

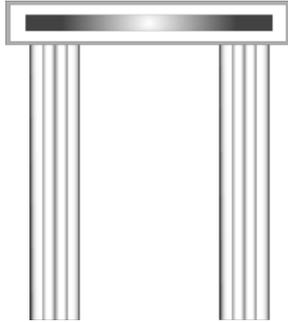


Barnabas Reynolds  
James Webber

**The Withdrawal Agreement,  
State Aid & UK Industry**  
**How to Protect UK Competitiveness**

**POLITEIA**

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**POLITEIA**

2019

First published in 2019  
by  
Politeia  
14a Eccleston Street  
London  
SW1W 9LT  
Tel: 0207 799 5034

Email: [secretary@politeia.co.uk](mailto:secretary@politeia.co.uk)  
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ISBN 978-1-9993662-1-6

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# **The Withdrawal Agreement, State Aid & UK Industry**

## **How to Protect UK Competitiveness**

### **Introduction: State Aid and EU Law**

State aid control was originally introduced into EU law as a part of the regulatory framework for the customs union in respect of goods. It was intended to ensure Member States did not advantage their businesses within the tariff-free zone through government subsidies given that, without tariff barriers, other states could not protect their homegrown industries.

However, as a result of the decisions of the European Court of Justice, and the decisions and policy approach of the European Commission, the concept has been steadily extended to cover services, as well as tax matters and many other key competitiveness measures. In essence it covers almost anything that might be seen to provide an incentive for a business, group of businesses or a sector within a Member State to behave in a certain way.

### **The Withdrawal Agreement: Provisions on State aid**

#### **The Backstop**

The most significant provisions are included in the Northern Ireland backstop. The backstop would give the Commission a high degree of control over State aid affecting goods in the UK, and quite probably services, potentially for ever. This would be so even though the Competition and Markets Authority, the UK body responsible for governing State aid in Great Britain after Brexit, would have nominal decision-making power. The control would come from three places:

1. The UK would be obliged to follow EU State aid substantive and procedural rules. This would be on a ‘dynamic’ basis – i.e. it would include any changes to those rules or expansion

in the definition of aid as determined from time to time by the ECJ. (N Ireland Protocol Art 12 and Annex 8).

The meaning and scope of EU State aid law has proved particularly elastic. It has been extended by the ECJ to control economic infrastructure spending and large parts of the corporate tax regime. The law – by design – also grants the Commission wide discretionary power to approve or prohibit aid that the Member States wish to grant.

2. The UK's expectation after Brexit on such EU State aid rules might have been to inherit or take over this discretionary power. But the Commission has sought in the Withdrawal Agreement to retain control over the exercise of that discretion. In particular, the Commission would formally control the UK's State aid decisions. In the case of Great Britain, the decisions would be taken by the CMA under the supervision of the Commission and could be delayed by the Commission. In the case of Northern Ireland the decisions would be taken directly by the Commission.

In Great Britain, no CMA State aid decision can take effect until the Commission has offered its “opinion”. In practice the Commission can delay giving this opinion for as long as it wishes. (N Ireland Protocol Annex 4, Part 4, Art 10(4), second sub-paragraph). These provisions do not apply the other way around – i.e. the UK does not get to offer its opinion on a State aid decision of the Commission even if it affects UK interests.

3. If the CMA made a decision that displeased the Commission, the Commission would have extensive remedies, which again would be unilateral and not reciprocal, in the following instances.
  - a. There would be an obligation on the CMA to take the utmost account of the Commission's opinion, and there would be automatic standing for the Commission in the English Courts to appeal if they do not do so (Art 11, N Ireland Protocol Annex 4, Part 4).
  - b. The Commission would be empowered to complain to the Withdrawal Agreement's arbitral tribunal and in the meantime unilaterally to impose compensatory and

unspecified ‘interim measures’ (Art 13(3) and Art 14, N Ireland Protocol Annex 4, Part 4).

- c. If all else failed, the Commission could launch a parallel investigation over the same aid measures using the Commission’s own executive authority over Northern Ireland (Protocol Art 12). This is because under the Withdrawal Agreement the Commission would retain direct and separate authority in State aid over Northern Ireland. The jurisdictional barrier (i.e. what falls to be considered in Northern Ireland and what in Great Britain) is low. This would mean that in practice the Commission could ultimately claim direct jurisdiction over much of the UK’s aid.

There would also be other, indirect, factors undermining the UK CMA’s position, particularly given that the CMA would only now be establishing State aid teams for the first time and adopting rules it has neither written nor ever implemented in the past.

The cumulative effect of these factors would be that the Commission would largely continue to control State aid across the UK in a backstop scenario.

## **The Transition Period**

In addition, during the transitional period the EU would apply its State aid rules to the UK as if the UK were a Member State. Given the inevitably politicised nature of EU State aid control the UK would risk uneven treatment because it would have no political power in Brussels during that period. If the Commission wished to develop EU State aid policy, the UK in transition, with no political power or voice in Brussels, would seem the easiest place to test it. That status would be made even weaker because the UK’s former partners would have little incentive to invest political capital protecting UK interests – unless theirs were directly engaged as well.

