

Official Journal of the European Union

L 83



English edition

Legislation

Volume 60

29 March 2017

Contents

II Non-legislative acts

DECISIONS

- ★ **Commission Decision (EU) 2017/501 of 12 June 2015 on tariffs applied by Hidroelectrica of Romania to S.C. ArcelorMittal Galați, S.C. Alro SA, S.C. Alpiq RomEnergie S.R.L., S.C. Alpiq RomIndustries S.R.L., S.C. Energy Financing Team Romania S.R.L. (EFT), S.C. Electrica SA, S.C. Electromagnetica SA, S.C. Energy Holding S.R.L., S.C. EURO-PEC SA, S.C. Luxten-Lighting Group SA, S.C. Electrocarbon SA Slatina and S.C. ELSID Titu SA — SA.33623 (2012/C), SA.33624 (2012/C), SA.33451 (2012/C) and SA.33581 (2012/C) (notified under document C(2015) 3919)⁽¹⁾** 1
- ★ **Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks (notified under document C(2015) 7143)⁽¹⁾** 38
- ★ **Commission Decision (EU) 2017/503 of 8 November 2016 on State aid scheme SA.39621 2015/C (ex 2015/NN) (notified under document C(2016) 7086)⁽¹⁾** 116

⁽¹⁾ Text with EEA relevance.

EN

Acts whose titles are printed in light type are those relating to day-to-day management of agricultural matters, and are generally valid for a limited period.

The titles of all other acts are printed in bold type and preceded by an asterisk.

II

(Non-legislative acts)

DECISIONS

COMMISSION DECISION (EU) 2017/501

of 12 June 2015

on tariffs applied by Hidroelectrica of Romania to S.C. ArcelorMittal Galați, S.C. Alro SA, S.C. Alpiq RomEnergie S.R.L., S.C. Alpiq RomIndustries S.R.L., S.C. Energy Financing Team Romania S.R.L. (EFT), S.C. Electrica SA, S.C. Electromagnetica SA, S.C. Energy Holding S.R.L., S.C. EURO-PEC SA, S.C. Luxten-Lighting Group SA, S.C. Electrocarbon SA Slatina and S.C. ELSID Titu SA — SA.33623 (2012/C), SA.33624 (2012/C), SA.33451 (2012/C) and SA.33581 (2012/C)

*(notified under document C(2015) 3919)***(Only the Romanian text is authentic)****(Text with EEA relevance)**

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having regard to the decisions by which the Commission initiated the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union, in respect of the aid SA.33623 (2012/C, ex 11/NN) ⁽¹⁾; SA.33624 (2012/C, ex 2011/CP) ⁽²⁾; SA.33451 (2012/C, ex 2012/NN) ⁽³⁾; and SA.33581 (2012/C) ⁽⁴⁾.

Having called on interested parties to submit their comments pursuant to the provisions cited above, and having regard to their comments,

Whereas:

1. PROCEDURE

- (1) On 28 January 2011 and on 2 August 2011, the Commission received three complaints from the investment fund S.C. FP Proprietatea SA ('FP' or 'the complainant') in relation to the sale of electricity by S.C. Hidroelectrica SA ('Hidroelectrica') to several buyers at prices allegedly set below market level.
- (2) On 25 April 2012, the Commission informed Romania that it had decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union ⁽⁵⁾ ('TFEU') in respect of the alleged State aid measures, hereinafter jointly referred to as 'the opening decisions':
 - SA.33623 concerning S.C. ArcelorMittal Galați SA ('ArcelorMittal'),
 - SA.33624 concerning S.C. Alro SA ('Alro'),

⁽¹⁾ Commission Decision C(2012) 2516 final of 25 April 2012 concerning case SA.33623 (OJ C 189, 29.6.2012, p. 3).

⁽²⁾ Commission Decision C(2012) 2517 final of 25 April 2012 concerning case SA.33624 (OJ C 268, 5.9.2012, p. 21).

⁽³⁾ Commission Decision C(2012) 2542 final of 25 April 2012 concerning case SA.33451 (OJ C 395, 20.12.2012, p. 5).

⁽⁴⁾ Commission Decision C(2012) 2556 final of 25 April 2012 concerning case SA.33581 (OJ C 395, 20.12.2012, p. 34).

⁽⁵⁾ OJ L 115, 9.5.2008, p. 92.

- SA.33451 concerning S.C. Alpiq RomEnergie S.R.L. ('S.C. Alpiq RomEnergie'), S.C. Alpiq RomIndustries S.R.L. ('Alpiq RomIndustries'), S.C. Energy Financing Team Romania S.R.L. ('EFT'), S.C. Electromagnetica SA ('Electromagnetica'), S.C. Energy Holding S.R.L. ('Energy Holding'), S.C. EURO-PEC SA ('Euro-Pec'), S.C. Electrica SA ('Electrica') and S.C. Luxten-Lighting Group S.A ('Luxten-Lighting'); hereinafter jointly referred to as 'electricity traders', and
 - SA 33581 concerning S.C. Electrocarbon SA Slatina ('Electrocarbon') and S.C. ELSID Titu SA ('Elsid'), hereinafter 'electrode producers'.
- (3) The opening decisions were published in the *Official Journal of the European Union* ⁽⁶⁾. The Commission called on the Romanian authorities and interested parties to submit their comments.
- (4) On 23 July 2012 the Romanian authorities provided the Commission with their comments on the opening decisions.
- (5) The Commission received comments from 11 ⁽⁷⁾ interested parties, i.e.:
- in case SA.33623 from ArcelorMittal on 30 July 2012 and 2 August 2012. On 5 December 2012 the Commission forwarded the comments of the interested parties to the Romanian authorities,
 - in case SA.33624 from Alro on 3 October 2012, 28 November 2012, 12 April 2013 and 30 May 2013, and on 5 October 2012 from a competitor. On 13 November 2012 the Commission forwarded the comments of the interested parties to the Romanian authorities,
 - in case SA.33451 from Alpiq RomEnergie and Alpiq RomIndustries on 1 August 2012 and 20 January 2013, from EFT on 4 February 2013, from Energy Holding on 18 and 21 January 2013, and from Electromagnetica on 22 January 2013. On 13 February 2013, the Commission forwarded the comments of the interested parties to the Romanian authorities,
 - in case SA.33581 from Electrocarbon and Elsid on 18 May 2012 and 18 January 2013. On 13 February 2013, the Commission forwarded the comments of the interested parties to the Romanian authorities.
- (6) The Romanian authorities replied to the comments of the interested parties on 15 January 2013 in case SA.33624 and on 24 March 2013 in cases SA.33451 and SA.33581.
- (7) The Commission requested further information from the Romanian authorities:
- in case SA.33623 (ArcelorMittal) by letters dated 30 October 2012, 15 April 2013 and 29 July 2013,
 - in case SA.33624 (Alro) by letters dated, 22 May 2012, 30 October 2012 and 15 April 2013,
 - in cases SA.33451 and SA.33581 (electricity traders and electrode producers) by letters dated 6 August 2014 and 25 September 2014,
 - in all four cases on 29 July 2013 and 21 February 2014.
- (8) The Romanian authorities provided further information:
- in case SA.33623 (ArcelorMittal), on 30 November 2012, 3 and 10 June 2013, 16 July 2013, 11 September 2013, 18 December 2013, 20 March 2014, 24 March 2014 and 14 May 2014,
 - in case SA.33624 (Alro) on 19 June 2012, 23 July 2012, 30 November 2012, 15 January 2013, 3 June 2013, 11 September 2013, 18 December 2013, 24 March 2014 and 14 May 2014,
 - in cases SA.33451 and SA.33581 (electricity traders and electrode producers) on 11 September 2013, 24 March 2014, 14 May 2014, 3 September 2014 and on 10 October 2014.
- (9) On 11 March 2014, the Commission sent a request for further clarifications to Energy Holding concerning its comments made in case SA.33451 (electricity traders). Energy Holding replied on 8 May 2014.

⁽⁶⁾ Case SA.33623 (OJ C 189, 29.6.2012, p. 3); case SA.33624 (OJ C 268, 5.9.2012, p. 21); case SA.33451 (OJ C 395, 20.12.2012, p. 5) and case SA.33581 (OJ C 395, 20.12.2012, p. 34).

⁽⁷⁾ Including the preliminary observations submitted by Luxten-Lighting and Euro-Pec before publication of the invitation to provide comments on the opening decision: Luxten-Lighting on 14 August 2012 and Euro-Pec on 13 August 2012.

- (10) The Commission received further submissions from interested parties:
- in case SA.33623 (ArcelorMittal) by email on 30 July and 2 August 2012,
 - in case SA.33624 (Alro) by letters of 30 May, 28 June, and 2 July 2013 and 21 March 2014,
 - in case SA.33451 (electricity traders) by letters dated 18 and 19 November 2013, 16 and 18 June 2014, and 25 July and 25 November 2014,
 - in case SA.33581 (electrode producers) by fax and by email on 18 January 2013.

2. DESCRIPTION OF THE ALLEGED AID MEASURES

- (11) This section describes the contracting parties (i.e. Hidroelectrica and alleged beneficiaries), as well as the electricity sale contracts, in the context of the Romanian electricity market.

2.1. The contracting parties

2.1.1. *Hidroelectrica*

- (12) Hidroelectrica was established in 2000, when the Romanian Government created four independent wholly State-owned companies. Hidroelectrica is governed by ordinary company law. Its share capital is held by the Romanian State through the Ministry of Economic Affairs and Trade (80,056 %) and the complainant (19,943 %). The Romanian State is represented in the general meetings of shareholders and appoints members of Hidroelectrica's Board of Directors. In fact, the members of Hidroelectrica's Board of Directors can combine this function with government posts ⁽⁸⁾.
- (13) Hidroelectrica is Romania's main electricity producer with an annual production capacity of around 17,5 TWh in a normal hydrological year. Hidroelectrica produces electricity through dams and run-of-the river generation plants. However, this production is subject to wide variations depending on hydrological conditions: in 2004, Hidroelectrica's output was 17,6 TWh whereas in 2009 it was 16,4 TWh and in 2010, 21,3 TWh. In 2013, Hidroelectrica's market share was 28,24 %, ahead of Complexul Energetic Oltenia, a thermo-coal based electricity producer, with a 20,83 % market share and Nuclearelectrica with a 20,65 % market share. Both Complexul Energetic Oltenia and Nuclearelectrica are State-owned companies.
- (14) The cost structure of Hidroelectrica is characterised by high fixed costs (relating to the amortisation of power dams and of civil works and to regular maintenance) and low variable productions costs. Hydroelectricity often has lower marginal costs than other electricity sources, in particular fossil fuels. This cost structure stems from the fact that the production of electricity based on hydropower does not typically have significant fuel costs or marginal costs ⁽⁹⁾. It follows that policies for sales and the full recovery of costs above marginal costs of

⁽⁸⁾ All members of Hidroelectrica's Board of Directors except the General Director of Hidroelectrica and the representative of Fondul Proprietatea (2010), cumulated other functions in various Ministries and were appointed through Orders issued by the Ministry of Economy and Trade, as follows: (i) in 2005-2006: the personal adviser in the cabinet of the Minister of Economy and Trade; the director of cabinet of the Minister for Small and Medium Enterprises; the personal adviser in the cabinet of the Minister in the Ministry of Public Finance and the personal adviser in the General Secretariat of the Government were members of Hidroelectrica's Board of Directors; (ii) in 2007-2008 — situation unknown; (iii) in 2009: the State Secretary in the Ministry of Economy and Trade was also the President of Hidroelectrica's Board of Directors (2009), while another State Secretary in the Ministry of Public Finance and two general directors in the Ministry of Economy and Trade were also members of Hidroelectrica's Board of Directors; (iv) in 2010: three personal advisers in the Ministry of Economy and Trade, a State Secretary in the Ministry of Finance and a General Director in the Ministry of Economy and Trade were members of Hidroelectrica's Board of Directors.

⁽⁹⁾ See International Energy Agency: 'Projected costs of generating electricity' 2010 edition, Section 4.2 'Country by country data on electricity generating costs', p. 89.

production across the range of output sold by hydropower producers are largely determined individually by each producer. Beyond the basic rule that full costs should be recovered in the long term for hydro power (or other power) generation, there are no prescriptive or normative economic rules for optimal price determination based solely on the costs for specific segments of buyers in the short to medium term. This rules out, for instance, all kWh sold necessarily having to have the same contribution to full recovery of fixed costs, irrespective of the output sold to each buyer. However, due to its dependency on the level of hydrology and its inability to adjust its fixed cost base, Hidroelectrica is, generally speaking, exposed in the long run to a degree of risk due to uncontrollable volatility of its output and, consequently, of its revenues. Hidroelectrica thus requires a stable output for its production in the long term in order to yield stable and predictable revenues.

- (15) By 2005, when most of the contracts under investigation were signed, Hidroelectrica's strategy involved modernising and building new hydro facilities with a capacity of 1,6 GW. The total investment was estimated at EUR 5,9 billion in the period 2005-2025. The modernisation programme required EUR 800 million of external financing.

Hidroelectrica began insolvency proceedings on 26 June 2012 ⁽¹⁰⁾, and these ended on 26 June 2013 ⁽¹¹⁾. As of 25 February 2014, Hidroelectrica again began insolvency proceedings. According to the Insolvency Report drawn up by the receiver, Hidroelectrica's insolvency was triggered by several factors, namely the obligation to sell a sizeable part of its production on the regulated market at prices below production cost, the obligation to buy large quantities of electricity from more expensive State-owned Romanian electricity producers (quantities that were then re-sold at lower prices), the portfolio of sale contracts, over-investment, bad management and inflated labour costs — all of which led to Hidroelectrica's not being able to pay its debts to its creditors ⁽¹²⁾.

