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Brexit: Implications for State Aid/Control of Subsidies

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In a referendum on June 23, 2016, voters in the United Kingdom voted to leave the European Union. The UK government is currently expected to trigger the Article 50 process to formally exit the EU in the spring of 2017. Once it does so, the UK will cease to be a member of the EU within two years from the date that it has given notice under Article 50 of the Treaty of European Union, unless the EU Member States (i.e., the UK plus the 27 remaining EU Member States) unanimously agree to extend that time period. This is the sixth in a series of briefing notes prepared by WilmerHale's Brexit team discussing the potential legal and regulatory implications of a future Brexit for the UK and the EU.

A future Brexit is likely to have significant potential impact on the monitoring and control of subsidies or other forms of aid granted by the UK and/or the remaining EU-27 to individual companies or entire sectors of industry, or to promote specific policies (e.g., renewable energy). Until Britain leaves the EU, all of these types of subsidies—both within the UK and in the other 27 EU Member States—are subject to the discipline imposed by EU State aid law, briefly summarized below. If a "hard Brexit" occurs, with the UK leaving the EU without a customs or trade agreement in place that extends to subsidies, the fallback rules controlling subsidies granted by the UK will be the World Trade Organization's (WTO's) Agreement on Subsidies and Countervailing Measures, and EU State aid rules would no longer apply to the UK. UK companies (like a company from any jurisdiction that competes with EU companies) would still have access to EU State aid rules to complain about State aid granted by EU Member States, but EU companies would not have access to a similar mechanism for UK government subsidies, unless some sort of post-Brexit regime is agreed upon. While WTO subsidy rules—which include both state-to-state dispute settlement proceedings and an option for governments to put in place anti-subsidy and anti-dumping mechanisms for companies to complain about subsidies by foreign governments—would continue to be available, if EU State aid rules no longer applied in the UK, subsidies for UK companies would be under significantly less systematic and pervasive scrutiny than at present. Going forward, the UK will have to decide whether and to what degree it wishes to impose discipline akin to EU State aid rules on subsidies granted to UK companies by UK governmental authorities, and the EU will need to decide to what extent it requires the UK to do so as part of a post-Brexit deal.

This alert explains key differences between EU State aid rules and the WTO anti-subsidy regime. It then examines various free trade agreements that have been concluded recently by the EU with third countries to see what types of State aid discipline have been agreed upon, and whether those provisions could serve as a model for any UK-EU agreement governing this issue.

As a working hypothesis, the more the UK continues to be fully integrated into the EU's Single Market after Brexit, the more likely it is that the UK will have to adopt rules on the control of State aid. This is because State aid discipline belongs to the mechanisms put in place by the EU to ensure a level competitive playing field across the economies of disparate Member States that have different historical national champions and compete to attract company investment. By contrast, a hard Brexit, with no follow-on trade agreement with the EU providing some form of Single Market access, would likely make it more difficult for many UK companies to compete in the EU, but would not limit the ability of the UK government to grant subsidies to companies, within the limits of WTO rules. A prominent working group on Brexit and its consequences for UK competition law has recently noted:

> [D]epending on the trade relationship with the EU and, indeed, trade relationships with other third countries, it is possible (even likely) that the UK would be required to accept (and might welcome) some limitations on giving State Aid to UK businesses. In the longer term, one issue that could be considered is whether, assuming that the general stance of policy remains anti-subsidy, it would be appropriate for the UK to create an "internal" discipline on subsidy policy[.][1]

Whether that is true or not, the exact shape and impact of any future UK internal discipline on subsidies remains to be seen, just as Brexit raises unanswered questions in a host of areas to which solutions will have to be worked out both in the domestic UK and the EU-UK political dialogues. The examples of possible solutions reviewed here may provide inputs for these discussions.

Key Points

- Once the UK leaves the EU, it will no longer be subject to comprehensive EU controls on State aid. Without a replacement framework, EU companies will not be able to complain in the UK about aid granted to their UK competitors. However, British companies will continue to be able to complain under EU State aid rules about State aid provided to their competitors in the EU.

