

The Commercial Market Operator principle, and the economic and financial tools used to apply it

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Overview

- A.** Introduction to the Commercial Market Operator (CMO) principle
Overview of the approach
- B.** Application of the CMO principle
Profitability analysis
Benchmarking analysis
- C.** Specifics of loan guarantees
- D.** Conclusions



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The Commercial Market Operator, CMO, principle (I)

Introduction

- a subsidy is defined, among other characteristics, as financial assistance that confers an **economic advantage** on one or more enterprises
- financial assistance does not confer an advantage if it is provided on terms that would have been **available on the market** to the enterprise
 - analysed through the Commercial Market Operator (CMO) principle
 - there are a number of different versions of the CMO test; however, the economic and financial tools are similar

Private investor test

- assess whether, in similar circumstances, a private investor operating in normal market conditions would have made the investment in question (e.g. equity injection)

Private creditor test

- compare the behaviour of a public creditor to a hypothetical private creditor in a similar situation, in order to determine whether debt renegotiations by a public creditor are on market terms

Private vendor test

- analyse whether a private vendor, under normal market conditions, could have obtained the same or a better price, to assess whether a sale by a public body is on market terms

The Commercial Market Operator, CMO, principle (II)

The economic and financial framework



In practice, there are two ways of looking at the CMO test, each underpinned by a specific rationale

1. Investor perspective

- in a financial deal entered into by the state, would the **expected return be acceptable to a private investor**?
- is the project expected to be sufficiently profitable?



Profitability analysis

2. Recipient perspective

- **did the recipient receive an advantage** from the arrangement, by virtue of state participation?
- could the recipient have obtained similar terms in the market?



Benchmarking analysis

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How do we apply the CMO principle?

Overview of profitability analysis



1) Examine the **expected profitability** of the arrangement on a **forward-looking basis**

- expected profitability can be measured using the internal rate of return (IRR)

2) Compare the expected profitability against the **return required by a private investor** (i.e. the market return)

- the appropriate market return depends on the risks associated with the arrangement in question

Example of the use of profitability analysis (I)

Equity injection from the French State to EDF



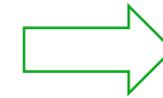
Expected profitability

What return was expected by the French State from the equity injection?



Market return

What return was required by a private investor for a similar investment?



Economic advantage

- **key elements:**

- EDF's market value at the time of the investment
- dividend income while the French State owned a stake in EDF's equity
- EDF's market value at the end of the investment period

- the cost of equity was used to assess whether a private investor would have invested in EDF
- the cost of equity was estimated using the Capital Asset Pricing Model (CAPM)

Example of the use of profitability analysis (II)

Funding provided to Ciudad de la Luz

- in 2012, the Commission concluded that €265m of aid must be repaid by the Ciudad de la Luz studios
- the Commission concluded that an equity injection from the Spanish authorities was not on market terms for the following reasons:

Robustness of the business plan

The projections in the business plan were overly optimistic; if corrected, the expected return would be very low

Assessment of the market return

The market return was estimated incorrectly; if corrected, the market return would be significantly higher

Example of the use of profitability analysis (III)

Funding provided to Ciudad de la Luz

- **the robustness of the business plan:** the Commission concluded that **estimates of the expected return** to the Spanish authorities were too optimistic, and there was no evidence that the assumptions had been challenged
- **significant differences in estimates of the market return on equity:**

Parameter		Spanish authorities	European Commission
Risk-free rate (%)	[A]	4.1 ¹	4.1
Equity beta	[B]	0.395	1.59
Equity risk premium (%)	[C]	3.75	6.8
Cost of equity ² (%)	$[D] = [A] + [B] \times [C]$	5.58	14.91

Note: ¹As the risk-free rate assumed by the Spanish authorities has not been reported in the Commission's Decision, for illustrative purposes, the European Commission's assumption has been adopted. ²The cost of equity is reported on a post-tax basis.

- substantial differences in estimates of the equity risk premium and **beta**
 - **choice of comparators:** the Spanish authorities' estimates were based on two established studios, whereas the Commission argued that investment in Ciudad de la Luz involved higher risk

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How do we apply the CMO?

Overview of benchmarking analysis

Assess the **terms and conditions** of the state intervention against those of comparable transactions, carried out by **similar private operators**, in similar circumstances

Selecting relevant benchmarks



Comparable operators

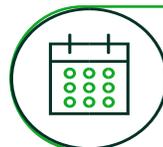


Comparable transactions



Comparable markets

Considerations when selecting benchmarks



Timing of the transactions



Specific features of the state transaction



Any distortions to market conditions

Examples of the use of benchmarking analysis (I)

Overview of the Munich Airport investigation

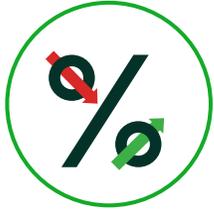
- loans granted by public development banks and publicly owned banks to terminal operating companies to finance development of a second terminal
- **two approaches** to assess whether loans were on market terms:
 - **credit default swaps**
 - **cross-checks** based on the Commission's proxies for market rates
- the results from both approaches showed that the loans had been granted on market terms



The measures did not confer an economic advantage

Examples of the use of benchmarking analysis (II)

Credit default swaps



Interest rates on loans assessed against credit default swaps (CDS)

Base
rate

Swap rate (fixed rate) with a maturity in line with the average duration of the loans in question

+

Risk
margin

CDS spreads on sample of approximately 30 non-financial companies with similar credit rating and maturity to loans in question

- the selection of similar comparator companies was an important consideration, which requires estimates of the credit rating

+

Fee

Bank fees based on Oxera's analysis

Examples of the use of benchmarking analysis (III)

Cross-checks based on proxies for the market return

Base rate

Average of one-year EURIBOR



Risk margin

Risk margin depends on credit rating and collateralisation

- credit rating based on parent company

Credit rating

- often relevant entity does not have a formal credit rating
- the rating can be proxied based on analysis of business and financial risks

Collateral

- categorisation depends on the extent to which underlying assets are likely to be written down in the event of bankruptcy

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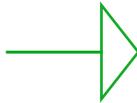


Applying the CMO principle to State guarantees on loans

Overview of the framework



Can state guarantees on loans be in line with the CMO principle?



Conditions set out in BEIS's subsidy control guidance:



There is a realistic assessment of the borrower's ability to repay the loan



The guarantee is linked to a specific transaction



The guarantee does not cover more than 80% of the outstanding financial obligation



A market-oriented price is paid for the guarantee

An example of assessing a State guarantee on a loan (I)

The Valencia football club ('Valencia CF') case

- the Spanish authorities provided a guarantee on a €75m loan, which was used to finance an equity injection by a local sports association into Valencia CF
- the guarantee covered all of the loan (plus the interest)
 - the loan and guarantee were provided in exchange for a pledge on Valencia CF's shares purchased by the sports association
- the Commission concluded that the guarantee conferred an advantage on Valencia CF:
 - the club was in financial difficulty at the time of granting the guarantee
 - the guarantee covered more than 80% of the loan (as the value of the pledge on the club's equity was close to zero)
 - the cost of borrowing (i.e. the interest rate on the loan plus the guarantee premium) was below the market price

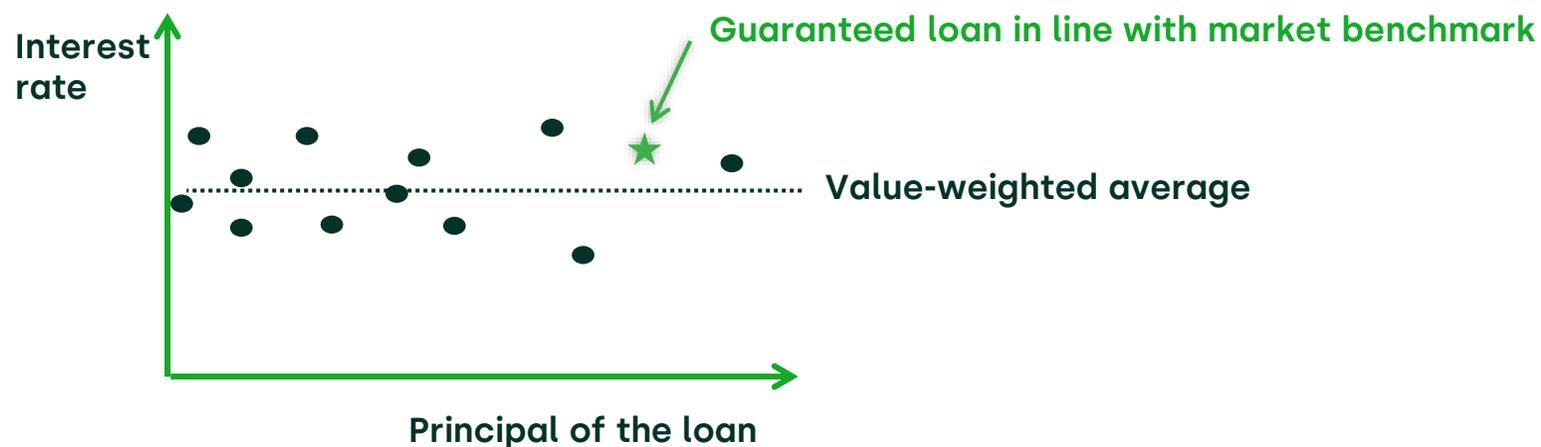
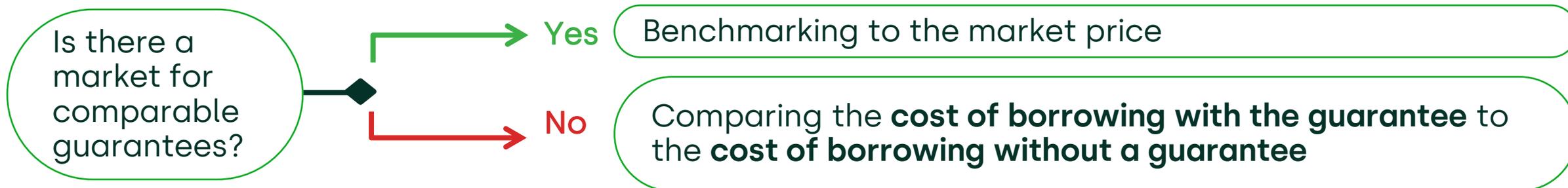
An example of assessing a State guarantee on a loan (II)

The Valencia CF case



- Valencia CF's appeal covered, among other aspects, whether the guarantee was provided on market terms

Was the guarantee provided at the market price?



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Conclusions

- the CMO test assesses whether the State has acted on market terms, and therefore has not conferred an advantage to an enterprise
- economic and financial analysis underpins the application of the CMO test
 - profitability analysis and benchmarking analysis are the key tools
 - importance of ex ante evidence that arrangements are underpinned by a robust economic and financial rationale



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