2.1.2. *The alleged beneficiaries*

- (16) The clients with which Hidroelectrica entered into the contracts under investigation were:

- eight electricity traders: **Alpiq RomEnergie**, previously SC EHOL Distribution, the legal successor to Energy Holding. EHOL Distribution was sold to Alpiq and renamed Alpiq RomEnergie; **Alpiq RomIndustries**, previously SC Buzmann Industries SRL, both owned by the private Swiss operator Alpiq, which was created by the merger of Aare-Tessin Ltd for Electricity and EnergieOuest Suisse in 2008 and which is active mainly in south-east Europe; **EFT**, a subsidiary of the Cyprus-based EFT Group, which is active mainly in the Balkan region; **Electrica**, a provider of electricity services to both eligible retail clients and its own subsidiary companies, active in Romania; **Electromagnetica**, a provider of lighting products and services and electricity trader based in Romania; **Energy Holding**, a privately owned energy supplier which is active in Romania and also in south-east Europe; **Euro-Pec**, a trader in iron and steel products for civil, industrial and naval constructions and electricity trader active in south-east Europe; and **Luxten-Lighting**, a producer of lighting products and electricity trader,
- two electrode producers: **Electrocarbon**, a publicly listed company manufacturing graphite electrodes, calcined petroleum coke, Soderberg paste, and carbon blocks for blast furnaces; and **Elsid**, which was set up in 1984 to produce graphite electrodes for the metallurgical industry,
- **ArcelorMittal**, a subsidiary of the multinational group active under the same name, which is the leading steel producer worldwide. ArcelorMittal produces hot rolled and cold rolled coils, galvanised coils, pickled and oiled coils, and plates. ArcelorMittal is Romania's largest steel producer and the second largest industrial consumer of electricity in Romania, with an annual consumption of electricity exceeding 1,7 TWh,
- **Alro**, a subsidiary of Vimetco NL, a Russian-owned holding company with its headquarters in the Netherlands. With an annual consumption of electricity exceeding 3 TWh/year in continuum band (24 hours per day), Alro is the largest industrial consumer of electricity in Romania.

⁽¹⁰⁾ Decision of Tribunal of Bucharest No 22456/3/2012 dated 26 June 2012.

⁽¹¹⁾ Decision of Tribunal of Bucharest No 6482 dated 26 June 2013.

⁽¹²⁾ Available in Romanian only at <http://www.euroinsol.eu/uploads/Raport%2059%20Hidro%20v11.pdf>

2.2. The contracts

- (17) Hidroelectrica concluded 14 contracts for the supply of electricity to the alleged beneficiaries, namely one contract with each of the eight electricity traders except for Electrica ⁽¹³⁾, Electrocarbon, Elsid and Alro, and two 1-year contracts with ArcelorMittal. The main characteristics of these contracts are described in detail in recitals 19 to 23, below. For more comprehensive descriptions and further details, reference is made to the opening decisions in each case and to Annex I to this Decision.
- (18) *Date of signature of the contracts:* Nine contracts were already in force in 2007, i.e. at the time of Romania's accession to the EU, and five contracts were signed after Romania's accession to the EU ⁽¹⁴⁾.
- (19) *Duration of the contracts:* Most contracts were signed for long periods, of between 5 and 10 years, i.e.: five contracts were concluded for an initial period of 10 years ⁽¹⁵⁾; two contracts were concluded for an initial period of 7 years ⁽¹⁶⁾; and three contracts were concluded for an initial period of 5 years ⁽¹⁷⁾, two of which were extended for additional periods of 5 years in 2004 ⁽¹⁸⁾; the four remaining contracts were concluded for periods of 1 year ⁽¹⁹⁾ or less ⁽²⁰⁾.
- (20) *Current status of the contracts:* Only the contract with Alro is still in force. All the other contracts were either: (i) terminated by Hidroelectrica's receiver during the insolvency proceedings in 2012; (ii) terminated individually by one of the parties ⁽²¹⁾; or (iii) they expired ⁽²²⁾.
- (21) *Contract prices applied:* the prices set out in the contracts under investigation were ad hoc prices negotiated with each buyer and not determined by reference to a pre-existing tariff grid applied by Hidroelectrica, e.g. as a discount or mark-up on an applicable tariff or as a tariff step.

— In the contract with Luxten-Lighting (electricity trader), the price was initially set at a fixed amount for an undetermined period. Subsequent addenda increasing the initial contract price were signed yearly.

— In the contracts with Electrocarbon and Elsid, the prices were initially set at a fixed amount only for the first year of the contract. On 1 September 2003 ⁽²³⁾, the price was adjusted to a fixed amount, identical for each of the years until the end of the initial contract period. Again, before 2007, the parties readjusted the pre-set price for subsequent years until the end of the period of the contracts to a fixed amount identical for each year ⁽²⁴⁾. In practice, despite the fact that the contract price was predetermined at a fixed amount, the parties each year renegotiated, and agreed on, prices above the contract level. However, when in 2010 Electrocarbon and Elsid refused to accept the whole price increase requested by Hidroelectrica, and Hidroelectrica wished to unilaterally interrupt the supply of electricity, the matter was brought before the competent court, which did not accept Hidroelectrica's request to increase prices above the level set out in the contracts ⁽²⁵⁾.

⁽¹³⁾ Electrica concluded two short-term contracts with Hidroelectrica.

⁽¹⁴⁾ Contract with Alpiq RomEnergie; two contracts with Electrica; and two contracts with ArcelorMittal.

⁽¹⁵⁾ Five contracts with electricity traders (Alpiq RomIndustries; Electromagnetica; Energy Holding; Euro-Pec; Luxten-Lighting).

⁽¹⁶⁾ Contracts with EFT (electricity trader) and Alro.

⁽¹⁷⁾ Contracts with Electrocarbon and Elsid and Alpiq RomEnergie (electricity trader).

⁽¹⁸⁾ Contracts with Electrocarbon and Elsid.

⁽¹⁹⁾ Two contracts with Arcelor Mittal.

⁽²⁰⁾ Two contracts with Electrica.

⁽²¹⁾ The contract with Luxten-Lighting (electricity trader) was terminated by Luxten-Lighting by notice dated 15 November 2011, with effect from 1 January 2012.

⁽²²⁾ Contracts with Electrocarbon and Elsid expired on 13 March 2013 and the contract with Electromagnetica (electricity trader) expired on 30 April 2014.

⁽²³⁾ Addendum 1 to the contract with Electrocarbon provided for a pre-set price (at a fixed amount — the same price) until 28 February 2008; Addendum 2 to the contract with Elsid provided for a pre-set price until 31 December 2007.

⁽²⁴⁾ On 1 July 2004 the parties agreed on a table pre-setting a per year fixed price for the period 2006-2013 (i.e.: Addendum 4 to the contract with Electrocarbon and Addendum 5 to the contract with Elsid). The prices were subsequently modified on 1 January 2005 with prices pre-set at a fixed amount until 31 December 2007 for Elsid and until 28 February 2008, for Electrocarbon. As of 2006 the contract prices were readjusted yearly for Electrocarbon and Elsid.

⁽²⁵⁾ Court of first instance: Olt Tribunal — File 2800/104/2010 (Electrocarbon) and Dambovită Tribunal — File 4102/120/2010 (Elsid).

(22) Right of the parties to terminate the contract unilaterally:

- In the contracts with Luxten-Lighting, Electrocarbon and Elsid, the buyer had the opportunity to individually terminate the contract upon prior written notice given 30 days before termination. In the event of this clause not being complied with, the buyer was obliged to pay the contractual amounts due until such time as Hidroelectrica signed a new electricity supply contract under equivalent conditions with a new buyer ⁽²⁶⁾.
- In the contracts with Luxten-Lighting, Electrocarbon and Elsid, Hidroelectrica was also able to terminate the contract in the following circumstances: (i) repeated non-payment of the contract price for the electricity bought and/or repeated non-payment of any penalties due under the contract; (ii) loss by the buyer of its status as an eligible consumer in accordance with Romanian law (which is a key element for the contract), in which case termination was possible within 5 working days from the date when this status was lost; (iii) refusal of the buyer to conclude a new contract or to amend the existing contract in the event of a change in the economic and technical circumstances obtaining at the date of the contract's being entered into, in which case termination was possible with prior notice of 30 calendar days; as well as (iv) in other cases stipulated by any applicable laws or regulations ⁽²⁷⁾.

2.3. The Romanian electricity market

- (23) Electricity trading in Romania in the period under consideration could take place on two markets: (i) the regulated electricity market on which electricity is traded on the basis of regulated tariffs and conditions; and (ii) the competitive electricity market on which electricity is traded freely, including through two main types of contract: bilateral contracts traded on the centralised market, and freely negotiated bilateral contracts, the so-called market for directly negotiated contracts.

The regulated electricity market

- (24) Transactions on the regulated electricity market are implemented through sale-purchase framework agreements concluded between the electricity producers active on the regulated market, including Hidroelectrica, and the 'suppliers of last resort', which ensure distribution of electricity to the end-user. The suppliers of last resort have the obligation to supply electricity to eligible consumers who are either: (i) final consumers that did not exercise their right to choose their supplier and to buy electricity on the competitive market; or (ii) households and non-household customers that have fewer than 50 employees and a yearly turnover of below EUR 10 million ⁽²⁸⁾. The eligible consumers buy electricity on the basis of regulated tariffs.
- (25) On the regulated markets, the Romanian Energy Regulatory Authority ('ANRE') sets out the prices and volumes to be delivered by the electricity producers *ex ante* every year. In line with ANRE's request, Hidroelectrica is obliged to supply electricity wholesale to distributors that supply electricity retail on the regulated market. The wholesale prices paid to Hidroelectrica are set by ANRE on the basis of a justified level of eligible costs plus a rate of return. Between 2004 and 2010, the wholesale prices paid to Hidroelectrica were as follows (RON/MWh) ⁽²⁹⁾:

2004	2005	2006	2007	2008	2009	2010
40	67	54,59	62,46	60,53	67,65	72

The competitive electricity market

- (26) Since 2005, Romania's competitive electricity market has been divided into five specific markets, i.e.:

- the centralised markets administered by OPCOM,
- the market for directly negotiated contracts,

⁽²⁶⁾ Article 10(2) of each of the three contracts.

⁽²⁷⁾ Article 10(1) of each of the three contracts.

⁽²⁸⁾ Article 55 paragraph 1 of the Electricity and Gas Law No 123/2012 as further amended by Law No 127/2014.

⁽²⁹⁾ KPMG Report, Annex 3 to Memorandum of Energy Holdings dated 27 February 2012, p. 8, source: Hidroelectrica's Annual Reports, 2010 Administrator's Report, KPMG Analysis.

- the ancillary services market,
- the balancing market, and
- the export market.

- (27) The centralised markets are administered by OPCOM. OPCOM was set up in 2001, pursuant to Government Decision No 627/2000, as a joint stock company and wholly-owned subsidiary of Transelectrica, the transmission system operator. By virtue of the licence granted by ANRE, OPCOM was designated as a platform for the wholesale trading of electricity in Romania. OPCOM is the only power exchange in Romania offering a framework for electricity trading and having a facilitator role.
- (28) There are five big types of market segment on OPCOM: (i) the day-ahead market; (ii) the intra-day market, which has been administered by OPCOM only as of July 2011, (iii) the centralised bilateral markets, i.e. the centralised market for bilateral contracts through public auction ('OPCOM-PCCB') and the centralised market for bilateral contracts through continuous negotiation ('PCCB-NC'); (iv) the centralised market for green certificates, and (v) the trading platform for greenhouse gas emission certificates. Green certificates and greenhouse gas emission certificates do not directly involve the trading of electricity and, therefore, are not described below. Transactions on OPCOM started only in 2005 and only on the day-ahead and OPCOM-PCCB markets.
- (29) At the time of Romania's accession to the EU in 2007, electricity was traded mainly on the regulated electricity market (approximately 29 TWh or about 55 % of final demand). On the competitive electricity market, electricity was traded: (i) on OPCOM-PCCB, and (ii) on the day-ahead market, both administered by OPCOM; then (iii) under directly negotiated contracts, often of long duration, both wholesale and retail, (iv) on the balancing market, on which the transmission system is the sole buyer, and finally (v) on the export market (3,3 TWh in 2007). Between 2007 and 2010, sales of electricity on these non-regulated markets in Romania were as follows ⁽³⁰⁾:

	(TWh)				
	2007	2008	2009	2010	Average 2007-2010
Electricity production – total	61,39	64,01	56,69	59,14	60,31
Balancing market – total	3,49	3,55	3,21	2,97	3,30
Day-ahead market – total	5,04	5,21	6,35	8,70	6,32
OPCOM-PCCB – total	5,88	8,77	6,33	4,39	6,34

Hidroelectrica sales across market segments

- (30) With annual sales of 18,2 TWh and a 30,2 % market share on average in the period 2007-2010, Hidroelectrica was (and remains) Romania's main electricity producer. Since 2003, in line with the progressive opening of the market to electricity buyers entitled to choose their suppliers, Hidroelectrica's sales were made predominantly through directly negotiated bilateral contracts. By 2007, such sales accounted for nearly two thirds of Hidroelectrica's total sales. As shown in the table below, during the period after Romania's accession to the EU, the proportion of Hidroelectrica's sales out of its total sales remained, between 2007 and 2010, relatively stable at around 19 % on the regulated market segment and at around 1 % for sales to other electricity producers. In the meantime, the proportion on the balancing, bilateral contracts and export markets decreased slightly, while the proportion of sales on OPCOM's administered market segments increased from near insignificance in 2007 and 2008 to [...] % ⁽³¹⁾ in 2010.

⁽³⁰⁾ KPMG report, Annex 3 to the Memorandum of Energy Holdings dated 27 February 2012, p. 21, source: ANRE.

⁽³¹⁾ Business secret.