## **Possible State aid action**

The following examples indicate possible UK Government action that could fall within the EU’s definition of State aid even if, historically, the Commission has not enforced State aid in that way:

- VAT - governing any change in VAT (other than to the prevailing rate). Although Great Britain would be outside the VAT Directives, changing VAT rates for an individual product or service would be very likely to be treated as State aid and therefore de facto require Commission approval. There is no reason to think the Commission would approve a different VAT treatment from that in the VAT Directives, or one which gave UK businesses a competitive edge.
- Subsidies and tax relief to businesses. Any subsidy or preferential tax relief from social security contributions or the like given by Government or local authorities in the UK to incentivise a business to locate or invest in the UK could be controlled. This might be particularly difficult if the UK wishes to incentivise a business to invest by compensating for the additional costs that some sectors may face on leaving the single market.
- Regulatory holiday. Any company-specific regulatory holiday or favourable private interpretation of the prevailing regulatory rules, for example temporary relief from costly social security, environmental or pension rules, could be treated as State aid.
- Tax changes favourable to a sector. An advantageous change to the UK's tax regime for a particular sector could be captured as State aid, e.g. lowering green energy levies. These steps would be likely to be subjected to State aid rules and subject therefore to Commission control.
- Tax changes to encourage investment. Any advantageous change to the tax regime to incentivise investment in the UK (other than the lowering of prevailing rates) is highly vulnerable to State aid control. Examples include the patent box, the tax system often used by countries to encourage research and development by taxing patent income differently from other business income; transfer pricing tax rulings (for goods sold between related legal entities); and differential treatment of overseas versus domestic profits.
- Infrastructure Investment. Any infrastructure investment that is likely to generate a direct economic return, e.g. toll roads, ports, airports, industrial parks, is all vulnerable to State aid control.

State aid control is therefore very extensive and, by contrast with before Brexit, the UK would be without a say or possible redress under the proposed withdrawal arrangements.

Historically, there were political constraints on the Commission using it aggressively and care was, and had to be, taken to advance policy in a consensual way. Moreover, as a large and powerful member of the EU, the UK had the ability to protect its interests. Indeed, the UK was one of the Commission's strongest supporters in enforcing the State aid rules to protect the integrity of the single market. But in the transition period the UK remains under EU State aid jurisdiction whilst having lost its voice and political authority. Rather than being part of the Union, the UK will steadily be becoming a competitor to it. The State aid provisions in the Withdrawal Agreement could become a means for the Commission to exercise extensive control over the UK's competitiveness in this phase.

## **Fixing the State aid provisions**

The Government should take advantage of the reopening of the Withdrawal Agreement in order to fix these provisions. Potential remedies are set out in the Schedule. Making these changes would be relatively simple in terms of legal drafting, and there is strong logic for a more limited application of State aid to the revised Withdrawal Agreement.

The reasoning for the proposed drafting changes is as follows.

*Services.* Although the UK has announced it will in any case choose to follow State aid discipline in services, the State aid provisions of the *backstop* should not be relevant to services. These account for 80 per cent of the UK's economy but do not have implications for the Irish border since there are no customs (or other border) inspections for trade in services. This needs to be clarified.

*Goods.* For goods, *State aid control is not usually included in free trade agreements*. If there were to be a customs union in the future relationship, which is not the Government's current policy, then some form of mutual State aid control in goods is to be expected. Indeed, it

would be desirable for the UK as the smaller of the two parties. However, the application of the rules would need to be more equitable. Even under the arrangements which unite EU countries with four others in the EU-linked European Economic Area, the State aid rules apply in a manner quite different from that proposed in the Withdrawal Agreement. An independent oversight body and court police the arrangements in a manner that aims to be neutral between EEA states and the EU itself. So, on any analysis, the State aid provisions of the backstop are outliers.

So far as State aid provisions do apply, including during the transition, they should respect UK interests in protecting itself from the final moment of Brexit just as much as they allow EU27 states to seek to attract business from a post-Brexit UK.

The options for a policy change in the Withdrawal Agreement, as set out in greater detail in the attached Schedule, include:

- extending UK membership of the EU pending negotiation of a new trade relationship in place of transition;
- removing the backstop and fixing the transitional provisions; or
- modifying the operation of the State aid provisions in the backstop, for instance so that the UK benefits from equivalent protections to the EU, and fixing the transitional provisions.

The UK should move swiftly to renegotiate the State aid provisions so they provide a stable basis for future UK-EU trade.

And, as government policy allows that there may be no deal, in that event the State Aid (EU Exit) Regulations 2019 should be reconsidered by the UK, as the UK would be entitled to do unilaterally, in line with its economic, fiscal and trade policy. These Regulations incorporate EU State aid law into UK law in a manner which involves the UK considering EU interests, whilst the EU makes no such commitment to address our interests.