- Regardless of what the EU and UK agree to bilaterally, both would remain bound by their obligations under the WTO, which has its own set of subsidy rules contained in the

[1] Brexit Competition Law Working Group (BCLWG), Issues Paper, October 2016, point 4.2. The BCLWG is composed of prominent former UK competition regulators and academics, chaired by Sir John Vickers.

Agreement on Subsidies and Countervailing Measures. WTO subsidy rules are similar in principle to EU State aid rules in many respects. However, they differ markedly in terms of legal process (no *ex ante* approval required and a different dispute settlement system), the requirement for private parties to reimburse subsidies that have been found to be illegal and their scope (WTO subsidy rules apply to "goods" only, not to subsidies for "services").

- Beyond WTO rules, the EU will continue to be able to rely on its own anti-subsidy and anti-dumping procedures. Pursuant to WTO rules, they allow the EU to impose import duties on goods (but not services) from foreign countries that are found to have benefited from illegal subsidization or that are dumped, i.e., sold below fair market value (usually defined as the price charged on the home market or the cost of production), whether or not such dumping is the result of home market government subsidies. The UK, for its part, does not currently have such an anti-subsidy or anti-dumping policy in place but, under WTO rules, would be allowed to implement such policies as well.

- There is precedent in (recent) EU free trade agreements as to how the EU and UK could go about creating some sort of bilateral agreement on the application of State aid rules. Whether they would agree to such a framework and what it would look like will of course depend on domestic UK political considerations, both sides' objectives and the course of the negotiations as a whole. The UK might well consider offering State aid discipline in certain areas in exchange for enhanced market access, particularly because the UK has historically had an anti-subsidy policy stance.

- Differing views have recently been expressed within the UK on the degree to which it will actually wish to impose self-discipline post-Brexit on policy choices regarding subsidies. On the one hand, Chancellor of the Exchequer Philip Hammond has suggested that the UK would act independently of EU "constraints" post-Brexit and set up a regime that would allow it to "intervene appropriately."[2] On the other hand, Joseph Johnson, the minister responsible for research and innovation, has noted that whether or not the UK ultimately would accept some form of EU State aid control, "[t]here will continue to be regimes governing government subsidies of one form or other to business in whatever scenario we might find ourselves in," adding that "[a]s a general point of principle, government wants to create a framework in which businesses can compete on a level playing field."[3] Speculation about the support that Nissan was recently promised by Prime Minister Theresa May to continue to invest in its plant in Sunderland highlights the

[2] Treasury Committee of the House of Commons, Oral Evidence: The Work of the Chancellor of the Exchequer, HC 777, October 19, 2016, Answer to Question 83, available at http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-work-of-the-chancellor-of-the-exchequer/oral/41671.html.

[3] The Select Committee on Science and Technology of the House of Lords, Inquiry on EU Membership and UK Science Follow-up, Evidence Session No. 5, October 25, 2016, Answer to Question 53, available at http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/science-and-technology-committee-lords/eu-membership-and-uk-science-followup/oral/42262.html.

political sensitivity of the question. As noted, both domestic political considerations and the need for trade-offs as required to secure the best possible Brexit deal for the UK are likely to determine the outcome.

1. EU Control of State Aid—What It Is and How It Works

The EU is the only jurisdiction worldwide that requires advance notification and central approval of subsidies granted by its Member States to companies doing business in its territory. "State aid" is defined by the EU treaties as any advantage provided through state resources that could distort competition by favoring certain companies or the production of certain goods.[4] The concern was initially with controlling the ability of EU Member States to favor their national champions, leading to a race to grant subsidies that could undermine the goal of creating in the EU a single internal market with a level competitive playing field. But even today, State aid policy is applied actively and its implications can be very broad. As recent decisions in the Starbucks and other cases have shown, even Member State corporate tax regimes and the benefits that individual companies obtain through them are potentially subject to EU State aid control, including the potential for *ex post* clawback of any benefits obtained.

Member countries of the EU must **notify** the European Commission (EC) of new State aid they decide to grant. Aid measures or frameworks that were already in place before a country became a member of the EU do not require notification. Such "existing aid" can, however, be challenged and declared incompatible with EU law by the EC. The EC—a supranational executive authority—is responsible for reviewing notified (and unnotified) aid measures and deciding whether or not they are compatible with EU law, including various policy frameworks (e.g., to support investment in economically weak regions, to promote green energy, to restructure banks or to roll out digital infrastructure).