Hidroelectrica sales per market segment	2007	2008	2009	2010	Average 2007-2010 (%)
Regulated market	[...]	[...]	[...]	[...]	19
Balancing market	[...]	[...]	[...]	[...]	6
Export market	[...]	[...]	[...]	[...]	7
Other electricity producers	[...]	[...]	[...]	[...]	1
Bilateral contracts	[...]	[...]	[...]	[...]	63
of which contracts under scrutiny	[...]	[...]	[...]	[...]	58
OPCOM (day-ahead & PCCB)	[...]	[...]	[...]	[...]	4

- (31) The contracts of Hidroelectrica with electricity traders Electrocarbon, Elsid and Alro were concluded on the market for directly negotiated contracts. The two contracts with ArcelorMittal for electricity supplies from 2010 and 2011 were concluded on OPCOM-PCCB, following the principle of the highest offer price. Although the economic and legal assessment of the contracts under examination should refer to the broader context of the Romanian electricity market, two segments in this market are, therefore, mainly relevant to, and concerned with, the Hidroelectrica contracts that are the subject of this Decision:

- OPCOM-PCCB as identified and referred to in the opening decisions, which is also particularly relevant for the contracts with ArcelorMittal,
- the market for directly negotiated contracts, on which all other contracts subject to the current proceedings were concluded.

OPCOM-PCCB

- (32) On the OPCOM-PCCB market segment, OPCOM organises public auctions for the sale and purchase of electricity. Sale or purchase offers by each supplier or consumer are submitted to the market operator. Each offer must specify the following: (i) either the minimum price at which the party will sell electricity or the maximum price at which it will buy electricity; and (ii) the framework agreement under which the party making the offer is planning to supply/purchase electricity. Sale and purchase offers specify supply conditions, including those relating to the amount of electricity, duration (minimum 1 month and up to 1 year) and the envisaged framework agreement. The price follows the principle of the best offer price.
- (33) After publication of the opening decisions, the Commission adopted a Decision in application of Article 102 TFEU, finding that the power exchange managed by OPCOM constituted a relevant service market, on which OPCOM was an undertaking holding a dominant position and that was separate from the market for directly negotiated contracts ⁽³²⁾.

The market for directly negotiated contracts:

- (34) The market for directly negotiated contracts is a free market which is not regulated by ANRE. Contracting parties negotiate quantities, prices and other contract clauses bilaterally. This provides the parties with a high degree of flexibility in negotiating the terms and conditions of the sale contracts. These terms and conditions are confidential.
- (35) By letter dated 21 February 2014, the Commission asked the Romanian authorities to provide it with data and information about contracts concluded on the Romanian market other than the contracts that are the subject of this Decision and with comparable durations and quantities of electricity supply. The Commission's request covered all Romanian electricity suppliers, whether state- or privately owned. On 14 May 2014, the Romanian

⁽³²⁾ Commission Decision of 5 March 2014, in application of Article 102 TFEU imposing fines pursuant to Article 7 of Regulation (EC) No 1/2003 in case AT.39 984 'Romanian Power Exchange/OPCOM'.

authorities provided the requested data on all long-term contracts that had been signed by electricity buyers with an annual electricity consumption of more than 150 GWh and that were in force at a point in time between 2007 and 2013 ⁽³³⁾.

- (36) In particular, relevant data from 96 contracts in force between 2007 and 2013 were submitted by the Romanian authorities. The Romanian authorities underlined the fact that all the contracts concluded by non-household consumers on the retail market under competitive conditions in the relevant period of time were subject to the ad hoc data collection requested by the Commission. On the supply side, the contracts were entered into by virtually all significant suppliers active on the Romanian market, whether producers in the nuclear power or fossil fuel sectors or traders having purchased wholesale for retail resale. On the demand side, the data reported covers contracts of major, relatively energy-intensive industries, such as the steel, chemicals, cement, car manufacturing and petrol & gas and coal & lignite extraction industries ⁽³⁴⁾.
- (37) The buyers concerned entered into bespoke long-term contracts on the basis of bilateral negotiations with other suppliers for durations and quantities similar, on average, to those for Hidroelectrica's contracts under scrutiny. As for Hidroelectrica contracts, the data reported show prices varying each year. On average for the period 2007-2010, these long-term contracts not covered by the proceedings represented 11,1 TWh of electricity, whereas Hidroelectrica's sale contracts under scrutiny represented 10,5 TWh. In relative terms, the latter Hidroelectrica contracts represented 35 % of the volume of electricity subject to directly negotiated contracts in 2007 whereas the other contracts covered approximately 41 % of the volume of electricity subject to directly negotiated contracts. The remainder (around 24 %) concerned contracts for lower quantities. Therefore, the relevant data from all the contracts fulfilling the Commission's required criteria of comparable periods and quantities reveal, by and large, a quantity similar to that for the total quantity supplied by Hidroelectrica under the contracts that are the subject of the proceedings.
- (38) The Commission does not possess information that would indicate that the conclusion of the contracts covered by the data supplied by Romania stemmed from non-market-compliant commercial behaviour or would have been affected by regulatory requirements. Likewise, for purposes of comparison with the Hidroelectrica contracts under scrutiny, Romania stressed that retail supply contracts based on wholesale supply by Hidroelectrica to parties subject to the investigation (electricity traders) had been excluded from the analysis. Accordingly, the contracts in the dataset can be deemed to represent market conditions agreed between willing buyers and willing sellers.

3. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE

- (39) In the opening decisions, the Commission expressed doubts as to whether the prices for the supply of electricity under the contracts were market-compliant and did not constitute State aid.
- (40) The Commission compared the prices stipulated in the contracts with the electricity traders, Electrocarbon and Elsid with the prices at which electricity was traded on OPCOM-PCCB and noticed that the prices at which Hidroelectrica sold electricity to the alleged beneficiaries were between 10 % and 70 % lower than the average prices on OPCOM-PCCB throughout the period 2007-2010.
- (41) In the case of the contract with Alro, the Commission took the preliminary view that Alro derived an undue advantage in the form of reduced, preferential electricity prices over the period 1 January 2007 to 31 December 2009 and from 1 January 2010 to 31 December 2011 respectively, based on the formulae for price indexation applicable in each period.
- (42) In case of the two contracts with ArcelorMittal, the Commission took the preliminary view that, by concluding the 2009 and 2010 contracts for deliveries of electricity in 2010 and 2011, Hidroelectrica had sold electricity at prices below what could have been obtained either: (i) by accepting one of the parallel 'buy' offers available on

⁽³³⁾ The dataset used for benchmarking included 114 observations, covering the period 2007-2010. The dataset included the following information: the identity of the seller and the buyer, the type of contract, the date of entry into force and the expiry date, as well as the quantity, profile of supply and the weighted average price for each year from 2007 to 2013.

⁽³⁴⁾ The list of buyers is provided in Annex II, Table 1.

OPCOM at the time for higher prices; or (ii) by placing its own sale offer on OPCOM for a price probably higher than that paid by ArcelorMittal. In the preliminary view of the Commission, the prices agreed could have constituted an undue advantage for ArcelorMittal.

- (43) The Commission reached the preliminary conclusion that the electricity tariffs under examination were selective in nature, since they applied only to certain undertakings. In so far as these undertakings were active on electricity and industrial markets open to competition on which trade between Member States took place, the Commission held that any possible economic advantage for the beneficiaries would be liable to distort competition and affect trade between Member States.
- (44) Furthermore, the Commission reached the preliminary conclusion that the preferential electricity tariffs could involve a transfer of State resources that would be imputable to the State, since Hidroelectrica was controlled by the Romanian State (80,06 % of its share capital was held by Romania). In addition, the Commission referred to Ministerial Order No 445/2009, through which the representatives of the Ministry of Economy, Trade and Business Environment and members of the boards of directors of the State-owned electricity companies were obliged to ensure that, as of 31 March 2010, the portion of electricity intended for the wholesale market should be traded exclusively on OPCOM. Consequently, the representatives of the Ministry of Economy, Trade and Business Environment could be deemed to have had control, or at least influence, over the contracting practices of State-owned companies, including those of Hidroelectrica.
- (45) Should these contracts have involved State aid, they would have been considered aid granted in breach of the notification and stand-still obligations laid down in Article 108(3) TFEU. The Commission also expressed doubt as to whether such aid would be compatible with the TFEU.
- (46) In the light of the above, the Commission reached the preliminary conclusion that the preferential electricity tariffs could potentially involve State aid and it invited Romania to provide sufficient information to alleviate its doubts.

4. ROMANIA'S COMMENTS

- (47) The Romanian authorities made observations only in relation to the opening decision concerning contracts with electricity traders, ArcelorMittal and Alro and abstained from making any observations in relation to the contracts with Electrocarbon and Elsid.
- (48) The Romanian authorities hold the view that the contracts with ArcelorMittal and Alro involved no aid. They stressed that the receiver did not terminate the contract with Alro during the insolvency proceedings, which proves that it was profitable.
- (49) In relation to the contracts with the electricity traders, the Romanian authorities did not provide substantial arguments. They argued that some of the contracts might have involved State aid (those with Alpiq RomEnergie, Alpiq RomIndustries, EFT, Energy Holding and Euro-Pec), abstained from expressing any views on certain contracts (those with Electrica and Luxten-Lighting) and claimed that there was no aid involved in one of the contracts (that with Electromagnetica). The Romanian authorities did not provide detailed explanations in support of their observations.
- (50) As regards the possibility of terminating the contracts individually (and particularly those with the electricity traders), the Romanian authorities explained that, in Romanian commercial practice, any party to a contract could have terminated the contract, incurring the risk of having to pay damages as determined by the competent court. Bearing in mind the characteristics of the contracts in question, the Romanian authorities made it clear that such damages would have been unusually high. Furthermore, the party requesting termination of the contract could also have faced the additional risk of being required by the competent court, through the so-called 'Presidential Order', to fulfil the contract until the dispute was settled, as happened in the cases of Electrocarbon and Elsid.
- (51) In addition, the Romanian authorities made it clear that the main difference between, on the one hand, the contracts concluded by Hidroelectrica with industrial consumers and, on the other hand, the contracts concluded by Hidroelectrica with the electricity traders consisted in the additional costs required to be paid under the contracts with the industrial consumers (i.e.: the payment of the 'T' component of the transport fee, system services charge, distribution fee and charges for imbalances).

5. COMMENTS BY THIRD PARTIES

- (52) All the alleged beneficiaries, except Electrica, submitted observations regarding the opening decisions, summarised in Section 5.1.
- (53) In addition, a competitor of Alro, an aluminium producer, submitted its observations regarding the opening decision on 5 October 2012.
- (54) On 6 September 2012 an anonymous citizen submitted observations in relation to the opening decisions concerning Alro and the electricity traders

5.1. Comments from alleged beneficiaries

- (55) The main observations of the alleged beneficiaries are similar and refer to: (i) the Commission's lack of competence to assess either the contracts concluded prior to Romania's accession to the EU ⁽³⁵⁾ or the subsequent addenda to the contracts ⁽³⁶⁾; (ii) there being no appropriate market-prices benchmark for comparing contract prices; (iii) Hidroelectrica's having acted like a private market vendor without conferring any economic advantage on the alleged beneficiaries; (iv) there having been no imputability to the State and no transfer of State resources; (v) the fact that there was no distortion of competition; (vi) the absence of selectivity; (vii) there having been no severability of the amendments from the initial contract; and (viii) Hidroelectrica's having declared itself insolvent to avoid its contractual obligations.

5.1.1. Commission's lack of competence to assess the contracts and their subsequent addenda

- (56) The interested parties argue that the Commission does not have competence to review alleged State aid measures implemented before Romania's accession to the European Union ('EU') in 2007. The same applies, in their view, to the addenda to the contracts that were signed after 2007, because the addenda were not severable from the initial contracts. The addenda were simply implementing contractual rules for future supplies, originally determined under the contracts.
- (57) According to the interested parties, the alleged State aid measures stemming from the contracts were not applicable after Romania's accession to the EU since the contracts were concluded prior to 2007; also the first addenda establishing the exact parameters of the price indexation ⁽³⁷⁾ system were signed prior to 2007.
- (58) Furthermore, in the opinion of the interested parties, even if it were proven that the contracts contained State aid, this would have to be regarded as existing, not new, aid, considering that all the conditions for granting existing State aid were met in accordance with Council Regulation (EC) No 659/1999 ⁽³⁸⁾. In particular: the alleged State aid measure did not meet the conditions for being classified as State aid when it was put into effect; it became State aid only later and due to changes in the market environment; and, finally, the alleged State aid measure was not substantially altered after it was put into effect. Consequently, the interested parties claimed that the Commission cannot investigate the alleged State aid measure under the regime for new State aid and cannot request the Member State to recover the aid retroactively.
- (59) The interested parties also argued that, according to the case-law, the relevant time for assessing any transaction with regard to the market vendor/market operator test was the time when the transaction was concluded. Therefore, for transactions concluded before 2007, the question would have been whether they would have constituted State aid if the State aid rules had been applicable at the time when they were concluded. The same principle was also applicable to the time when the economic advantage had to be assessed, i.e.: the moment when the contracts were concluded. The interested parties argued in particular that, in Romania ⁽³⁹⁾, there were no legal or economic changes on the electricity market to justify taking 2007 as the reference point for assessing the economic advantage: the Romanian energy markets were already emerging before 2004; the Romanian wholesale market was opened in September 2000.

⁽³⁵⁾ Certain electricity traders (i.e.: Alpiq RomIndustries, EFT, Alro Electrocarbon and Elsid).

⁽³⁶⁾ One electricity trader (EFT) and Alro.

⁽³⁷⁾ Only in the case of Alro.

⁽³⁸⁾ Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 108 of the treaty on the functioning of the European Union (OJ L 83, 27.3.1999, p. 1).