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## **Schedule Potential Remedies**

### **A. Removal of the backstop**

This would remove the vast majority of the issues and leave the transition period only.

Transition leaves the UK under EU jurisdiction without political influence. This is, of course, the basic bargain of the transition – but State aid is especially problematic as it grants the Commission direct executive authority. Contrary to popular belief, the Commission has relatively little direct executive authority under the Treaties. State aid is an exception.

There is a risk that the UK will be discriminated against in ways that are political / discretionary / otherwise not justiciable (i.e. are not obvious or not vulnerable to legal challenge). For example, the Commission could focus enforcement effort on the UK. The Commission could apply an unfair evidentiary burden on the UK, which is a particular issue with aid under the block exemption regulation, where the UK has primary decision-making power subject to Commission oversight, or in new UK aid notifications. In each of these, the Commission has very extensive discretion.

If the transition is likely to lead to a Free Trade Agreement structure for the future relationship, or no deal (even temporarily before a subsequent trade deal), the UK will likely find it difficult to get aid schemes to mitigate the impact of this for UK firms through the Commission during the transition period.

### **Possible Remedies**

- extension of Article 50 and continuing UK membership of the EU in place of transition, whilst a trade deal is negotiated
- removal of 4 year limitation period for State aid investigations at the end of transition (delete Art 93(1)) – there is no need for this, since an unlawful State aid finding does not result in ‘compensation’ for damage. It seeks to reverse the distortion in

the single market, but any UK recipient is already outside the single market at that point

- replacement of 3 month deadline for the Commission to inform the UK of new State aid investigations against it with a much shorter timeframe e.g. 10 working days (amend Art 93 (1))
- new prohibition on Commission launching a case against the UK unless: the basis for the case has been unambiguously established in EU State aid law before the date of UK departure; or, if the Commission wishes to take a case against the UK which moves the interpretation of EU State aid law, the Commission is permitted to do so but only if the Commission is also proceeding on the same basis against a continuing Member State
- provide that the UK can provide aid on the basis of a serious disturbance to its economy in the context of the end of the transition period, including for the commencement of a Free Trade Agreement or Mutual Recognition Agreement, or no deal – on the same basis as for any other Member State such as Ireland.

## **B. Amending the backstop**

If the backstop is retained, the detail of the State aid provisions could be amended to assist the UK as follows:

### **Remedies**

- **Remove “dynamic” alignment**  
Rationale: Non-regression is sufficient. The existing notion of State aid is already extensive, controlling any State measure that could conceivably cause actual damage to the level playing field. Further extensions of the notion of aid sit in a single market context which is no longer relevant to the UK. There is no rational basis to treat State aid differently from other level playing field provisions (eg. social, environmental).
- **Remove the ability for the Commission to extend the 3 month period the Commission has to provide its “opinion” on CMA State aid decisions; or allow the CMA to adopt a decision if the Commission has not offered an opinion within that timescale**  
Rationale: (i) the Commission is providing an opinion not a decision. The opinion could itself say that the CMA has received insufficient information for it to sensibly arrive at its proposed conclusion; (ii) this provision also appears in Commission State aid

procedure and is regularly used to extend the statutory timetable in the procedural regulation; (iii) the opinion comes at the end of the CMA's State aid investigation – which is very likely also to have been extended as the CMA is modelling its process on the Commission. It is unfair for UK aid grantors and beneficiaries to be subject to the burden of two sequential substantive reviews whereas their counterparts in the EU are subject to one.

- **Remove Commission jurisdiction over Northern Ireland**  
Rationale: (i) it is undemocratic to allow Commission supervision over fiscal decisions in Northern Ireland; (ii) this is unnecessary as the CMA in Great Britain has been accepted as sufficient to ensure a level playing field within the single customs territory.
- **Unambiguously state that the UK shall be treated as a Member State for the purposes of any compatibility assessment by the Commission of aid in other Member States during the backstop.**
- **Remove or make reciprocal the remedies in Art 11 (2), 13 and 14 (N Ireland Protocol Annex 4, Part 4).** I.e. the UK also has standing in the Union courts for any State aid decision during the backstop; the UK has the ability to request consultations, and to impose “interim measures” if aid approved in the EU threatens to seriously undermine the equal conditions of competition between the parts of the single customs territory.
- **Unambiguously state that State aid provisions only refer to trade in goods and that there is no State aid control over services anywhere in the UK in the backstop.**

### **C. No Deal**

Under a no deal scenario, the State Aid (EU Exit) Regulations 2019 will apply. These effectively replicate the EU State aid regime, consistent with the UK's approach of adopting all EU law upon Brexit on the basis it can subsequently be amended. However, the way this is done for State aid is uneven in that it requires the CMA to consider the impact of aid in the UK on trade with the EU. There will be no equivalent obligation on the EU in a no deal scenario to consider the impact of aid in the EU on the UK.

This apparent imbalance is a domestic political choice which can be changed if appropriate in the future - and it should indeed be changed if the position ends up being unreciprocated or disadvantageous.

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