Aid that the EC is **not notified** of and does not approve in advance or does not fall within the scope of preapproved policy frameworks is **per se illegal** and the EC **must order recovery**; competitors can sue in national courts to have that aid clawed back from its recipient. Defenses based on principles such as non-retroactivity or good faith are rarely effective.

Although State aid control is enforced through proceedings between the EC and an EU Member State, private parties, i.e., beneficiaries of alleged aid or their competitors, have certain procedural rights (as well as the substantive obligation to repay illegal aid). A potential beneficiary of aid that is not approved by the EC can challenge that EC decision if it is directly affected (i.e., does not just fall within a general category of beneficiaries defined by an aid framework but is part of a limited group of companies that would benefit and that can be identified in advance). A competitor of a beneficiary of aid who wants to ensure a level playing field can bring a complaint against that aid and challenge a decision by the EC to approve the aid or to reject the complaint. As noted, very substantial financial consequences can result from a finding that a company has received illegal State aid. Unlike the situation under the WTO

[4] Article 107 of the Treaty on the Functioning of the European Union (TFEU).

regime, in this case the company itself (and not the government that provided the aid) will be forced to repay that aid.

2. Brexit and EU State Aid—Why Is It Relevant?

Once the UK leaves the EU, the treaty provisions requiring State aid control will by definition no longer apply to the UK. Therefore, unless new provisions introducing some form of State aid control are agreed upon, when Brexit takes place EU State aid enforcement will be significantly affected—*by removing UK State aid from EU review*. This may have important implications for business, both in the UK and in the remaining 27 EU Member States.[5] Notably, where UK and EU companies remain in close competition, EU companies will not benefit from the system of EU control of State aid with respect to aid granted by the UK. However, both EU- and UK-based companies will still be able to make use of EU State aid control to challenge aid granted to their competitors by EU countries to the extent such aid impacts competition in the EU, provided that they fulfill applicable standing requirements.[6]

At the same time, the government of the UK will lose its legal right—without having to meet any standing requirements—to challenge State aid decisions.[7] This means that companies will not be able to enlist the UK's support (or opposition) in legal proceedings concerning State aid before EU courts. Historically, they have done so when companies did not themselves meet applicable standing requirements, but could enlist the UK to make use of its automatic right to intervene (e.g., to ensure a level playing field for a given industry sector).

3. WTO Rules and Anti-Subsidy Measures—Both a Fallback and a Parallel Subsidy Control Mechanism

Whether or not the UK and the EU conclude a free trade agreement (FTA) that addresses State aid, both would remain bound by their obligations under the **WTO Agreement on Subsidies and Countervailing Measures** (SCM Agreement). The EU, moreover, could have recourse to its anti-subsidy procedures (the EU equivalent of the US's and other countries' countervailing duty, or CVD, processes), and the UK could decide to put in place a similar process, as long as it does so consistently with WTO law. No UK State aid rules, in other words, does not mean that there will be no subsidy regime in place as between the UK and the EU, and vice versa.

A. WTO Subsidy Rules

The SCM Agreement creates two basic categories of subsidies: those that are prohibited and those that are actionable, i.e., subject to challenge at the WTO. Prohibited subsidies include

[5] The remaining EU member countries are designated as the EU-27, as long as the UK is still the 28th member of the EU.

[6] The Commission examines complaints submitted by any "interested party." (Art. 12(1), Regulation (EU) 2015/1589.) Individuals are entitled to challenge Commission decisions on State aid if those decisions are of "direct and individual concern" to them. (Art. 263(4) TFEU.)

[7] Cf. Art. 263(2) TFEU, which provides for an automatic right of action that EU Member countries can use to challenge EU legislation, including Commission decisions.

export subsidies and subsidies contingent on the use of domestic content. Most subsidies are "actionable," which means they can be challenged if they cause injury to a domestic industry or serious prejudice to the interests of another Member but, in the absence of such economic harm, they are not prohibited per se.