⁽³⁹⁾ Contrary to the Hungarian preferential electricity tariffs cases — T-80/06 and T-182/09 *Budapesti Erőmű v Commission* (ECLI:EU:T:2012:65).

5.1.2. No appropriate price benchmark

5.1.2.1. OPCOM-PCCB was not an appropriate and valid price benchmark

- (60) All the alleged beneficiaries that submitted comments regarding the opening decision claimed that there was no appropriate and valid price benchmark for comparing the prices stipulated in the contracts. The interested parties (the alleged beneficiaries) argued that OPCOM-PCCB prices were not a relevant price benchmark for the following reasons:

- OPCOM-PCCB prices did not reflect the correct situation in the relevant period,
- the contracts under OPCOM-PCCB differ from the contracts under investigation on various counts (i.e.: a long-term obligation to purchase quantities at prices fixed in the context of a volatile market is completely different from the obligation to purchase executed either on a day-ahead market or on a fully operational power exchange, especially in the context of a liberalised market. The OPCOM-PCCB market deprived private suppliers of the flexibility of being able to modify their contracts once an agreement had been reached. The OPCOM-PCCB market had not been organised by then as a platform suitable in terms of large industrial clients' electricity needs and the options they required),
- they did not match the same delivery period,
- OPCOM-PCCB and the contracts represented two separate markets (e.g.: the period of the supply contracts traded on the OPCOM-PCCB market was of 1 year or less compared with a much longer period for the contracts under discussion; the prices on the OPCOM-PCCB platform were higher than those negotiated individually under the contracts ⁽⁴⁰⁾ and were volatile and dependent on the fluctuations of demand and supply,
- OPCOM-PCCB did not even exist when most of the contracts were concluded, as it became operative only in 2005, and
- only a small portion the total electricity available on the Romanian market was traded on the OPCOM-PCCB platform.

- (61) One of the interested parties ⁽⁴¹⁾ argued that OPCOM-PCCB was either a non-representative benchmark or a benchmark inappropriate for the prices stipulated in the contracts, since only a small portion of the electricity available on the Romanian electricity market was actually sold on the OPCOM-PCCB market during the period of the Commission's assessment (i.e., ranging from 2 % of total internal consumption in 2006 to 14,62 % in 2012).
- (62) In addition, other interested parties ⁽⁴²⁾ claimed that a proper benchmark for market prices could only have been found and developed through the use of a 'fundamentals' model, based on: (i) similar facts and conditions; (ii) concomitant expectations; and (iii) the same period of time as the one covered by the present Decision.
- (63) Finally, one of the interested parties ⁽⁴³⁾ argued that, on Romania's complex and specific electricity market, there was no valid price benchmark available that would have been relevant for the prices stipulated in the contracts.

5.1.2.2. Other electricity traders' offer in the case of the contracts with ArcelorMittal

- (64) ArcelorMittal claimed that the assumption that Hidroelectrica could have accepted one of the parallel offers of OPCOM-PCCB traders for a price higher than that obtained under the two contracts with ArcelorMittal was not realistic because the Romanian electricity market was characterised by overcapacity.

⁽⁴⁰⁾ For further reference please see the ANRE Annual Monitoring Report for 2007 and for the following years.

⁽⁴¹⁾ Energy Holding.

⁽⁴²⁾ Alpiq RomIndustries and Alpiq RomEnergie.

⁽⁴³⁾ Energy Holding.

- (65) ArcelorMittal further argued that, in a market characterised by overcapacity, Hidroelectrica had to take into account the risk that, if it had sold the electricity to the traders, they might not have been able to place it on the market or have had to re-sell it at a loss. It also claimed that the traders placed those purchase offers on OPCOM with the evident intention of re-selling the electricity to ArcelorMittal at a higher price.
- (66) Moreover, ArcelorMittal argued that a comparison between the price specified in the two contracts concluded with Hidroelectrica and the prices under the traders' offers would have been valid only if:
- ArcelorMittal had been forced to buy from the traders — whereas ArcelorMittal claims that this was not the case, as it had the alternative of buying from other Romanian producers or from Hungary or Bulgaria,
 - the traders had been able to re-sell the quantities that ArcelorMittal did not buy from them — whereas the fact that the offers were withdrawn shows that the traders had not counted on selling those quantities to clients other than ArcelorMittal,
 - the traders had not had the capacity to withstand the losses in the event of their not having been able to re-sell the electricity bought from Hidroelectrica. In this connection, ArcelorMittal produces evidence that Arelco and Petprod were not financially robust companies.
- (67) ArcelorMittal also argues that the 2009 and 2010 contracts cannot be benchmarked against OPCOM prices, because OPCOM was not yet operating normally at that time. It considers that the average price, published by ANRE, for large bilateral transactions is more representative.

5.1.3. Hidroelectrica acted like a private market vendor/without conferring any financial advantage on the alleged beneficiaries.

- (68) Most of the interested parties claimed that Hidroelectrica had acted like a private market vendor when entering into the contracts and that they had therefore not obtained any financial advantage: (i) the contracts were negotiated and concluded on market conditions; (ii) Hidroelectrica benefited from certainty of income by concluding the contracts; (iii) the contracts ensured the sale of a large quantity of Hidroelectrica's electricity production; (iv) the contracts ensured that Hidroelectrica was protected from any price decreases relating to alternative sales on other different markets; (v) the price agreed in the contracts takes into account the risks and obligations imposed on the buyer, and the contract conditions were negotiated primarily in the interest of Hidroelectrica; (vi) the contract prices paid for the electricity bought from Hidroelectrica were constantly between 80 % and 100 % higher than the prices for electricity sold by Hidroelectrica on the regulated market; and (vii) the contracts were the best alternative for Hidroelectrica on the date when they were signed.
- (69) In addition, the interested parties claimed that the Commission should have looked into Hidroelectrica's financial position on the date when the contracts were signed, considering that, in accordance with case-law ⁽⁴⁴⁾, the Commission's assessment may have taken no account at all of information not available, and developments not foreseeable, when the contracts were signed.
- (70) Alro argued that each successive amendment to its contract with Hidroelectrica was always in Hidroelectrica's favour, for the following reasons: (i) a price indexation clause was introduced, taking into account Hidroelectrica's own costs; (ii) the currency used was changed from USD to RON in June 2007, at a time when the leu was appreciating against the USD, which allowed Hidroelectrica to gain 40 % on the price and eliminate its currency risks; (iii) the LME formula was introduced in 2010, leading to a sharp increase in prices.
- (71) Moreover, Alro submitted comprehensive and extensive economic studies performed by Brattle Group and Nera in order to support its argument that the contract with Hidroelectrica did not involve State aid. According to the Brattle Group's 2005 study, the estimated net present value (hereinafter the 'NPV') of the Alro contract (EUR 393,09 million) was higher than that resulting from the counterfactual sales scenario (EUR 355 million)

⁽⁴⁴⁾ Case C-482/99 *French Republic v Commission (Stardust Marine)* [2002] ECR I-4397.

based on the assumption of a perfectly competitive market. Similar estimates were also provided by Brattle Group for 2007, with similar results as for 2005: the EUR 348 million NPV for the 2007 Alro contract was, in addition, higher than the EUR 300 million NPV of its counterfactual.

- (72) Alro also submitted Brattle Group and Nera studies and reports in order to sustain its argument that no illegal aid was granted through its contract with Hidroelectrica.
- (73) Energy Holding, an electricity trader, submitted an economic analysis, price model simulations and price reports produced by KPMG, an independent consultancy firm, in order to sustain its argument that there had been no illegal aid. KPMG confirmed that the contract with Energy Holding was: (i) Hidroelectrica's best alternative at the time; and (ii) that it brought Hidroelectrica a higher return or presented it with a lower risk compared with the next-best alternative. KPMG's analysis was based on an absolute and relative valuation analysis rather than on any other method of contract valuation (e.g.: marginal profitability analysis, truncated IRR analysis). It referred to two valuation periods (i.e.: 2004-2013 and 2010-2018) and reflected the terms of the contract concluded with Hidroelectrica in 2004 and the terms renegotiated in 2009 when the contract was renewed. The same analysis was at a later stage extended by KPMG for 1 January 2007. Its conclusion was the same as the one described above for both absolute and relative valuation.

5.1.4. No imputability to the State and no transfer of State resources

- (74) Almost all interested parties ⁽⁴⁵⁾ claimed that their contracts with Hidroelectrica were not imputable to the State, because in accordance with Hidroelectrica's statutes, the board of directors delegated its executive powers to the chief executive officer. It was therefore claimed that the board members did not participate in the day-to-day business of Hidroelectrica, including the negotiation of the contracts.
- (75) According to one interested party ⁽⁴⁶⁾, the burden of proof concerning the imputability rested on the Commission. The interested party claimed that concluding that a measure was imputable to the State just because the State had a majority shareholding in Hidroelectrica was not sufficient. It further argued that the Commission had reached that conclusion on the basis only of 'indications' and presumptions and not of concrete facts, which was contrary to the requirements of case-law. The interested party argued that concrete evidence such as documents, factual elements and concrete actions on behalf of the State were required to sustain that conclusion.
- (76) Other interested parties ⁽⁴⁷⁾ argued that there was no transfer of State resources. In particular, they argued that the allegedly lower prices offered by an undertaking under State control were not a factor sufficient to invoke the existence of State resources. They also claimed that the Romanian State's intervention regarding the use of these resources needed to have been established *in concreto*. Furthermore, the interested parties emphasised that, according to Hidroelectrica's statutes, concluding contracts fell within the exclusive competence of the General Director and not of the Board of Directors, and therefore the State was not involved in Hidroelectrica's contractual decision-making process.

5.1.5. No distortion of competition

- (77) Some of the interested parties ⁽⁴⁸⁾ argued that there was no potential or actual distortion of competition deriving from their contracts with Hidroelectrica for the following reasons: (i) no relevant market was identified on which the State aid granted strengthened the position of an undertaking in relation to other undertakings within intra-EU trade; and (ii) the Romanian electricity market is not concentrated as shown by the Herfindahl-Hirschman (HHI) concentration index.

⁽⁴⁵⁾ Alpiq RomEnergie, Alpiq RomIndustrie, Electromagnetica, Energy Holding, Electrocarbon and Elsid, ArcelorMittal and Alro.

⁽⁴⁶⁾ Energy Holding, an electricity trader.

⁽⁴⁷⁾ EFT, Electromagnetica, Luxten-Lighting and Energy Holding.

⁽⁴⁸⁾ EFT, Electromagnetica, Luxten-Lighting and Alro.

5.1.6. *No selectivity*

- (78) Some of the interested parties ⁽⁴⁹⁾ argued that there was no selectivity deriving from their contracts with Hidroelectrica because contracts of the same or a similar type were concluded with other traders (for the electricity traders) or were available to other parties on the market (for non-traders).

5.1.7. *No severability of the amendments from the initial contract*

- (79) Electrocarbon and Elsid claimed that the amendments to the contracts were not separate from the contracts. They also suggested that, even in a situation in which such amendments would have been regarded as separate commitments, the price changes were still complying with the market economy vendor principle and they therefore did not involve State aid.

5.1.8. *The only reason why Hidroelectrica declared itself insolvent was to get out of its contractual obligations*

- (80) Some of the electricity traders ⁽⁵⁰⁾ argued that the only reason why Hidroelectrica declared itself insolvent was to terminate its contractual obligations. They argued that, while Hidroelectrica took full advantage of contracts in the past, it was no longer prepared to honour the obligations assumed and, therefore, the declaration of insolvency seemed to be a way of exiting the contracts.

5.2. **Comments from other interested parties**

- (81) In relation to the opening decision concerning Alro, the Commission received comments from parties other than the alleged beneficiaries: (i) comments from one of Alro's competitors; and (ii) comments from an anonymous party (citizen).

5.2.1. *Comments submitted by one of Alro's competitors*

- (82) One of Alro's competitors argued that both power exchange market prices and spot-market prices were irrelevant as a price benchmark for electricity supply contracts for aluminium smelters. According to Alro's competitor, aluminium smelters need to rely mainly on long-term and relatively predictable electricity supply contracts in order not to have to suspend operations because of unsustainably high electricity costs and in order to avoid any potential risk of their having to shut down because of electricity prices and the generator's profits.
- (83) Alro's competitor also argued that by comparing the tariffs under the long-term electricity supply contracts with electricity prices on the power exchange and/or on spot markets and/or with other industries' tariffs, the market reality could have been distorted and a bad precedent set, entailing a significant risk not only for Alro and/or its competitors but also for the entire European market.
- (84) In addition, Alro's competitor argued that the impact on competition should have been assessed by reference to the prices paid by aluminium smelters for their electricity at global, or at least European, level. Since electricity costs represented more than one third of the total costs of aluminium production and considering that aluminium producers bought electricity on the national market and afterwards engaged in competition worldwide, a relevant assessment would have required an assessment based on electricity prices paid by aluminium producers all over the world. Consequently, Alro's competitor claimed that, for a proper assessment of a potential distortion of competition, the Commission should have verified whether the alleged State aid had actually reduced Alro's production costs to below those of its competitors and, therefore, conferred on Alro an advantage, given the tariffs of its European and/or global competitors.

⁽⁴⁹⁾ EFT, Luxten-Lighting, Electrocarbon and Elsid.

⁽⁵⁰⁾ Alpiq RomEnergy and Alpiq RomIndustries.

- (85) Furthermore, Alro's competitor argued that, in the absence of relevant information for defining a comparable 'market price', 'benchmarking prices to costs and a reasonable profit margin could have been acceptable as a legitimate pricing methodology'. The same logic might have been applied 'to a decision to offer prices indexed on the basis of LME prices'. It also claimed that aluminium smelters' unique characteristics and client profile might objectively justify an electricity price below power exchange prices, cost-based pricing and LME-indexed pricing.

5.2.2. *Comments submitted by a citizen*

- (86) The citizen argued that Alro bought electricity from Hidroelectrica at a preferential price, i.e. at a price below market price (such as OPCOM and ANRE prices). In addition, the citizen invoked the argument that the adjustment of the contract price for Alro through an indexation mechanism based on the LME formula was a pricing mechanism discriminatory in relation to other buyers of electricity on the market.
- (87) The Commission received comments from the same citizen concerning the contracts with the electricity traders, to the effect that the contracts entailed State aid. No evidence was provided to justify this argument.

6. COMMENTS BY THE ROMANIAN AUTHORITIES ON THE OBSERVATIONS BY THIRD PARTIES

- (88) The Romanian authorities responded to the observations made by the interested parties. In particular, the Romanian authorities maintained its view, expressed in July 2012, with regard to the contracts concluded by Hidroelectrica with the electricity traders and explained that those contracts were not typically robust and long-term contracts for at least two reasons: (i) the buyer was able unilaterally to terminate any of the contracts with 30 days' notice without having to pay adequate compensation, while Hidroelectrica was not able to do so; and (ii) the hourly output deliverables to the buyer could be, and were, variable at the buyers' discretion.
- (89) In addition, the Romanian authorities claimed that after the contracts had been concluded, or the amendments made to them, the buyers had the right (which they actually exercised) to increase or decrease the quantity of electricity needed by means of notices issued even just 1 day before delivery, which is a characteristic of spot transactions.
- (90) In relation to the contracts with Electrocarbon and Elsid, the Romanian authorities abstained from expressing any views. As reasons for doing so, the Romanian authorities added that they did not know whether Electrocarbon and Elsid were also involved in wholesale electricity trading.
- (91) The Romanian authorities provided well-substantiated and detailed comments on the observations made by Alro and ArcelorMittal in support of their conclusion that their contracts did not entail State aid. In particular, the Romanian authorities explained that the State had not given any instructions to its representatives on Hidroelectrica's board of directors and that Romanian company law obliges board members to act in the interests of the company, and not in the interests of the shareholders who appointed them.
- (92) The Romanian authorities claimed that Alro was served from Hidroelectrica's own production and that, therefore, profitability had to be measured only by reference to Hidroelectrica's own production costs. The Romanian authorities also made it clear that ArcelorMittal is the second-largest consumer of electricity in Romania, after Alro, and they explained that the same was true of electricity as of any other product: the higher the volume purchased, the lower the contract price.
- (93) In addition, the Romanian authorities confirmed the observations made by ArcelorMittal, to the effect that, as reported by ANRE, the average price paid by industrial consumers with demand in the order of 150 000 MWh/year was only 11 RON/MWh higher than the price paid by ArcelorMittal in 2010. The authorities used the following arguments to explain this difference: (i) delivery in this linear profile provides the electricity supplier with the opportunity to optimise its productions costs; (ii) maintenance costs are significantly reduced; (iii) both the number and duration of accidental stoppages are reduced; and (iv) imbalances on the electricity market are significantly reduced, a factor also reflected in a reduction in electricity acquisition costs.

- (94) In relation to the observations made by Alro's competitor, the Romanian authorities entirely endorsed the latter's position and supported its view according to which a European aluminium producer was in competition with any other global aluminium producer. Moreover, the Romanian authorities argued that the contract with Alro did not distort competition on the global aluminium market.
- (95) Furthermore, the Romanian authorities argued that, from a financial point of view, any rational electricity producer would have offered the aluminium producer a tariff better than the OPCOM-PCCB or spot market ones, given the aluminium producer's specific characteristics. They also explained that the price on the spot market would not have been a correct benchmark for a long-term contract concluded with an industrial consumer. The prices under bilateral contracts with advantageous payment conditions and covering large volumes of electricity in predictable band consumption had to be much lower than electricity prices on the spot market.
- (96) As regards the observations made by the citizen, the Romanian authorities claimed that these were groundless. As regards the allegation made by the citizen to the effect that the prices granted to Alro were below the prices for equivalent transactions in Romania, the Romanian authorities explained that the citizen had completely disregarded the price fluctuation based on the specific elements of each transaction (i.e. large volumes of electricity with band consumption, the high level of predictability, and advantageous financial conditions for the seller).
- (97) As regards the second argument invoked by the citizen, to the effect that the opportunity given to Alro to adjust prices on the basis of the LME formula discriminated against other participants in the electricity market, the Romanian authorities argued as follows: (i) this practice was allowed under Romanian legislation as long as Hidro-electrica made a profit out of the contract concerned; and (ii) the arrangement was a form of partnership between seller and buyer, who were sharing the profit from the sale of the aluminium.

7. ASSESSMENT

7.1. Existence of State aid

- (98) By virtue of Article 107(1) TFEU, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market. In order to constitute State aid within the meaning of Article 107(1) TFEU, the measure at issue must fulfil all these conditions.
- (99) It is therefore necessary to assess whether the contracts under investigation provided State aid within the meaning of Article 107(1) TFEU to the buyers of electricity sold by Hidroelectrica, i.e. Alpiq RomEnergie, Alpiq RomIndustries, EFT, Electrica, Electromagnetica, Energy Holding, Euro-Pec, Luxten-Lighting, Alro, ArcelorMittal, Electrocarbon and Elsid after Romania's accession to the European Union.
- (100) This would be the case, among other conditions of application of Article 107(1) TFEU, only if the contracts at issue favoured certain buyers by affording them an economic advantage above normal market conditions and, if so, only if the advantage deriving from the contracts and their subsequent amendments can be attributed not only to resources of the Romanian State, but also to actions, instructions or decisive influence of the State, as opposed to independent commercial decisions of Hidroelectrica.
- (101) According to the decision in the case of *Budapesti Erőmű* ⁽⁵¹⁾, State aid measures put into effect before accession and still applicable after accession should be considered either existing aid or new aid following accession. In order to be considered existing aid, these measures should be listed expressly in the Act of Accession of a Member State to the European Union; in the present case by Annex V to the Treaty of Accession of Romania and Bulgaria to the European Union ('Act of Accession') ⁽⁵²⁾. The contracts were not listed explicitly in Annex V to the Act of Accession. Considering that the contracts were still applicable after the date of accession, they could be regarded only as new aid, in the light of the quoted case-law, must therefore be assessed as from the date of accession (1 January 2007) in the light of the four conditions laid down in Article 107(1) TFEU.

⁽⁵¹⁾ Joined Cases T-80/06 and T-182/09 *Budapesti Erőmű v European Commission*, paragraphs 50 to 62.

⁽⁵²⁾ OJ L 157, 21.6.2005, p. 96.

Therefore, the Commission would have to evaluate the contracts as possible new aid measures as from the time of Romania's accession on 1 January 2007. That evaluation cannot be based on the circumstances obtaining on the market when the contracts were entered into (see recital 19), in particular for the purpose of deciding whether the contracts in question were in line with market prices when they were concluded. Such circumstances will not, therefore, be further assessed hereinafter.

7.2. Assessment of possible economic advantage over market conditions

- (102) In order to establish whether the prices and conditions at which Hidroelectrica supplied electricity to the alleged beneficiaries would not have been otherwise available on the Romanian market as from 2007, the Commission must first find an appropriate price benchmark that reflects a market price (i) available in a period of time when the contracts were in force after Romania's accession to the EU; and (ii) for the period of time for which the Commission initiated the formal procedure in relation to the contracts.

7.2.1. Economic advantage over market conditions

- (103) In assessing whether or not there was economic advantage, the Commission takes as its point of reference a market operator subject to the same or similar obligations as Hidroelectrica, having the same opportunities and faced with the same legal and economic conditions as those obtaining in Romania in the period examined, given the operator's constraints and commercial objectives⁽⁵³⁾. If the presence of State aid is to be excluded, a publicly owned company must, when selling its products, behave as would a private operator in the market economy, seeking to maximise revenues or minimise losses. In other words, assessing the presence of a possible undue economic advantage in a commercial supply contract from a State-owned supplier involves assessing to what extent a non-State-owned supplier in a similar situation would have behaved in the same way.
- (104) Likewise, whereas price differences between electricity tariffs set by the State and higher free market prices might, on first examination, indicate the presence of State aid, it may, for objective reasons, still be possible to find that lower price levels in the contracts under investigation do not afford electricity buyers an economic advantage over market conditions⁽⁵⁴⁾. Finally, in examining the possibility of State aid defined as electricity prices above market conditions on electricity markets under complex market settings, the Commission may lawfully rely on specific methods or economic models to determine to what extent contract prices differ from market prices⁽⁵⁵⁾.
- (105) In fact, the price for the contracts was either adjusted annually above the price set out in the contract or established annually for a number of contracts, except in the case of Alro, for which the actual annual price resulted from the application of the contractual indexation formulae. Whether or not there was economic advantage is therefore assessed for each of the years covered by the investigation as of 1 January 2007.

— Contracts with electricity traders, electrode producers and Alro

- (106) As described in recitals 24-35, the Commission examined several electricity market segments in Romania between 2007 and 2010. In order to compare like with like, it is appropriate to examine the closest and most adequate comparators for the prices provided for in the contracts in the period under examination.
- (107) In well-functioning electricity markets with adequate liquidity and instruments allowing the prices of future deliveries to be predicted, spot prices are a good indication or approximation of market prices and can be used as benchmarks for assessing price levels in specific contracts. However, in the present case, given the relatively high proportion of demand that, in Romania in 2007, was still being satisfied on the basis of regulated tariffs, the limited liquidity of OPCOM trading platforms in the period 2007-2010, the volumes of electricity subject to the contracts under investigation, the establishment of power exchanges managed by OPCOM as a relevant antitrust market on which abuse of dominant position was practised (recitals 30-31 and 34), and taking into account the comments made by third parties (recitals 60-63), it cannot be established on a *prima facie* basis that spot prices or prices on the OPCOM-PCCB platform can be deemed to constitute suitable benchmarks for assessing the possible presence of an economic advantage over market prices.

⁽⁵³⁾ See case-law in footnote 39, paragraphs 69 to 89.

⁽⁵⁴⁾ Commission Decision 2014/456/EU of 4 February 2014 on State aid No SA.21817 (C 3/07) (ex NN 66/06 implemented by Spain, Spanish Electricity Tariffs: consumers (OJ L 205, 12.7.2014, p. 25), recitals 113 to 120.

⁽⁵⁵⁾ Joined Cases T-80/06 and T-182/09 *Budapesti Erőmű v European Commission*, paragraphs 104-114.

- (108) The Commission has therefore set aside its reliance on average OPCOM prices as benchmarks for comparing Hidroelectrica's contract prices, on which it had based the doubts raised in the relevant opening decisions about the presence of an economic advantage in the ten contracts with electricity traders and the two with electrode producers. The investigation has shown that trading on platforms like OPCOM, for shorter durations and on standard terms and whether on a 'day-ahead' or 'one-year or less' basis or with a view to providing ancillary or balancing services to the electricity network operator, cannot be viewed as a reasonable alternative to Hidroelectrica's bespoke contracts under scrutiny in the specific circumstances of the Romanian market in the period under consideration. The contracts concerned were negotiated directly to accommodate the specific supply needs of the buyer and the seller, with flexibility not available in other market segments. Therefore, in order to ascertain the presence of an economic advantage over market conditions, it is necessary also to examine the conditions obtaining on other market segments available in Romania in 2007 and thereafter, even if these were not identified in the opening decisions.
- (109) As regards the regulated market, on which Hidroelectrica effectively supplied approximately one fifth of its production at the time of the facts (recital 31), a comparison with the regulated prices charged yearly by Hidroelectrica based on eligible costs and a rate of return set by the electricity regulator ANRE shows that all the contract prices under scrutiny were constantly and significantly above the regulated prices between 2007 and 2010 (recital 26 and Annex 1). It was therefore economically rational for Hidroelectrica to continue supplying all alleged beneficiaries in the current proceedings as from 2007, as the contracts concerned were more lucrative than those supplied on the regulated markets. In any event, and drawing a comparison with the theoretical alternative of increasing the quantities supplied on the regulated market, Hidroelectrica could not at will switch its supplying of electricity from the contracts under scrutiny to the regulated market, since the quantities supplied on the regulated market were set *ex ante* by ANRE.
- (110) The same is true, *mutatis mutandis*, for trading conditions on the balancing and day ahead markets. Given the characteristics of Hidroelectrica's production, based partly on dispatchable electricity and low marginal costs, it is arguable that Hidroelectrica could have secured occasionally higher revenues by switching its supplying of electricity from the contracts under consideration to the day-ahead and balancing markets, focusing in particular on supplying electricity at peak times, when prices rise considerably. However, for various reasons, the market conditions and prices prevailing on those market segments cannot be considered representative of market conditions with which the contracts under examination can be compared in order to ascertain whether they conferred an economic advantage on the buyers.
- (111) Firstly, it is apparent that Hidroelectrica supplied electricity on these market segments too between 2007 and 2010, albeit to a limited extent — in the order of less than 10 % of its sales (recital 31). The relevant issue is whether such markets could have constituted a valid alternative for a rational operator acting in lieu of Hidroelectrica and determining the destination of 63 % of its sales — sales that Hidroelectrica made on the basis of bilateral contracts between 2007 and 2010.
- (112) Trading on those market segments involved distinct features that make it impossible to determine market conditions valid for the whole Romanian market or for Hidroelectrica's long-term contracts. Indeed, balancing or ancillary services are supplied by electricity producers to the transmission system operator on the basis of unpredictable demand and patterns of demand on the part of a single buyer. Day-ahead supply also implies prices and quantities unpredictable from one day to the next. In other words, the long-term contracts under examination, even leaving aside their contract provisions and assuming they could be segmented into a succession of annually revisable contracts, cannot be compared with a succession of 365 1-day contracts for the same period. None of these alternative market segments would offer the predictability and stability of revenue required by Hidroelectrica or match Hidroelectrica's production characteristics and investment plan (recitals 13-15).
- (113) Finally, and as a matter of fact, the total volumes traded each year from 2007 until 2010 between all Romanian suppliers and the relevant buyers on the day-ahead and balancing markets always altogether amounted to less than the annual volume supplied under the contracts under investigation (see recitals 30, 31 and 38). During that period, none of the market segments had the capacity and liquidity necessary for absorbing the volumes of sales made under the contracts under investigation. In other words, even on the unrealistic assumption that Hidroelectrica could have replaced all Romanian producers and sellers on one or both of those two markets segments,

Hidroelectrica would still have needed to find additional buyers for the volumes in question. Accordingly, the terms and prices applied in those rather niche market segments, whatever they amount to, cannot be used as a reference for a significant and objective comparison with Hidroelectrica's prices under long-term contracts.

