drawn and permit it, *inter alia*, to enter into *any* financial transaction:

*"... with any sovereign state, governmental agency, quasi-governmental agency, company, institution, partnership or any other person (whether domestic or overseas) by any means whatsoever and upon any terms . . ."*¹⁰
"(emphasis added).
 - 9.3. No mention is made of ECGD in GEFCO's Memorandum and Articles of Association, and there are no clauses that restrict GEFCO to carrying out its business solely with ECGD.
 - 9.4. Although the UK Representation asserts in its undated response to DG Competition concerning our Complaint that GEFCO has entered into a contract with ECGD under which GEFCO "may not, without ECGD's consent, enter into transactions except for the purpose of refinancing loans guaranteed by ECGD",¹¹ *the UK has provided no documentary evidence to support this assertion.*

- 9.5. We would therefore request that DG Competition require the UK Government to disclose the contract between ECGD and GEFCO in order that the clauses cited by the UK can be verified to have the effect that the UK claims.
- 9.6. Absent such disclosure, we strongly contend that DG Competition can legitimately rely only on documentation it has seen – namely GEFCO’s Memorandum and Articles of Association – in order to test whether or not GEFCO is permitted to engage in offering goods and services to the market.
- 9.7. In our view, the evidence from the Memorandum and Articles of Association clearly shows that GEFCO is such an entity and that there are no restrictions placed on it limiting its activities to supporting ECGD.
10. GEFCO’s tax status in the UK, as stated in the company’s 2009 annual accounts (Annex 2), is that of an “investment company,”¹² and thus appears at odds with the UK’s position that GEFCO is simply conducting a non-profit service for the ECGD.¹³
- 10.1. Under HM Revenue and Customs rules, an investment company was defined until 2004 as a company:
- “whose business consists wholly or mainly in the making of investments, and the principal part of whose income is derived from those investments (emphasis added).¹⁴
- 10.2. Since 2004, the definition has been relaxed, requiring only that the company’s business consists “wholly or partly in the making of investments”.
- Under either definition, both of which have applied during the relevant period covered by the Complaint, GEFCO’s tax status would appear to be entirely inconsistent with the claim by the UK that GEFCO’s business is exclusively with ECGD, and that it involves only the refinancing of ECGD’s FREF loans on a non-profit making basis.¹⁵
- 10.3. UK case law deems it necessary for any assets held by a company claiming “investment company” status to be held for *the purpose of making a profit*.¹⁶

The UK denies that this is the case for the assets (interest rate swaps and other derivatives) held by GEFCO as part of its refinancing of FREF loans, since it holds the entire refinancing operation to be non-profit-making in its intent. In effect, on the UK's account, the investments made by GEFCO are merely incidental to the carrying on of other business.

10.4. In effect, if the UK's account of GEFCO's arrangement with ECGD is accepted, there are strong grounds for assuming that GEFCO's investment company status derives from the company making other investments either on its own account or for clients other than ECGD, since GEFCO would not otherwise be able legitimately to claim to be an investment company for tax purposes.

10.5. We would therefore request that DG Competition seeks further particulars from the UK to explain the clear discrepancy between the UK's account of GEFCO's relationship with ECGD and the company's tax status as an investment company.

11. GEFCO's annual accounts do not appear to support the UK's claim that GEFCO undertakes no business other than that of refinancing ECGD's FREF loans.

11.1 GEFCO's accounts do not state that GEFCO's business is *exclusively* with ECGD, merely that the refinancing of ECGD's FREF loans constitutes the company's "primary" business, allowing for the possibility of other business.¹⁷

11.2 In addition, GEFCO's accounts include line items for "*other* operating income" and "*other* operating expenses".¹⁸ The accounts do not specify where such "other" income and expenses derive from, but the wording provides clear grounds for questioning whether it is from a source other than GEFCO's "primary" business.

11.3 We would strongly argue that DG Competition should require ECGD to explain GEFCO's "other" sources of income and expenditure before accepting at face value UK Government assertions that GEFCO's business is exclusively with ECGD. Absent documentary evidence to substantiate the

UK's claim, DG Competition should base its assessment of whether or not GEFCO constitutes an "undertaking" should be based on the available corporate documentation which strongly suggests that it is indeed such a body.

C. GEFCO's transactions with ECGD do not confer any advantage to either GEFCO or its shareholders.

"Even if the conduct of GEFCO would be considered to be an economic activity, the measure can be qualified as State Aid within the meaning of the Article 107 (1) TFEU only if it conveys an advantage to the recipient undertaking. In the present case, the advantage arising from the transactions performed for ECGD is entirely passed on to ECGD, which is also demonstrated by the financial result of GEFCO, which shows only a negligible profit. In this context British authorities also clarified that the profit generated by GEFCO each year arose solely from the interest on its capital and was not distributed to shareholders. It seems therefore that GEFCO does not enjoy any advantage from the transactions it performs for the ECGD. It seems also convey an advantage to its shareholders."

12. Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU) defines State Aid as being unlawful if it "distorts or threatens to distort competition by *favouring* certain undertakings" (emphasis added).¹⁹

12.1 The TFEU does not limit the interpretation of "favouring" (or conferring an advantage) to whether or not the undertaking derives financial or pecuniary profit from the State aid. On the contrary, it is clear that the phrase "favouring" relates to advantages gained *over other market players* that thereby distort competition, not to any particular pecuniary or financial advantage that the undertaking might gain.

12.2 We would therefore dispute DG Competition's determination that the state support granted to GEFCO does not constitute State Aid within the terms of Article 107 (1) because the advantage arising from that aid has been passed on to ECGD and because GEFCO does not derive profit from the arrangement, as claimed by the UK.

12.3 In our view, the sole test of whether the arrangements between ECGD and GEFCO constitute State Aid within the meaning of Article 107 (1) is whether the guarantees and other support provided by ECGD distort or *threaten to distort*: (a) the market in which GEFCO operates by providing

GEFCO with a market advantage over other interest rate swap traders, the swaps market being the principal market in which GEFCO operates in relation to ECGD; and (b) the market in which UK exporters who receive FREF support operate, due to GEFCO being used (as we allege) to remove operating and other costs from ECGD's books, thus allowing ECGD to charge lower premiums than its competitor ECAs within the EU, to the disadvantage of other EU exporters.

12.4 We would note that, despite the representations made by the UK, DG Competition's letter of 1 October 2010 does not question the evidence we have previously provided on the distorting impacts of the state support provided by ECGD to GEFCO.

13. We would therefore request that DG Competition reconsider its determination on this point and provide reasons why our interpretation of Article 107 (1) is incorrect.

14. Even if the meaning of "favouring" were restricted to the pecuniary advantage gained by GEFCO as a result of its arrangement with ECGD, we note that this advantage has not in fact been entirely passed on to ECGD, as claimed by the UK, since:

14.1 Three of GEFCO's directors were collectively paid £70,000 in 2009 and have previously received annual payments of the same magnitude.²⁰

14.2 GEFCO has retained profits in excess of £100,000 (although, as noted above, these may not entirely derive from GEFCO's arrangement with ECGD).²¹

14.3 The suggestion by the UK that GEFCO's recorded profits arise solely from the interest on GEFCO's capital is not credible, since any sum derived from such interest would vary from year to year in line with the fluctuations of interest rates, whilst GEFCO's profits have remained at exactly £5000-6000 year on year. A more credible explanation is that the profits reflect fees paid to GEFCO by its clients.

CONCLUSION

15. For the reasons set out above, we would request that you reconsider your decision not to investigate our Complaint further. Please do not hesitate to contact us if you require further information.

Yours Sincerely



Nicholas Hildyard
The Corner House



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 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>.

- 2 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 24:
- "The types of State support which GEFCO has received during the last ten years are: guarantees by ECGD in respect of bonds issued by GEFCO . . . ; two loans granted by ECGD to GEFCO; guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO; a guarantee of GEFCO's obligations under its overdraft facility; and reimbursement of the costs and expenses . . . which GEFCO incurs in refinancing loans at ECGD's request."
- 3 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.
- 4 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 24:
- "The types of State support which GEFCO received during the last ten years are . . . guarantees by ECGD in respect of bonds issued by GEFCO . . . two loans granted by ECGD to GEFCO . . . guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO . . . a guarantee of GEFCO's obligations under its overdraft facility . . . and reimbursement of the costs and expenses . . . which GEFCO incurs in refinancing loans at ECGD's request."
- 5 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 22.

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- 6 Background on GEFCO and ECGD, appended as Annex 2 to Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 8.
- 7 Background on GEFCO and ECGD, appended as Annex 2 to Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 10: "From 1999 onwards, refinancing of FREF Loans were funded by loans made by ECGD to GEFCO under the terms of the Direct Funding Loan Agreement".
- 8 Background on GEFCO and ECGD, appended as Annex 2 to Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 7:

"Under the refinancing arrangements between ECGD and GEFCO, any surplus arising as a result of the interest received by GEFCO under the refinanced FREF Loans exceeding the interest payable by GEFCO under the bonds was, after deduction of the costs incurred by GEFCO in managing the refinanced loans, paid to ECGD."
- 9 ECGD, Resource Accounts 2008-09, page 108, <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>.
- 10 GEFCO, Memorandum and Articles of Association, 10 January 1986, Para 4 a
- 11 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 18.
- 12 GEFCO, 2009 Directors' Report and Financial Statements, 2009, p.12
- 13 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 7:

"GEFCO does not offer or provide any service to anyone other than ECGD, and the service it provides to ECGD is non-profit-making".
- 14 HM Revenue and Customs, "CTM08020 - Corporation Tax: management expenses: investment company: status", <http://www.hmrc.gov.uk/manuals/ctmanual/ctm08020.htm>.

HM Revenue and Customs, "CTM08040 - Corporation Tax: management expenses: investment company: with investment business", <http://www.hmrc.gov.uk/manuals/ctmanual/CTM08040.htm>.
- 15 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 7:

"GEFCO does not offer or provide any service to anyone other than ECGD, and the service it provides to ECGD is non-profit-making".
- 16 HM Revenue and Customs, "CTM08050 - Corporation Tax: management expenses: investment company: business of making investments: case law", <http://www.hmrc.gov.uk/manuals/ctmanual/CTM08050.htm>.
- 17 GEFCO, 2009 Directors' Report and Financial Statements, 2009, para 18, page 15.:

"The company uses financial instruments (including derivatives) as part of its primary function which is to refinance loans supported or guaranteed by ECGD."
- 18 GEFCO, 2009 Directors' Report and Financial Statements, 2009, page 5.
- 19 Treaty on the Functioning of the European Union, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:EN:PDF>.
- 20 GEFCO, 2009 Directors' Report and Financial Statements, 2009, p.6
- 21 GEFCO, 2009 Directors' Report and Financial Statements, 2009, p.11