Depending on the UK's future status as a WTO Member—an issue to be discussed in a future alert—both the UK and the EU will remain subject to these subsidy rules and each could challenge the other's subsidies at the WTO. The WTO "dispute settlement" process is a state-to-state arbitration-like process including both a mandatory period for "consultations," a first-phase dispute heard by a WTO "panel" of three ad hoc appointed panelists and a possibility for appeal before the WTO's Appellate Body.[8]

The outcome of a WTO panel or Appellate Body decision finding a violation of WTO obligations is an order to bring the offending measure into compliance. In the event that the responding Member fails to bring its measure into compliance, the complaining Member or Members may initiate further proceedings to request a suspension of concessions to address the continuing noncompliance. This may take the form of trade sanctions (punitively higher import tariffs, temporary revocation of IP rights, etc.) in order to force compliance, or the Members involved may agree on a mutually satisfactory level of "compensation," which can take a number of forms. The WTO does not have the authority to impose fines on a noncomplying Member.

WTO dispute settlement has proven itself to be an effective form of adjudication that, in almost all cases, eventually leads to compliance. Timelines are fairly fast, with typical disputes taking between one and two years (at most) for the first-stage panel process, six to nine months for the appeal and between one and two years until compliance or another satisfactory outcome is reached. Ultimately, this is not much longer, and in some instances may be faster, than an intra-EU or European Economic Area/European Free Trade Association (EEA/EFTA) State aid case (including European Court appeal), although remedies, importantly, are only "prospective" in nature. Exceptionally, the WTO dispute settlement process can be substantially longer than the normal procedural timeline suggests. Such delays, however, tend to be limited to disputes that are both highly politically sensitive and in which compliance cannot immediately be achieved.

Despite the relative effectiveness of the system, reliance on WTO dispute settlement alone would mean a major shift. Among other things:

- *Only WTO Member governments may refer disputes to WTO dispute settlement*. Consequently, private companies in the EU would lose the right to directly challenge subsidies granted in the UK (as indicated previously, UK companies could still do so within the EU), although in many situations, private companies play an active role in WTO disputes "behind the scenes."

[8] The Appellate Body is a standing body of seven judges. A chamber of three Appellate Body members hears each individual dispute, but will consult with the other four in deciding a case.

- *The EU State aid regime is significantly stricter than the WTO rules on subsidies,* as the EC has greater competence to investigate State aid measures, of which it must be notified in advance, and compel EU Member States to obtain the reimbursement for illegal State aid from the entities that received it. While WTO Members are obligated to notify subsidies granted or maintained to the Committee on Subsidies and Countervailing Measures and Subsidiary Bodies (SCM Committee), the SCM Committee does not approve subsidies *ex ante*. Rather there is only the *ex post* dispute settlement mechanism, which provides only prospective relief and cannot order recovery of past subsidies the way the EU State aid regime can.

- *WTO subsidy rules apply only to trade in goods, not services,* whereas EU State aid rules apply more broadly. At the same time, the definition of what constitutes a subsidy has been interpreted more broadly under the WTO rules than under the EU State aid rules, which require a showing that the challenged transfer of state resources involved a charge on the public accounts in a way that WTO subsidy rules do not.[9]

- In practice, a relatively small number of disputes are referred to the Dispute Settlement Body (DSB) of the WTO compared with the number of State aid cases within the EU system. Since 1996, Members have claimed violations of the SCM Agreement in more than 110 disputes referred to the DSB, of which 67 specifically concerned subsidy challenges.[10] In contrast, the EC addressed 648 State aid–related cases in 2015 alone.[11] That being said, WTO disputes will typically involve larger subsidies and are often brought on a sectoral basis (rather than just regarding a particular company or State aid measure), and the large number of intra-EU State aid cases should of course be viewed against the backdrop of the particular role that the EU State aid regime has played in efforts to create and strengthen the EU internal Single Market.

B. Domestic Trade Defense Rules

In addition to the right for any WTO Member government to challenge another Member's actionable or prohibited subsidies in a WTO dispute, such a Member may also use an alternative, domestic mechanism for addressing unfair subsidization. Specifically, the SCM Agreement allows WTO Members to conduct domestic investigations, and impose so-called countervailing duties, to address unfair subsidies. Private parties have a right to bring cases to this "trade remedy" system; if successful, such cases allow the importing government to impose countervailing tariffs (i.e., offsetting charges upon importation) on the products of the subsidized foreign company. The WTO also allows countries to have in place a parallel anti-dumping

[9] See Marco M. Slotboom, *Subsidies in WTO Law and in EC Law: Broad and Narrow Definitions*, 36 J. World Trade 517, 538–39 (2002).

[10] See the WTO Dispute Settlement website as of November 17, 2016, available at https://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm?id=A20.

[11] See the European Commission Foreword to the Annual Competition Report 2015, available at http://ec.europa.eu/competition/publications/annual_report/2015/foreword_commissioner_vestager_en.pdf.

mechanism that provides for procedures to establish when imports are sold at below fair market value (usually defined as the price for which they are sold in their home market or some other objective standard) and allows for the imposition of countervailing import duties in the case of such "dumping." In many instances, anti-dumping rules will also apply where the "dumping" is in fact caused or facilitated by government subsidies.

Within the EU, the European Commission's Directorate General for Trade is responsible for conducting trade defense investigations (anti-subsidy and anti-dumping). Private parties may file complaints to request an investigation of allegedly unfair subsidization (or dumping) by other countries that, post-Brexit, would include the UK. The EU anti-subsidy rules define a subsidy in the same manner as the SCM Agreement, with only prohibited subsidies or actionable subsidies that cause adverse economic effects subject to anti-subsidy or countervailing duty tariffs. Such tariffs, however, are typically quite effective, with rates often set at levels between 10 and 30 percent (and potentially even higher), thus effectively neutralizing the benefit of the subsidy and, in many instances, not just leveling the playing field but effectively putting the importer at a competitive and pricing disadvantage.

The UK does not currently have its own trade defense rules, but it would be allowed to adopt a trade defense system post-Brexit, including anti-subsidy rules of the kind currently available within the EU. Those anti-subsidy rules, at that point, could be applied against the EU and other third countries but, importantly, would not cover subsidization provided within the UK by the UK government itself.

4. Prior EU FTAs—Potential Models for a UK-EU State Aid Cooperation Framework?

If negotiators decide to discuss a possible extension of the State aid regime to the UK as part of a post-Brexit EU-UK market access or trade deal, this could take several forms, depending, ultimately, on what UK and EU negotiators wish to accomplish.

The two main sets of hypothetical scenarios are as follows:

- British EEA membership, which would include compliance with EEA State aid control and enforcement by the EFTA Surveillance Authority (which enforces EEA competition and State aid rules in the EEA states) subject to control by the EFTA Court (a framework that is very similar to the current EC and European Court framework.

- A tailor-made solution, inspired perhaps by the State aid and related rules the EU has included in some of its more recent FTAs.

The first scenario—i.e., British EEA membership and application of EEA/EFTA State aid rules—appears highly unlikely at this stage, in light of post-referendum statements by UK Prime Minister May, the key role that not being subject to the European Court played in the Brexit campaign, and the fact that it would involve accepting free movement of persons and accepting

EU laws without having any say in them—the heart of what the UK voted against in the Brexit referendum.

The second option—i.e., a post-Brexit EU-UK trade agreement that could contain some elements of State aid discipline—is more likely, but since it would be tailor-made, its substantive content is hard to predict. Nonetheless, a look at some existing EU trade agreements that contain State aid or subsidy-related rules may be useful, if only to see what models there are.

In particular, the EU's Association Agreement with the Ukraine, which includes a Deep and Comprehensive Free Trade Agreement (DCFTA); the EU Air Transport Agreement with Switzerland; and the EU-Korea FTA, the EU-Vietnam FTA and the recently approved Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada all provide some form of oversight of aid measures. Specifically, these agreements show that at least three core elements have previously been sought by the EU in its existing trade agreements and could flow into an EU-UK FTA, should the parties agree to put such a regime in place:

- *Agreement on a certain level of State aid control in both jurisdictions* (i.e., here, both the EU and the UK), including permitting certain forms of State aid while prohibiting State aid that distorts competition. Thus, for example, the EU-Korea FTA prohibits some of the most distortive forms of State aid, such as unlimited guarantees and subsidies for ailing companies without a restructuring plan, where there is an adverse impact on trade. CETA prohibits agricultural export subsidies, once import tariffs have been eliminated. The Air Transport Agreement with Switzerland provides for application of EU State aid rules by both parties in the air transport sector. The DCFTA requires the Ukraine to apply EU State aid rules, including their interpretation in EU legislation, guidelines and court judgments, to trade in the goods and services covered by the DCFTA between the Ukraine and the EU.

- *Self-enforcement of State aid control by each jurisdiction* (i.e., this would require the UK to set up its own State aid enforcement mechanisms), as is provided for in the Air Transport Agreement with Switzerland and the DCFTA. Self-enforcement provisions can also be found in the accession agreements with countries that join the EU; more recent accession agreements have also provided for EC review of such self-enforcement during a transition period leading up to accession. However, the posture of such agreements is different from EU-third country FTAs, since newly acceding EU members have an institutional interest in preparing their economies for full EU State aid discipline even before becoming EU Member States.

- *Coordination on State aid issues through a bilateral (here, UK-EU) committee*. For example, the Air Transport Agreement with Switzerland establishes the Community/Switzerland Air Transport Committee, or Joint Committee, to examine and make recommendations on matters referred to it related to State aid. CETA also establishes a Joint Committee (as well as several specialized committees) to oversee

the agreement, which includes provisions that can trigger consultations between the EU and Canada on subsidies for goods as well as government support for trade in services.

The key question will be whether any of these models are appropriate to the EU-UK relationship, or whether something different and more specific may be envisaged, given the special circumstances. It could also be that certain sectors where there is particular sensitivity are singled out for State aid discipline, rather than a blanket control of State aid being put into place or, of course, that the UK refuses to impose any kind of domestic State aid regime, so as not to tie its hands.

5. Conclusion and Outlook: Toward Some Type of UK State Aid Control?

As a matter of principle, the UK may not want to limit its ability to provide benefits or tax advantages to companies that wish to make new investments (or simply to remain) in the UK after Brexit takes effect. This would also be consistent with the Brexit goal of regaining full sovereignty.

On the other hand, introducing some form of control of aid measures in the UK post-Brexit in return for more unrestricted access to the EU's Single Market could be an option for UK Brexit negotiators and could be a key request by EU negotiators. In comparison with other large economies in the EU, such as France and Germany, the UK provides significantly less aid to its industries. Offering an internal system of subsidy control in return for better access to the EU Single Market could be viewed as a concession that does not impose a significant cost from a domestic UK political perspective. It may also be politically desirable from the government's perspective. A UK State aid framework would provide the government with a more principled rules-based system to resist calls for individual company subsidies. Conceivably, the rules could provide for a more consistent and horizontal approach to support sectors that require specific transitional assistance to cope with Brexit. Given that the UK has been subject to and is already familiar with State aid control through its membership in the EU, retaining some sort of formal subsidy discipline would represent continuity, rather than a departure from the norm. On the other hand, the UK may well decide that it does not, at least at this stage, wish to tie its hands and limit its options to offer support to companies wishing to settle (or simply remain) in the UK, particularly given the other uncertainties that Brexit and the post-Brexit relationship with the EU will entail.

Finally, it is very likely that EU-27 negotiators will feel that some type of transitional provision will have to be agreed upon in the post-Article 50 negotiations, in particular to deal with UK aid that is illegal under EU rules but has not been recovered or ongoing State aid investigations that affect UK companies. Again, the UK position on this, for now, remains unknown.

Recent discussion of the "support and assurances" given to Nissan by the UK government so that it would decide to build its future Qashqai and X-Trail models at its UK automobile plant in Sunderland illustrate the political sensitivity of the issues. Reactions included speculation about a "secret deal," a warning from EC President Jean-Claude Juncker that the UK would have to

continue to respect EU State aid rules as long as it remained an EU Member State, a request from the EC to the UK authorities for more information on the support for Nissan and a statement by an association of UK automobile manufacturers that UK manufacturers are not seeking special deals but are encouraged by the government's reassurance that it intends to make sure the sector remains competitive, notwithstanding Brexit.

It remains to be seen what form of State aid discipline, if any, will exist in a future UK outside the EU. As reviewed in this alert, a number of alternatives exist. Both domestic political considerations in the UK—as well as the negotiations between the EU and UK, which may require trade-offs for concessions in other areas—can be expected to play a significant role in determining the outcome.

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