- (114) Given the essential characteristics of the contracts in terms of flexibility of supply, long duration and quantities contracted, and in the specific circumstances of the Romanian market in the period under investigation, the closest comparators available for determining the possible presence of an economic advantage over prevailing market conditions in Romania were the prices agreed by large consumers having concluded bespoke contracts negotiated directly in terms that were non-rigid and pre-established. It is therefore appropriate to analyse whether the contracts under scrutiny were in line with the prices of other sellers on the Romanian market for directly negotiated contracts. The dataset described in recitals 35-38 above covering the directly negotiated bilateral contracts in force that were contemporaneous with the contracts under investigation constitutes the most adequate basis available to the Commission in this case for comparing the contract prices charged to electricity traders, Alro, Electrocarbon and Elsid. Therefore, the Commission compared those prices with the prices resulting from the dataset referring to the period from 1 January 2007 to the end of 2010.

— Contracts with ArcelorMittal

- (115) As regards the two contracts concluded in 2009 and 2010 by Hidroelectrica with ArcelorMittal on the OPCOM-PCCB market, the Commission does not consider that the prices under the parallel offers of the two traders available on the OPCOM-PCCB market referred to in the relevant opening decision represent an adequate price benchmark, for the following reasons:

— in relation to the 2009 contract, neither of the two parallel offers made on OPCOM were actually valid. Energy Holding withdrew its parallel offer for the same period, quantity and delivery terms before the offer of ArcelorMittal was auctioned ⁽⁵⁶⁾. The other offer, by Petprod, was not acceptable for benchmarking purposes because it covered only half of the quantity that ArcelorMittal offered to buy,

— in relation to the 2010 contract, the financial data for the two traders with parallel offers showed that they would not have been able to withstand losses if they had been unable to re-sell the large quantity of electricity that they intended to purchase from Hidroelectrica: the real intent of these two traders in 2010 was to re-sell the electricity to ArcelorMittal at a higher price. In fact, both offers were withdrawn immediately after the buy offer on the part of ArcelorMittal was accepted by Hidroelectrica on 29 December 2010, which shows that the traders concerned did not count on selling those quantities to clients other than ArcelorMittal ⁽⁵⁷⁾.

- (116) In the absence of fully comparable contracts having been applied, OPCOM-PCCB average prices are not a valid benchmark for the two contracts with ArcelorMittal, given that the volume of energy traded on OPCOM was limited and the types of transaction effectively carried out were not comparable.

- (117) Notwithstanding the preliminary views put forward in the opening decisions, and in consideration of the large quantities of electricity purchased by ArcelorMittal, the fact that ArcelorMittal was a reliable and financially stable client of Hidroelectrica's and the fact that neither of the two parallel offers by traders nor the average OPCOM-PCCB prices represented a valid comparator for the two contracts with ArcelorMittal, the Commission considers that the best indicator for a price benchmark for comparison purposes would be that used for the other contracts identified under the dataset. Therefore, in the light of the comments received in response to the opening decision, the Commission has modified its analysis and examined the prices of these two contracts with ArcelorMittal on the basis of the same dataset used to compare long-term contracts.

⁽⁵⁶⁾ The ArcelorMittal offer was auctioned by Hidroelectrica on 23 December 2009, while Energy Holding withdrew its offer on 22 December 2009.

⁽⁵⁷⁾ The two parallel offers of Arelco and Petroped were withdrawn on 20 and 30 December 2010, respectively.

— The Commission's econometric analysis of long-term contract prices

- (118) In well-functioning electricity markets with adequate liquidity and instruments allowing the prices of future deliveries to be predicted, spot prices are a good indication or approximation of market prices and can be used as benchmarks for assessing price levels in specific contracts. However, in the present case, given the relatively high proportion of demand that, in Romania in 2009, was still being satisfied on the basis of regulated tariffs, the limited liquidity of OPCOM trading platforms in the period 2007-2010 and the fact that the power exchanges managed by OPCOM had been designated as a relevant antitrust market on which abuse of dominant position is practised, it is appropriate to rely on other suitable benchmarks for assessing the possible presence of an economic advantage over market prices.
- (119) Accordingly, the Commission used the dataset provided by the Romanian authorities, considering it the best available source of evidence to reflect the market conditions in Romania. The dataset contains information adequate to enable the Commission to analyse the conditions on the Romanian electricity market in the period of time under investigation, as shown in recitals 36 and 37. On the basis of the dataset, the Commission carried out an econometric analysis in order to estimate a price benchmark based on electricity supply contracts contemporaneous with the investigated Hidroelectrica contracts throughout the investigated period. The use of economic models to quantify possible advantages over market conditions is in line with precedent in complex market settings (recital 104), such as the one at issue in Romania as from 2007 (recitals 24-38 and 107). A full and detailed technical description of the econometric analysis and its results is provided in Annex II.
- (120) In order, in the absence of a definite reference for establishing the 'market conditions', to check whether the contracts had prices above market level, a benchmark of market prices was estimated as a proxy, under conservative assumptions, namely by taking account of important deviations downwards from the estimated market price. Based on this conservative approach, the Commission performed a comparison between the prices of Hidroelectrica's contracts and the annual benchmark market price between 2007 and 2010. The comparison was made on an annual basis because, in fact, the selling prices were modified each year ⁽⁵⁸⁾, despite the relevant provisions in the contracts.
- (121) The analysis shows that only three alleged beneficiaries benefited from prices lower than those within the range in which they could be considered in line with the benchmark market price:
- in each year between 2007 and 2010, Electrocarbon and Elsid exhibit contract prices below the benchmark market price for the corresponding year,
 - for Luxten-Lighting, this difference is higher than the benchmark price only in 2008 and 2009.
- (122) The analysis shows that the prices applied by Hidroelectrica in nine of the contracts between 2007 and 2010, namely those with Alpiq RomIndustries, Alpiq RomEnergie, EFT, Electromagnetica, Energy Holding, Euro-Pec, Electrica, ArcelorMittal and Alro, were fully in line with the benchmark market price. In the case of the contract with Luxten-Lighting, the prices applied in 2007 and 2010 do not differ significantly from those for other directly negotiated contracts concluded on the Romanian market.
- (123) In view of the above, the Commission concludes that there was no undue economic advantage over market conditions granted under the contracts with Alpiq RomIndustries, Alpiq RomEnergie, EFT, Electromagnetica, Energy Holding, Euro-Pec, Electrica, ArcelorMittal and Alro for the entire period of time under investigation, as well as with Luxten-Lighting for the years 2007 and 2010.
- (124) At the same time, the empirical analysis identifies three contracts as having prices not in accordance with the benchmark price, namely the contract between Hidroelectrica and Luxten-Lighting for 2008 and 2009 and those with Electrocarbon and Elsid for 2007-2010.
- (125) In view of the above, Hidroelectrica's decision to maintain the three contracts with Elsid, Electrocarbon and Luxten-Lighting cannot be deemed to be that of a rational market operator, since the contracts with Luxten-Lighting for 2008 and 2009 and with Electrocarbon and Elsid for 2007-2010 appear to be below market conditions, under conservative assumptions (Annex II). Therefore, Hidroelectrica's contracts conferred an undue economic advantage on Luxten-Lighting for 2008-2009 and on Electrocarbon and Elsid for 2007-2010.

⁽⁵⁸⁾ See Annex I to the present Decision.

- (126) It follows that Hidroelectrica's contracts with Luxten-Lighting for 2008 and 2009 and with Electrocarbon and Elsid for 2007-2010 appear to have favoured the buyers by affording them an undue economic advantage above normal market conditions and, therefore, the possibility cannot be excluded of the contracts having involved State aid within the meaning of Article 107(1) TFEU.
- (127) Therefore, in the light of the findings of the Commission's econometric analysis described in recital 120, it is necessary to analyse further whether one of the other cumulative conditions for the existence of State aid is fulfilled as regards Luxten-Lighting, Electrocarbon and Elsid.

7.3. State resources and imputability to the State

- (128) Considering that Hidroelectrica is 80 %-owned by the State and that a potential shortfall of sales revenues reduces the resources available to Romania in its capacity as shareholder, the Commission can conclude that revenues or shortfalls thereof from the sale of electricity under the three contracts with Luxten-Lighting for 2008-2009 and Electrocarbon and Elsid for 2007-2010 involve State resources within the meaning of Article 107(1) TFEU.
- (129) However, the same conclusion is not necessarily warranted as regards the imputability to the Romanian State of commercial decisions of Hidroelectrica in relation to prices and sales revenues accrued through the three contracts with Luxten-Lighting, Electrocarbon and Elsid after 1 January 2007. Indeed, the mere fact that the prices in application of the contracts under scrutiny were charged by Hidroelectrica, a public undertaking majority controlled by the Romanian State, is not sufficient reason to conclude that these decisions were imputable to the Romanian State.
- (130) In fact, all three contracts were in force on 1 January 2007 (recital 19, Annex I). The Commission is not competent to establish whether the conclusion of the three contracts in question in 2002 and 2004 and of any amendments in the period before Romania's accession to the EU were imputable to the Romanian State, or to assess the market circumstances in which the contracts were concluded or amended before the relevant date (recital 101). The decisions of Hidroelectrica that the Commission is competent to assess are therefore as follows:
- an express or tacit decision to maintain in force after 1 January 2007 the sales contracts concluded before Romania's accession to the EU, and
 - any decisions to substantially modify the contract conditions after Romania's accession to the EU, in particular decisions to amend contract prices.
- (131) In that respect, even if the Romanian State had been in a position to control Hidroelectrica's policy and to exercise a dominant influence over its decisions, it cannot automatically be presumed that, in the matter of maintaining the contracts with Luxten-Lighting for the years 2008-2009 and with Electrocarbon and Elsid for the years 2007-2010, and amending the contract prices, it actually exercised that control.
- (132) Pursuant to the relevant case-law ⁽⁵⁹⁾ it is necessary to examine both whether the Romanian authorities can be considered as having been involved, in one way or another, in maintaining the contracts in force and in modifying the contract prices, and the unlikelihood of their not having been involved in these decisions. To that effect, the imputability to the Romanian State of the decisions regarding the contracts under investigation may be inferred from a set of indicators arising from the circumstances, and from the context, in which Hidroelectrica supplied electricity to Luxten-Lighting for the years 2008-2009 and to Electrocarbon and Elsid after 2007.
- (133) In particular, and on the basis of the relevant case-law, maintaining the three ongoing contracts and introducing modifications to the contract prices after 2007 may be imputable to Romania (i) if Hidroelectrica could not have decided on these matters without taking account of the requirements of the public authorities; or (ii) if Hidroelectrica had to take account of directives issued by a governmental or an interministerial body. Likewise, regard

⁽⁵⁹⁾ Judgment in *France v Commission (Stardust Marine)*, C-482/99, ECLI:EU:C:2002:294, paragraphs 51 to 58.

must be also had to (iii) whether Hidroelectrica is integrated into the structures of the public administration; (iv) the nature of its activities and the exercise of the latter on the market in normal conditions of competition with private operators; (v) the legal status of Hidroelectrica (in the sense of its being subject to public law or ordinary company law); (vi) the intensity of the supervision exercised by the public authorities over its management; or (vii) any other indicator of either involvement by the public authorities in maintaining the contracts and modifying the contract prices, or the unlikelihood of their not being involved, having regard also to (viii) the compass of the decisions taken by Hidroelectrica, their content or the conditions which they contain ⁽⁶⁰⁾.

- (134) Hidroelectrica is a company governed by ordinary company law and not integrated into the structures of the public administration. In fact, members of Hidroelectrica's board of directors can cumulate functions with government posts (recital 12). This could suggest that members of the board of directors were chosen mainly on the grounds of their closeness to the Government rather than on the basis of their business experience or competence. While there are indications that Hidroelectrica is obliged to take into account directives issued by a governmental or interministerial body, there are no indications that any such directives were issued for the purposes of maintaining in force the three contracts at issue and increasing the contract prices. In particular, there are no indications that Hidroelectrica's general meeting of shareholders or board of directors played any role in decisions related to (maintaining) commercial electricity supply contracts and/or to amending prices applied in application of those contracts (recital 12). As noted by several interested parties, according to Hidroelectrica's articles of incorporation and Romanian company law, the chief executive officer manages the company, represents it in its day-to-day business and independently takes decisions on matters other than those reserved for the general meeting of shareholders and the board of directors. The Romanian authorities stress that members of the board of directors must take decisions in the interest of the company.
- (135) Ministerial Order 445/2009, to which the Commission referred in the opening decisions (recital 44), had no effect on the terms and conditions of the three contracts at issue. Pursuant to Article 1(2) of this Order, ongoing bilateral contracts were generally exempted from the rule on the basis of which the representatives of the Ministry of Economy, Trade and Business Environment and members of the boards of directors of the State-owned electricity companies were obliged to ensure that, as of 31 March 2010, the volume of electricity intended for the wholesale market should be traded exclusively on OPCOM. As noted in recital 101, the competence to examine the contracts at issue from the perspective of EU State aid rules started as from Romania's accession to the EU, that is to say 3 years before the time-limit set in Ministerial Order No 445/2009 and more than 2 years before the Order's adoption. It follows that no such rule existed when the contracts at issue became susceptible of review under EU rules. Furthermore, the retail contracts between Hidroelectrica and Elsid and, respectively, with Electrocarbon — in force before 31 March 2010 — would not have been involved, even if the measure had applied also to contracts that existed when the order came into force, since only (future) wholesale sales were of relevance.
- (136) Moreover, although Ministerial Order 445/2009 suggests a degree of influence on the part of the State on the commercial policy of State-owned electricity producers, its aim is mainly of a regulatory nature, namely to increase transparency of energy transactions on the wholesale market and to ensure greater volumes and liquidity on the trading platforms administered by OPCOM. This Ministerial Order applies to all State-owned producers, not only to Hidroelectrica. It cannot therefore be deduced from the terms and aims of Ministerial Order 445/2009 that the Romanian State exercised control over every transaction, contract or contract amendment regarding the supply of electricity by State-owned electricity producers, which account for the large majority of producers on the Romanian market, or, in particular, by Hidroelectrica. In other words, the Order does not make it plausible that the Romanian State was involved in the ordinary day-to-day commercial activity, sales contracts, amendments thereof, price negotiations, etc. in relation to the three contracts under examination.
- (137) Except for the supply of electricity on the regulated market (recitals 25-26) Hidroelectrica exercises its electricity supplying activities in open markets with non-captive buyers, in competition with other private or publicly owned suppliers. In particular, a significant volume of electricity well above the total amount of Hidroelectrica's supplies under all the contracts under investigation was traded through bilateral bespoke long-term contracts on the Romanian market, where many other suppliers compete (recitals 30 and 38). Hidroelectrica's contracts under scrutiny and, in particular, the three bespoke long-term contracts with Luxten-Lighting, Electrocarbon and Elsid, maintained after 1 January 2007, are, therefore, not abnormal or extraordinary, which would suggest a particular interest of the State in maintaining them.

⁽⁶⁰⁾ See footnote 59.

- (138) Furthermore, the contracts with Electrocarbon and Elsid were maintained and renegotiated by Hidroelectrica's receiver after insolvency proceedings were begun in 2012, which provides an indication that these contracts were still of interest to Hidroelectrica's temporary new management, well after Romania's accession to the European Union in 2007 and well after the contracts were concluded and were amended, in particular with regard to prices. Likewise, Hidroelectrica requested increased prices above contract levels and gave notice to Electrocarbon and Elsid of the interruption of supplies in order to prompt them to accept further price increases in 2010 (recital 22), thus behaving like a revenue-maximising seller and not like a grantor of aid.
- (139) This is not to say that the Romanian State is not in the position of being involved with the commercial contracts of State-owned electricity suppliers in the interests of specific and major industrial buyers. For instance, before Romania's accession to the EU, an Internal Note dated 2 February 2006, signed by the State Secretary of the Economy and Trade Ministry and approved by the Prime Minister, proposed the implementation of special preferential treatment for the ten largest energy-intensive users in Romania (including aluminium or steel producers supplied by Hidroelectrica or Nuclearelectrica). As regards the contract with Arcelor-Mittal, in particular, Hidroelectrica's board of directors' decision No 13/2009 dated 16 December 2009 empowered Hidroelectrica's chief executive officer 'to negotiate the ongoing sale-of-electricity contract in the best conditions for Hidroelectrica'. The board of directors did this by approving the main terms of the contracts of 2009 and 2010 with ArcelorMittal. Addendum No 17 in 2009 to the contract with Alro (inserting the LME formula in the calculation of the contract price) was also approved by Hidroelectrica's board of directors.
- (140) Likewise, a memorandum of 3 February 2011 from the two General Managers of Nuclearelectrica and CE Hunedoara, which, like Hidroelectrica, are State-owned, requested the approval of the Ministry of Economy and Trade for the conclusion of a wholesale sale of electricity contract between Nuclearelectrica as a seller and CE Hunedoara as a purchaser. This transaction needed a derogation from the provisions of Order 445/2009 requiring that any wholesale electricity transaction involving a State-owned enterprise should take place only on OPCOM. This derogation was requested in view of the fact that the electricity acquired would serve 'the electricity needs of a number of industrial consumers of national importance in 2011'. This memorandum was fully endorsed by the Minister of Economy and Trade.
- (141) It follows that there is some indirect evidence that does not allow it to be completely ruled out that the Romanian State would have been involved in concluding, or making major amendments to, Hidroelectrica's contracts with big energy-intensive industrial buyers.
- (142) Moreover, the Commission has concluded that other purchase contracts into which Hidroelectrica entered with two other State-owned companies, Electrocentrale Deva and Termoelectrica, in 2008 and 2009, were imputable to the Romanian State. That conclusion was based mainly on direct evidence of the other two State-owned companies having sought approval of the contracts from the Minister responsible also for the State-owned Hidroelectrica as a means of (cross) financing their current operations and that of the State-owned mines which supplied them with coal, for social and other non-commercial reasons ⁽⁶¹⁾.
- (143) However, the considerations that may render plausible (or not exclude the possibility of) the Romanian State's being involved in a number of Hidroelectrica's contracts with big industrial buyers of national importance for the Romanian economy and with other State-owned sellers cannot be extrapolated from in such a way that all Hidroelectrica's commercial contracts and, in particular, those with Elsid, Electrocarbon and electricity traders are considered to be imputable to the Romanian State. Unlike Electrocentrale Deva and Termoelectrica, Elsid, Electrocarbon and the electricity traders were privately-owned and none of them can be held to be a big industrial buyer of national importance for the Romanian economy. In particular, the evidence available in the investigation does not point at any specific interest or involvement on the part of the Romanian State in prompting Hidroelectrica to conclude or, after Romania's accession, to maintain the contracts with Elsid, Electrocarbon and the electricity traders.

⁽⁶¹⁾ Commission Decision (EU) 2015/1877 of 20 April 2015 on tariffs charged by S.C. Hidroelectrica SA of Romania to S.C. Termoelectrica SA and S.C. Electrocentrale Deva SA — SA.33475 (12/C) (OJ L 275, 20.10.2015, p. 46), recitals 96-100.

- (144) Moreover, as regards Elsid, Electrocarbon and Luxten-Lighting, which were specifically singled out in the previous Section 7.1, several facts make it implausible that the decision to maintain the contracts and amend the prices of the contracts with Luxten-Lighting for 2008-2009 and with Electrocarbon and Elsid for 2007-2010 could be attributed to the Romanian authorities.
- (145) In particular, the actual prices under the three contracts were constantly increased each year. Between 2007 and 2010, the prices charged to Elsid, Electrocarbon and Luxten-Lighting increased by 44,5 %, 44,5 % and 41,4 %, respectively. Price increases reduce the absolute value of the aid granted. These contract changes which reduce the putative amount of the alleged State aid, were always triggered by, and for the benefit of, Hidroelectrica. A strategy aimed at reducing the amount of aid granted to the beneficiaries seems to contradict the purpose of granting aid or, at least, to be too sophisticated to be plausible. Moreover, contrary to Alro and ArcelorMittal, Elsid, Electrocarbon and Luxten-Lighting cannot be deemed to be industrial consumers of national importance: by way of illustration, their annual consumption purchases from Hidroelectrica amounted to less than one tenth of those of Alro (Annex I). It is therefore unlikely that decisions reducing the amount of aid by considerably increasing the contract prices can be imputed not to a commercial decision of Hidroelectrica but to a decision of the Romanian State aimed at providing aid to the alleged beneficiaries.
- (146) The fact that it is unlikely that the State would be involved in subtly reducing the amount of aid is also apparent with respect to the contracts with Electrocarbon and Elsid. In particular, it is implausible that Hidroelectrica was acting under instructions from the State when requesting price increases above the contract prices in 2010, threatening to discontinue the electricity supply and arguing the matter in court (recital 22), for the requested price increases had the effect of reducing the putative amount of aid, and discontinued supplies could have jeopardised the productive activities of the buyers. This behaviour of not adhering to a contract price that purportedly provides aid, threatening to interrupt supplies and defending price increases in court is not behaviour typical of a grantor of aid, but is, rather, that of a revenue-maximising company defending its commercial interests and not concerned with following non-commercial goals, possibly under instructions received from the State.
- (147) As regards Luxten-Lighting, there is no obvious reason of public policy, such as low end-user prices, behind sales to a trader which can only sell retail at higher prices than if Hidroelectrica had sold the same electricity retail on its own. For instance, before being supplied retail by Hidroelectrica as from 2005, Alro purchased electricity from a trader, Energy Holding, that bought electricity wholesale from Hidroelectrica. It was rational behaviour for Alro to be supplied directly by Hidroelectrica, thus saving a trading margin, if its supplier was not adding value to Hidroelectrica's wholesale supply. In the same vein, it is rather implausible that the Romanian State should have prompted Hidroelectrica to maintain the contract with Luxten-Lighting in 2008 and 2009, for, if Luxten-Lighting did not add value to its retail sales to industrial users or other buyers, the latter would have obtained lower prices by contracting directly with Hidroelectrica. Furthermore, Luxten-Lighting unilaterally terminated its contract with Hidroelectrica in November 2011, before the Commission opened proceedings; this behaviour is not consistent with that of a beneficiary of State aid.
- (148) On the basis of all the above considerations, it is not established that the contracts with Luxten-Lighting for 2008-2009 and for Electrocarbon and Elsid for 2007-2010 are imputable to Romania.
- (149) As the essential element of imputability to Romania for the existence of State aid is not present in the three contracts with Luxten-Lighting for 2008-2009 and with Electrocarbon and Elsid for 2007-2010, it is not necessary to analyse whether the other cumulative conditions for the application of this provision, such as the potential effect on competition and trade between Member States, are met.
- (150) In the light of the above, the three contracts under scrutiny, with Luxten-Lighting for 2008-2009 and with Electrocarbon and Elsid for 2007-2010, do not constitute State aid within the meaning of Article 107(1) TFEU.

8. CONCLUSION

- (151) The contracts covered by the present Decision do not constitute State aid within the meaning of Article 107(1) TFEU,

HAS ADOPTED THIS DECISION:

Article 1

The contracts concluded between Hidroelectrica and ArcelorMittal, Alpiq RomEnergie, Alpiq RomIndustries, EFT, Electrica, Electromagnetica, Energy Holding, Euro-Pec, Luxten-Lighting, Electrocarbon and Elsid, and the contract with Alro, do not constitute State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union.

Article 2

This Decision is addressed to Romania.

Done at Brussels, 12 June 2015.

For the Commission
Margrethe VESTAGER
Member of the Commission

ANNEX I

OVERVIEW OF THE CONTRACTS

SA.33451 ELECTRICITY TRADERS	Date of signature and contract period (initial period/after extension of period)	Date of termination	Quantity	Price (RON/MWh)
Alpiq RomEnergie	3 April 2008 Initial period: 5 years Prolongation (2009): by 5 additional years (until 2018)	20 July 2012	— 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2008: [...] — 2009: [...] — 2010: [...]
Alpiq RomIndustries	29 November 2004 Initial period: 10 years Prolongation (2009): by 5 additional years (until end of 2019)	20 July 2012	Initial quantity: 1 GWh — 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
Energy Financing Team Romania (EFT)	25 March 2004 Initial period: 7 years Prolongation (2010): by 5 additional years (until end of 2015)	18 July 2012	Initial quantity (2006): [...] GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
Electrica	Contract 111: 17 August 2010 Contract 112: 14 September 2010	Contract 111 31 July 2011 Contract 112 31 December 2010	Contract 111 [...] GWh from September 2010 to 31 July 2011 Contract 112 [...] GWh from October to December 2010	Contract 111 — 2010: [...] Contract 112 — 2010: [...]
Electromagnetica	21 April 2004 Initial period: 10 years	30 April 2014	Initial quantity: [...] GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
Energy Holding	14 January 2004 Initial period: 10 years	24 July 2012	Initial quantity: 3 692 GWh — 2007: [...] GWh — 1st half 2008: [...] GWh — 2nd half 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
EURO-PEC	3 March 2004 Initial period: 10 years	26 June 2012	Initial quantity: [...] GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]

SA.33451 ELECTRICITY TRADERS	Date of signature and contract period (initial period/after extension of period)	Date of termination	Quantity	Price (RON/MWh)
Luxten-Lighting	2 March 2004 Initial period: 10 years	December 2011	Initial quantity: [...] GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
SA.33581 ELECTRODES PRODUCERS	Date of signature and contract period (initial period/after extension of period)	Date of termination	Quantity	Price (RON/MWh)
Electrocarbon	28 March 2003 Initial period: 5 years Prolongation (2004): by 5 additional years (until 31 March 2013)	31 March 2013	Initial quantity: 800 GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
ELSID	18 December 2002 Initial period: 5 years Prolongation (2004): by 5 additional years (until 31 March 2013)	31 March 2013	Initial quantity: 280 GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
SA.33624 Alro	Date of signature and contract period (initial period/after extension of period (if applicable))	Date of termination	Quantity	Price (RON/MWh)
Alro	8 September 2005 Initial period: 7 years Prolongation (2010): by 5 additional years (until 31 January 2018)	Ongoing until end of 2018	Initial quantity: [...] GWh — 2007: [...] GWh — 2008: [...] GWh — 2009: [...] GWh — 2010: [...] GWh	— 2007: [...] — 2008: [...] — 2009: [...] — 2010: [...]
SA.33623 ARCELORMITTAL GALAȚI	Date of signature and contract period (initial period/after extension of period (if applicable))	Date of termination	Quantity	Price (RON/MWh)
ArcelorMittal	23 December 2009 Period: 1 year 22 December 2010 Period: 1 year	31 December 2010 6 January 2012	[...] GWh [...] [...] GWh	2010: [...] 2011: [...]

ANNEX II

ASSESSMENT OF THE ALLEGED ECONOMIC ADVANTAGE — ECONOMETRIC ANALYSIS

Rationale and description of the econometric analysis

The econometric analysis undertaken by the Commission is designed to create benchmark prices for contracts. These prices result from a regression analysis carried out on the features of the contracts in the dataset. As a first step, the regression analysis allows a benchmark price to be constructed on the basis of the characteristics of the contracts in the dataset ('in-sample predictions'). As a second step, the results of the regression analysis are used to predict a benchmark price for the contracts investigated, taking into account the characteristics of the contracts ('out-of-sample predictions'). In the regression analysis, the variation in prices among the contracts in the dataset is explained with reference to the following characteristics: quantity purchased, supplier identity and year dummies. The 'contract duration' and 'buyer off-take profile' variables are not included since they are not statistically significant.

The econometric analysis rests on the principle that there are a number of drivers of prices, such as quantities. It would be misleading to compare the prices across different contracts without considering these drivers. In particular, whereas the contracts in the dataset have certain characteristics in common with the contracts under investigation (bilateral negotiation, bespoke conditions, quantities above 150 GWh per year, etc.), no contract in the dataset has exactly the same quantities, or was concluded for the same duration and with the same entry into force, as the contracts under investigation — a factor that may justify price differences. For example, two contracts under investigation concern supplies of [...] GWh/year (Alro 2007-2010) and [...] GWh/year (Energy Holding 2007-2008). In the meantime, the contract with the highest quantity in the dataset out of the 114 price/contract data observed between 2007 and 2010 did not exceed 1 400 GWh/year. It is doubtful whether a mere comparison of prices for these contracts could allow any valid conclusion to be drawn as to whether the contracts under investigation were in line with market prices. Alternatively, it could be concluded that these two contracts could not simply be compared with other market contracts. The rationale of this quantitative exercise is therefore that, once a number of external factors are taken into account, the prices across different contracts can be better compared. In the absence of normalisation, only perfectly identical contracts could be compared meaningfully.

It should be noted that this empirical exercise is not aimed at estimating a causal relationship between prices and certain external factors. For example, estimating a causal relationship between certain factors and prices would require the risk of endogeneity to be taken into consideration: that is, the risk that a causal variable (e.g. the quantities) might itself be influenced by the explained variable (e.g. the price), due to omitted variables or simultaneity bias. The purpose of the quantitative exercise is to 'normalise' the prices across different contracts to enable a better comparison to be made between them. This normalisation is necessary in the absence of perfectly identical contracts and supply characteristics.

The regression analysis reflects the main features of the bilateral contracts at issue:

- including the quantity variable in the regression reflects the fact that prices are in general lower when quantities purchased are higher ⁽¹⁾,
- including the supplier identity reflects the fact that some suppliers have characteristics which would allow them to establish prices differently from others, taking into account that contract supplies from virtually all electricity suppliers active in Romania are included in the dataset,
- including year dummies reflects the time dimension and the possible change in market conditions from one year to another.

As regards the first step of the empirical analysis, the results of the regression analysis of the dataset contracts are reported in Table 1 below.

⁽¹⁾ A preliminary processing of the data eliminated four (non-suspect) contracts corresponding to the intra-group sales of ALRO from 2007 to 2010, as they are likely to reflect market conditions different from those prevailing in bilateral contract negotiations between a supplier and an independent buyer, which is the crucial factor in this case.

As regards the second step of the empirical analysis, the Commission has identified a benchmark for every year and has then tested the position of the contracts relative to this benchmark in order to conclude whether the prices charged by Hidroelectrica were lower or higher than the modelled benchmark price. The following steps describe in detail the methodology used to determine the benchmark:

Firstly, for each contract of the dataset, it was calculated how far the actual price departed from its corresponding benchmark price, calculated on the basis of the regression and of the characteristics of the contract;

Secondly, the most-downward-diverging contract ('MDD') was identified; this was the dataset contract whose observed price departed most from its own corresponding benchmark price (in absolute terms). There were reasons, very conservative as they were, for choosing the MDD contract, involving a range of variation below the central estimated value of the benchmark price. Firstly, the econometric model does not fully explain the observed price in the dataset, and the single estimate of the benchmark price was provided with a confidence interval and a margin of error above or below the estimate. Secondly, deviations from a single possible price exist on the real market; the MDD contract, which stems from a contract based on market conditions (see recitals 36 to 38) supplies quantified information about the possible extent of such deviations and provides a market-based range around the calculated benchmark price.

Thirdly, the price difference in relation to the MDD contract is used to separate contracts below the benchmark price from contracts above this:

- if a contract has an observed price below its corresponding benchmark price and if the price difference for this contract is larger than the MDD price difference, then this contract is considered *prima facie* not to be market-compliant,
- otherwise the contract should be deemed to be market-compliant.

The table below presents detailed results from the regression analysis of the sample of contracts from the dataset. The regression explains 74 % of the variations in the data, which is a relatively good fit. The coefficient estimates presented in the table below are used at a second stage to predict the 'benchmark' price for the sample of contracts under investigation ('out-of-sample predictions').

Results of the econometric analysis

Table 1

Regression analysis ⁽¹⁾

Dependent variable: Average price	Coefficient	Std error
Annual quantity (GWh)	– 0,01951**	0,007878
Year 2008	22,58369***	4,781887
Year 2009	30,73545***	5,471158
Year 2010	21,32171***	5,695673
ALPIQ ROMENERGIE	– 2,34966	9,310078
ALPIQ ROMINDUSTRIES	– 5,47044	9,975876
ARCELORMITTAL GALATI	– 1,78779	14,62595
AXPO ENERGY RO	0,896041	10,40766
CE HUNEDOARA	38,02612***	11,41575
CE OLTENIA	27,86802***	9,458818
CEZ VANZARE	9,515878	11,40325
EFT RO	2,966594	18,83573
ELECTRICA	9,787691	11,04511
ELECTROMAGNETICA	– 9,19285	9,553932

Dependent variable: Average price	Coefficient	Std error
ENEL ENERGIE MUNTENIA	16,97181	12,529
ENERGY HOLDING	– 34,5329***	9,620757
ENERGY NETWORK	36,58137***	12,47443
EON ENERGIE	3,589147	12,43953
EURO-PEC	0,511251	9,50637
HIDROELECTRICA	– 30,3327**	12,62379
NUCLEARELECTRICA	– 9,804	18,78678
OMV PETROM	6,482914	18,79837
RAAN	33,0402**	14,6577
RENOVATIO TRADING	29,5599	18,95553
TINMAR IND	0	(omitted)
Constant	160,5678***	8,50624
Number of observations: 109 R-squared = 0,7426 Adjusted R-squared = 0,6691		

Note: Prices are in RON/MWh

Source: Commission's regression analysis based on the data submitted by the Romanian authorities.

(¹) Standard errors are presented in parentheses: *** means that the coefficient is statistically significant at a 1 % level, ** means that it is statistically significant at a 5 % level and * means that it is statistically significant at a 10 % level.

The following tables show the results of the empirical analysis, which uses the regression analysis detailed in Table 1 in which, for each year, the most-downward-diverging contract ('MDD') is selected on the basis of the difference in price levels (in RON/MWh) between each contract's estimated price and its corresponding observed price. Tables 2-4 below show the differences between Hidroelectrica's contract prices for each of the years (i.e.: 2007-2010) vis-à-vis the 'simulated' benchmark prices for all the contracts under investigation.

For 2007, the MDD contract, that is to say the contract in the non-suspect dataset with the highest difference between the observed price and its corresponding estimated price, has a price difference estimated at [...] RON/MWh. Two Hidroelectrica contracts have an observed price below their estimated price with a price difference larger than [...] RON/MWh, namely the contracts with *Electrocarbon* and *Elsid*, with an observed price difference of approximately [...] RON/MWh (see Table 2).

Table 2

Analysis of contracts from 2007

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
MDD contract in the dataset					
AZOMURES SA	HIDROELECTRICA	[...]	124	[...]	

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
Contracts under investigation					
Alro	HIDROELECTRICA	[...]	72	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	50	[...]	Yes
EFT	HIDROELECTRICA	[...]	127	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	111	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	111	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	125	[...]	Yes
ELSID	HIDROELECTRICA	[...]	126	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	126	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

For 2008, the price difference in relation to the MDD contract is estimated at [...] RON/MWh, and three Hidroelectrica contracts have a larger price difference, namely those with Luxten-Lighting, Electrocarbon and Elsid, with an observed price difference of approximately [...] RON/MWh for Luxten-Lighting and [...] RON/MWh for Electrocarbon and Elsid (see Table 3).

Table 3

Analysis of contracts from 2008

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
MDD contract in the dataset					
PETROM SA	Energy Holding	[...]	147	[...]	
Contracts under investigation					
Alro	HIDROELECTRICA	[...]	94	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	133	[...]	Yes
EFT	HIDROELECTRICA	[...]	149	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	73	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	133	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	147	[...]	No
ELSID	HIDROELECTRICA	[...]	148	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	149	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

For 2009, the MDD price difference is estimated at[...] RON/MWh and, again, three Hidroelectrica contracts have a larger price difference, namely those with Luxten-Lighting, Electrocarbon, and Elsid, with an observed price difference of approximately[...] RON/MWh for Luxten-Lighting and of[...] RON/MWh for Electrocarbon and Elsid (see Table 4).

Table 4

Analysis of contracts from 2009

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
MDD contract in the dataset					
Ductil Steel SA	Alpiq RomEnergie	[...]	187	[...]	
Contracts under investigation					
Alro	HIDROELECTRICA	[...]	102	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	142	[...]	Yes
Alpiq RomEnergie	HIDROELECTRICA	[...]	126	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	142	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	116	[...]	Yes
EFT	HIDROELECTRICA	[...]	157	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	156	[...]	No
ELSID	HIDROELECTRICA	[...]	157	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	157	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

For 2010, the price difference in relation to the MDD contract is estimated at [...] RON/MWh, and two Hidroelectrica contracts have a larger price difference, namely those with *Electrocarbon* and *Elsid*, with an observed price difference of approximately [...] RON/MWh (see Table 5).

Table 5

Analysis of contracts from 2010

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
MDD contract in the dataset					
SILCOTUB SA ZALAU	Energy Network	[...]	214	[...]	
Contracts under investigation					
ArcelorMittal Galati	HIDROELECTRICA	[...]	118	[...]	Yes
Electrica	HIDROELECTRICA	[...]	132	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	107	[...]	Yes

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (in absolute terms)	In line with benchmark indices
Alpiq RomEnergie	HIDROELECTRICA	[...]	116	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	132	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	144	[...]	Yes
Alro	HIDROELECTRICA	[...]	93	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	146	[...]	Yes
EFT	HIDROELECTRICA	[...]	148	[...]	Yes
ELSID	HIDROELECTRICA	[...]	147	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	148	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

Sensitivity analysis

In the previous empirical analysis, the MDD contract was defined as the contract in the dataset, for a given year, that presented the highest price difference in absolute terms (RON/MWh) between the observed price and its corresponding estimated price.

In order to check the robustness of the results, a sensitivity analysis was performed. The same analysis was now performed, but defining the MDD contract as the contract with the largest difference between the estimated price and its corresponding observed price, expressed as a percentage of the estimated price. In the sensitivity analysis, the MDD contract was now defined as the contract with the largest difference between the estimated price and its corresponding observed price, expressed as a percentage of the estimated price. While this analysis should not affect significantly the selection of the MDD contract, it could affect the contracts that are selected. The results are shown in Tables 6-9 below. They confirm the validity of the results from the main analysis.

Table 6

Sensitivity analysis of contracts from 2007

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
MDD contract in the dataset					
AZOMURES SA	HIDROELECTRICA	[...]	124	[...] %	
Contracts under investigation					
Alro	HIDROELECTRICA	[...]	72	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	50	[...]	Yes
EFT	HIDROELECTRICA	[...]	127	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	111	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	111	[...]	Yes

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
Luxten-Lighting	HIDROELECTRICA	[...]	125	[...]	Yes
ELSID	HIDROELECTRICA	[...]	126	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	126	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

Table 7

Sensitivity analysis of contracts from 2008

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
------------------	------------------	----------------	-----------------	------------------------------------	--------------------------------

MDD contract in the dataset

PETROM SA	Energy Holding	[...]	147	[...] %	
-----------	----------------	-------	-----	---------	--

Contracts under investigation

Alro	HIDROELECTRICA	[...]	94	[...]	No
Electromagnetica	HIDROELECTRICA	[...]	133	[...]	Yes
EFT	HIDROELECTRICA	[...]	149	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	73	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	133	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	147	[...]	No
ELSID	HIDROELECTRICA	[...]	148	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	149	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

Table 8

Sensitivity analysis of contracts from 2009

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
------------------	------------------	----------------	-----------------	------------------------------------	--------------------------------

MDD contract in the dataset

Ductil Steel SA	Alpiq RomEnergie	[...]	187	[...] %	
-----------------	------------------	-------	-----	---------	--

Contracts under investigation

Alro	HIDROELECTRICA	[...]	102	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	142	[...]	Yes

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
Alpiq RomEnergie	HIDROELECTRICA	[...]	126	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	142	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	116	[...]	No
EFT	HIDROELECTRICA	[...]	157	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	156	[...]	No
ELSID	HIDROELECTRICA	[...]	157	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	157	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

Table 9

Sensitivity analysis of contracts from 2010

Name of customer	Name of supplier	Observed price	Benchmark price	Price difference (as a percentage)	In line with benchmark indices
------------------	------------------	----------------	-----------------	------------------------------------	--------------------------------

MDD contract in the dataset

ARCELORMITTAL GALAