The European Commission's Draft Guidelines on Foreign Subsidies Distorting the Internal Market: Comments by RBB Economics

1. Intoduction

In force since January 2023, the Foreign Subsidies Regulation ("**FSR**")[1] aims to fill a perceived regulatory gap by allowing the European Commission ("**the Commission**") to scrutinise financial contributions granted by non-EU countries to firms active in the EU's Single Market.

The FSR aims to address potential distortions caused by foreign subsidies in the context of large concentrations and large public procurement processes through two notification-based procedures. It also allows the Commission to open *ex officio* investigations into foreign subsidies in all other market situations. The goal is to ensure a level playing field in the Single Market, with the aim of achieving lower prices, higher quality and more choice for European consumers.

However, due to its broad coverage, combined with the threat of extensive redressive measures, the FSR is not without costs. Not only is there the usual risk of false positives, i.e. of taking action against subsidies that are not distortive or whose distortive effects are offset by economic benefits, but there is a broader risk of deterring foreign direct investment ("**FDI**") into the Single Market. FDI is often a driver of competition (for instance, if it promotes market entry or expansion), while also contributing to innovation, as well as positively affecting employment and wages and thus contributes to economic growth more generally.[2] [3]

To minimise these negative effects of the FSR, it is important that the Commission applies the FSR in a targeted and consistent manner, accompanied by sufficient guidance to enhance legal certainty and transparency.

Against this background, the Commission's draft Guidelines for the application of key provisions under the FSR ("**the Draft Guidelines**") are welcome.[4] They provide clear and helpful guidance in many areas. From an economic perspective, however, the Draft Guidelines appear to opt for a rather broad interpretation of the FSR in some places and would benefit from further clarification and detail in certain areas.

Our main concerns and recommendations are summarised below:

- An important initial step in the Commission's assessment is determining **when a foreign financial contribution amounts to a foreign subsidy**. While this is not mandated by the FSR, the revised Guidelines should set out the Commission's approach in this regard, providing specific examples of comparators and methodologies to promote predictability and consistent application.
- As regards the criteria for determining whether a foreign subsidy actually or potentially **distorts competition**, the Commission should:
  - consider narrowing the Draft Guidelines' broad definition of "economic actors", so it is more closely aligned with the **consumer-welfare standard** underpinning established competition law principles;
  - adopt a **high threshold for intervention**, supported by **safe harbours**. Specifically, the Commission should reconsider the "*contributing factor*" threshold for demonstrating a negative impact on competition, and replace it with a more rigorous standard based on **a clear counterfactual analysis**. Safe harbours would not only reinforce a high bar for intervention but also provide greater legal certainty and to allow the Commission to focus on cases with a real potential for significant distortions;

1. Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market, OJ L 330, 23.12.2022.
2. Since the FSR applies to EU and non-EU companies alike, it also risks deterring outward FDI by European companies. Companies may be reluctant to invest in non-EU countries if this involves foreign financial contributions and thus would expose them to the FSR.
3. For a more detailed discussion of this issue, please refer to RBB Economics (2021): "Assessing the European Commission's proposal to address distortions caused by foreign subsidies", available at: https://www.datocms-assets.com/79198/1666963939-rbb-a-review-of-the-ec-proposal-on-foreign-subsidies1.pdf.
4. The FSR tasked the Commission to clarify the following central concepts under the FSR in the Draft Guidelines: (i) The application of the criteria for determining the existence of a distortion according to Article 4(1) of the FSR; (ii) the application of the balancing test in accordance with Article 6; (iii) the application of the Commission's power to request the prior notification of any concentration according to Article 21(5) or foreign financial contributions received by an economic operator in a public procurement procedure according to Article 29(8); (iv) and the assessment of a distortion in a public procurement procedure according to Article 27.

  - provide greater clarity on the assessment of distortions of competition in the context of concentrations. In particular, the Commission should refine the Draft Guidelines' approach to **deterring potential investors** in acquisitions, which appears overly broad, and make clear that it will independently assess potential **post-acquisition distortions** (and explain how such an assessment will be carried out), even where the acquisition process itself does not raise immediate concerns.
- With respect to the **balancing test**, the revised Guidelines should recognise the important differences between state aid and foreign subsidies, and set out clearly when and how benefits will be taken into account in the balancing exercise.

2. When does a foreign financial contribution amount to a subsidy?

Determining when a foreign financial contribution amounts to a subsidy is central to the Commission's ability to identify and address any potential distortions in the internal market. Indeed, across all three procedures available to the Commission to investigate foreign financial contributions, three key questions must be addressed:

1. Does the financial contribution under examination constitute a foreign subsidy?
2. Does that subsidy distort competition in the internal market?
3. Are any distortive effects of the subsidy outweighed by positive effects?

Sections 2 and 3 of the Draft Guidelines discuss the second and third questions, respectively, but the Draft Guidelines remain silent on the first. We understand that this is because Article 46(1) of the FSR does not oblige the Commission to issue guidance on this point. From a practical perspective, however, this approach is viable only if the FSR itself provides sufficient clarity on what constitutes a subsidy.

Unfortunately, this is not the case. Article 3(1) of the FSR merely sets out two broad conditions for a subsidy: the foreign financial contribution must confer a benefit, and this benefit must be exclusive to one or more firms or industries.

In relation to the first of these conditions, the FSR's preamble explains that the existence of a benefit relates to market conformity of the financial contribution, which "*should be determined on the basis of comparative benchmarks*".[5] Four examples of benchmarks are provided.[6] However, these examples are insufficient, given the wide variety of potential foreign subsidies – such as capital injections, grants, loans, guarantees, tax exemptions, or purchases or sales of goods or services – and the many ways benchmarks can be constructed.[7] Furthermore, the FSR mentions that, in the absence of such benchmarks, "*existing benchmarks could be adjusted or alternative benchmarks could be established on generally accepted assessment methods*".[8] Yet, the FSR includes no examples of these adjustments or alternative assessment methods.

The importance of the market conformity test is already evident in practice: the first FSR commitment decision dedicated almost half of its pages to analsying whether the financial contributions at issue qualified as foreign subsidies.[9]

Accordingly, the revised Guidelines should provide concrete, practical guidance. In particular, they should:

- provide specific examples of comparators for the main categories of financial contributions;
- describe comparator methodologies and the circumstances in which each is appropriate; and
- explain how existing benchmarks can be adjusted and give examples of alternative assessment methods where direct benchmarks are unavailable.

3. When does a subsidy distort competition?

This section sets out our key comments on the criteria for determining whether a foreign subsidy actually or potentially distorts competition under the FSR.

We recommend that the Commission refine several aspects of the Draft Guidelines to ensure a more targeted and proportionate enforcement framework. In particular, we suggest narrowing the broad definition of "economic actors" to better align with established, consumer-welfare-based competition law principles (Section 3.1); adopting a higher threshold for intervention, supported by appropriate safe harbours to improve legal certainty and focus enforcement on genuinely distortive cases (Section 3.2); and providing greater clarity on how distortions will be assessed in the context of concentrations (Section 3.3).

5. FSR, preamble, para. 13.
6. The examples are: "*the investment practice of private investors, financing rates obtainable on the market, a comparable tax treatment, or the adequate remuneration for a given good or service*", see FSR, preamble, para. 13.
7. For instance, market conformity may be established by comparing the conditions of the financial contribution in question to other contributions granted to the same firm by private actors (this is often referred to as internal benchmarks) or by comparing them to the conditions granted to other comparable firms (this is often referred to as external benchmarks). The FSR provides no guidance on which guidelines may be considered appropriate by the Commission, nor does it explain in what instances other approaches may be acceptable and what those approaches could be.
8. FSR, preamble, para. 13.
9. Case FS.100011 - *e&/PPT Telecom Group*.

3.1 The Commission should consider a narrower definition of economic actors

The FSR sets out that a subsidy is distorts the internal market where it is liable to improve the competitive position of the subsidised firm and thereby "*actually or potentially negatively affects competition in the internal market*" but tasks the Commission to define what constitutes a negative effect on competition.[10] Although the Draft Guidelines address this issue, we consider that the principles set out should be more firmly grounded in the consumer welfare standard, as outlined below.

The Draft Guidelines consider a subsidy to have a negative effect on competition if it results in "*an alteration of, or interference with, competitive dynamics to the detriment of other economic actors in the internal market.*"[11]

While we appreciate the Commission's emphasis on the impact on the competitive process, we believe that the broad definition of "*economic actors*" – encompassing actual and potential competitors, consumers, workers, and states engaged in economic activity[12] – raises important conceptual and practical challenges not currently addressed in the Draft Guidelines.

This is because subsidies rarely affect all groups of economic actors in the same way: a subsidy could benefit one group of economic actors while harming another. For example, a subsidy enabling a firm to reduce prices may harm rivals' sales and profits but benefit consumers; it may also disadvantage rivals' workers while advantaging those of the subsidised firm. Conversely, a subsidy could change the outcome of an acquisition in a way that generates cost synergies but also leads to job losses. In such a scenario, workers might benefit, but consumers could be harmed if post-merger prices were higher than in the counterfactual.

These examples highlight the complexity of considering the interests of different groups of economic actors in the assessment of a subsidy's impact. The Commission would need to determine which actors to include in the assessment and how to weigh their interests. These difficulties are recognised by the Commission in other areas of competition law – such as cases under Article 102 TFEU or foreclosure analysis in the context of non-horizontal mergers – where it applies a consumer welfare standard. In this context, harm to competitors is not ignored, but is considered a harm to competition only to the extent that it is likely to lead to harm to consumers.

Given the above considerations, to ensure clarity and consistency with the consumer welfare standard underlying broader competition law principles, a narrower interpretation of "*economic actors*" appears to be preferable. Since other policy tools are better suited to address the interests of groups beyond consumers,[13] the Commission, when applying the FSR, should focus on consumer interests. This would also allow the Commission to make use of established analytical frameworks, such as the as "*ability-incentive-effects-framework*" in foreclosure analysis or the "*as efficient competitor principle*" in Article 102 TFEU cases. While these frameworks may require adjustments to account for the effect of the subsidy, they can be a useful starting point for the Commission's assessment.[14]

Another practical question not addressed in the Draft Guidelines is how the Commission will balance short-term benefits against longerterm harm when assessing whether a subsidy is liable to distort competition.[15] Indeed, many subsidies are expected to produce immediate and material benefits for consumers – such as lower prices or increased choice – while negative effects, like reduced competitiveness of rivals tend to materialise only in the long term and are less certain. For instance, a subsidy allowing a firm to charge lower prices would benefit consumers immediately, while the long-term risk of rivals being marginalised and prices rising again in the long-term is not guaranteed. Rivals may restructure or adapt, or their competitiveness may not depend crucially on the level of sales. The Draft Guidelines should explain how the Commission will balance short-term benefits against longerterm harm when deciding whether a subsidy distorts competition.

3.2 A high bar for intervention and the case for safe harbours

As explained above, the FSR introduces a powerful new enforcement tool, and its effective application requires a careful balancing act: deterring genuinely distortive subsidies without unduly chilling legitimate FDI. To that end, we believe the Commission should adopt a high bar for intervention, grounded in robust economic analysis and implemented with clear safe harbours to enhance legal certainty.

As currently drafted, the Draft Guidelines suggest a relatively low threshold for enforcement. Specifically, they state that "*the foreign subsidy should be a contributing factor to the negative impact on competition*" and that "*it is not necessary that it be the only or even the main factor*".[16] This low bar appears to diverge from the more rigorous counterfactual analysis described in paragraph 55, which requires the Commission to show that competition harm "*should reasonably follow from the foreign subsidy*".[17]

10. FSR, Article 4(1).

11. Draft Guidelines, para. 38 (emphasis added).

12. Draft Guidelines, footnote 23.

13. For instance, the rights of workers are protected by employment legislation.

14. For instance, the "*as efficient competitor test*" would need to be adjusted to take into account that the subsidy may reduce the long-run average incremental costs and average avoidable costs, against which prices charged by the subsidised firm are compared.

15. We understand that this assessment would not be part of the balancing test, which only considers positive effects on the development of the relevant subsidised economic activity and positive effects in relation to relevant policy objectives.

16. Draft Guidelines, para. 41 (emphasis added) and para. 92.

17. Draft Guidelines, para. 55 (emphasis added). To establish this, the Commission should "*[compare] the competitive situation in the internal market in the presence of the foreign subsidy with the competitive situation that would have existed in the internal market in the absence of the foreign subsidy.*"

In our view, this latter standard – focused on identifying a material distortion of competition that can be causally linked to the subsidy – should guide enforcement decisions. It better aligns with economic principles and reduces the risk of "*false positives*" where subsidies that play only a marginal role in market outcomes are mistakenly treated as distortive.

To support this high bar, the Commission should incorporate safe harbours into the Guidelines. These could build upon the indicators listed in paragraph 56 of the Draft Guidelines that the Commission will use to assess whether a subsidy is distortive: (a) the scope, purpose and conditions of the foreign subsidy; (b) the amount of the foreign subsidy; (c) the type of the foreign subsidy; (d) the size of the undertaking and the scope of its activities; (e) the characteristics of the sector where the undertaking operates or is likely to operate; and (f) the legal context.

From an economic perspective, this set of indicators appears reasonable and it is also helpful that the Draft Guidelines clarify that those indicators "*should not be taken in isolation but examined in combination with one another*" when assessing a foreign subsidy's impact.[18] However, the open-ended nature of these indicators – and the absence of quantitative thresholds – creates broad scope of discretion and thus contributes to a low bar for intervention, and, as an additional concern, limits legal certainty.

There are two areas where safe harbours would be particularly valuable:

- Indicator (b) subsidy amount: While the Draft Guidelines note that larger subsidies are more likely to distort competition, they also state that even "*a relatively limited amount may also give rise to a material impact*."[19] This broad formulation offers little practical guidance. A clearly defined quantitative threshold below which subsidies are presumed non-distortive would significantly reduce scope for discretion and improve legal certainty.
- Indicator (d) size of the subsidised firm and scope of its activities: The Draft Guidelines discuss firm size in absolute terms – for example, whether the undertaking is an SME or a large enterprise. However, from a competition perspective, relative size is a more meaningful metric. A subsidy to a firm with a modest market share – say, under 20% – is unlikely to result in significant distortive effects, even if it may slightly increase the firm's capacity to engage in exclusionary or predatory strategies.

While we understand the Commission may be hesitant to adopt safe harbours based solely on the amount of the subsidy or based solely on the market share of the subsidised firm, safe harbours could be designed to consider both the market share of the subsidised undertaking <u>and</u> the size of the subsidy, allowing enforcement to focus on cases where these combined factors signal a genuine risk of competitive distortion.

3.3 Clarity on the distortions considered in the context of large concentrations

In the context of concentrations, foreign subsidies may distort competition in two distinct ways: first, by affecting the acquisition process; and second, by distorting competition in the product market after the transaction has closed ("**post-closing effects**"). The following two subsections set out our comments and recommendations regarding the Draft Guidelines in relation to each of these concerns.

3.3.1 A higher bar for addressing subsidies that alter the outcome of an acquisition process

According to the FSR, a foreign subsidy may distort competition by altering the outcome of an acquisition process – that is, where the target would have been acquired by a different buyer in the absence of the subsidy.[20]

While we agree that the crowding out of other potential buyers may harm competitors, such an effect cannot automatically be presumed to harm consumers, which – as argued in Section 3.1 above – should be the relevant benchmark for establishing competition harm. Therefore, the Commission should adopt a high bar for intervention, assess in each case (a) if the subsidy resulted in the crowding out of <u>all credible</u> alternative buyers, thereby changing the outcome of the acquisition process, and (b) if this crowding out is likely to result in (material) consumer harm.

The Draft Guidelines currently propose a much lower threshold. They appear to presume that competition is harmed whenever a subsidy alters the outcome of an acquisition process, and extend the scope for intervention beyond cases where <u>actual</u> alternative buyers were crowded out, to include situations where <u>potential</u> investors may have been deterred from participating in the acquisition process.[21] As a result, even where no competing offers were made for the target, the Commission may still consider a subsidy distortive. The underlying premise seems to be that the mere presence of a subsidised firm in an acquisition process could deter other firms from bidding, and that such deterrence constitutes a distortion of competition.

18. Draft Guidelines, para. 57.

19. Draft Guidelines, footnote 26.

20. The FSR raises similar concerns in the context of public procurement processes, namely, that a contract may have been awarded to a different bidder in the absence of the foreign subsidy. To avoid repetition, this subsection focuses on acquisition processes. However, our comments equally apply to the approach taken in the Draft Guidelines with respect to public procurement processes.

21. Draft Guidelines, para. 46. In public procurement processes, the Commission may intervene if the subsidy has the potential to deter <u>potential</u> bidders (para. 94).

In our view, this broad interpretation is both problematic and impractical:

- It creates a large risk for false positives. The deterrence of potential investors is unlikely to change the outcome of an acquisition and therefore is unlikely to distort competition. This is because the firms most likely to be deterred are those with the lowest probability of success in the first place, while credible bidders, are unlikely to be deterred if participation costs are low.[22] Moreover, where other actual bidders participate in an acquisition process and/or in instances, where the participation of other bidders is unknown (and cannot be inferred with sufficient certainty), concerns around deterrence if potential bidders should not arise.
- There are clear practical obstacles in terms of determining whether potential investors were in fact deterred, and in line with the above, whether they would have been credible bidders:
  - The Commission will generally need to rely on the subsidised firm's rivals to identify allegedly deterred investors. Such rivals may act strategically to harm the subsidised firm.
  - Proving a negative is inherently difficult, so the subsidised firm will often struggle to demonstrate that no credible investors were deterred. In this context, the Draft Guidelines set out that the Commission may benchmark the price offered by the subsidised firm with the price of similar past acquisitions to determine whether the foreign subsidy is likely to lead to an offer that may have deterred other investors.[23] However, benchmarking in this context raises significant practical difficulties: truly comparable transactions are often unavailable; buyers' willingness to pay varies greatly depending on expected synergies and business models; and superficial similarities such as industry or revenue size do not guarantee comparable valuations.

In light of these concerns, the revised Guidelines should opt for a narrow interpretation of what constitutes a distortion in the context of an acquisition or procurement procedure. It should focus its effort on instances where there is a risk that actual bidders were crowded out through the foreign subsidy.

At a minimum, the Commission should acknowledge that the crowding out of potential bidders is not an issue where other actual bidders participated, and should make clear that concerns will arise only where credible potential bidders are deterred. The Guidelines should also provide practical criteria for identifying when such deterrence is more or less likely – for example, depending on the cost of participating in the acquisition process or the degree of transparency regarding other bidders and their offers. Furthermore, the Commission should explain how it will evaluate claims by firms that they were deterred from bidding, and how it will determine whether such firms would have been credible bidders.

Finally, the crowding out of credible alternative buyers should not automatically be presumed to distort competition. Instead, the Commission should articulate a coherent theory of harm explaining why, in the specific case, consumer harm is likely to result.

3.3.2 More guidance regarding post-closing effects

The Draft Guidelines do not provide any specific guidance on post-closing effects, which are only mentioned in passing, explaining that "*acquisitions may stem from fixed subsidies, which may in turn indirectly affect prices to the extent they alter the undertaking's variable cost structure*".[24]

However, post-closing effects are just as relevant as distortions in the acquisition process and have been central to the Commission's in-depth reviews to date.[25] Therefore, the revised Guidelines should make clear that the Commission will investigate both questions in the context of large concentrations and that it will do so independently. In other words, the Commission should make clear that if it concluded that the subsidy did not distort the acquisition process, it could still find that the subsidy distorts competition post-transaction.

In this respect, the Commission's approach should be governed by the same principles as those applied in *ex officio* investigations, to ensure consistency and promote legal certainty. The revised Guidelines should state this explicitly. As argued above, in both contexts the Commission should adopt a rigorous standard grounded in consumer welfare principles, and possible effects on competition should be established on the basis of a counterfactual analysis.

22. In this context it should ne noted that acquisition processes can be designed in a way that credible bidders are not deterred from participating.

23. Draft Guidelines, para. 64. According to the Draft Guidelines the Commission may also "*assess the valuation model used*". The Forthcoming Guidelines should clarify what valuation model the Draft Guidelines refer to and how it would be assessed, as neither is currently clear from the Draft Guidelines.

24. Draft Guidelines, para. 52.

25. In *e&/PPF Telecom Group*, the Commission accepted commitments to alleviate such concerns that the foreign subsidies received by e& could have led to a distortion of competition post-transaction and in ADNOC/Covestro, the Commission explained that it will assess whether potential foreign subsidies may lead to negative effects in the internal market with respect to the merged entity's activities after the transaction (see https://ec.europa.eu/commission/presscorner/detail/en/ip_24_4842 and https://ec.europa.eu/commission/presscorner/detail/en/ip_25_1894).

4 When do positive effects outweigh distortions of competition?

Article 6 of the FSR allows the Commission to balance the negative effects of a foreign subsidy on the internal market against any positive effects for the subsidised economic activity or broader policy objectives.[26] The FSR itself, however, offers no detail on how that balancing test is to be carried out.

The Draft Guidelines provide useful examples of subsidies that could promote a particular economic activity or attain a policy goal, as well as of relevant policy objectives that could be considered;[27] examples of positive effects in the context of public procurement procedures;[28] and a description of the principles applied by the Commission in the balancing test.[29]

However, they do not yet explain clearly how the Commission will apply the balancing test in the specific context of foreign subsidies. The following issues in particular require clarification.

First, the revised Guidelines should not seek to evaluate the effects of foreign subsidies in the same way as state aid. Unlike state aid, foreign subsidies will rarely be specifically designed to promote EU policy goals. Instead, such positive effects in the context of foreign subsidies are more likely to be incidental side effects than deliberate policy outcomes. Moreover, unlike state aid, whose effects are assessed ex-ante (before it is granted), the potential effects of foreign subsidies are assessed only ex-post.[30]

In our view, this means that it would not be appropriate to apply the standards and principles from state aid assessments to the balancing exercise mandated by the FSR. Specifically, for the reasons set out above, it seems inappropriate to assess whether the positive effects resulting from a subsidy could have been attained by a less distortive subsidy (a standard premised on deliberate public policy design).[31] Instead, the appropriate counterfactual is whether the positive effect would likely have occurred absent the subsidy in question.

The revised Guidelines should set out this counterfactual approach and adjust the explanation of how the Commission will perform the balancing in Section 3.3.2 accordingly.

Second, the revised Guidelines should clarify what qualifies as a positive effect and the timeframe over which it should be assessed. At present the Draft Guidelines mention that the positive effects must be specific to the subsidy, such that "*absent the foreign subsidies, such positive effects would not occur, or otherwise not to the same degree*".[32] The Commission however does not clarify whether the faster development of an economic activity, or the earlier attainment of a policy goal, should also be considered a positive effect to be considered in the balancing exercise. For example, a certain policy goal might have been attained absent a subsidy but only in a significantly longer time frame. This is particularly relevant given that, at least in the case of policy objectives, these will likely be pursued via other policy tools at a later stage if market forces are insufficient.

Relatedly, the Commission should specify the time horizon for assessing positive effects in the balancing exercise. In our view, this time horizon should match the horizon used to assess distortive effects. If a subsidy poses only long-term distortionary risks, long-term benefits should also be eligible for consideration in the balancing exercise.

26. FSR, Article 6(2).

27. Draft Guidelines, paras. 105-109.

28. Draft Guidelines, paras. 113-116.

29. Draft Guidelines, paras. 117-132.

30. For example, consider a state contemplating the grant of state aid to finance an acquisition. In such a case, the aid would have to be notified and assessed before it could be paid out and the acquisition completed. By contrast, in the context of a foreign subsidy, the sequence is reversed: the subsidy is granted, the acquisition takes place, and only afterwards must the subsidy be notified and assessed.

31. Draft Guidelines, para. 123.

32. Draft Guidelines, para. 117.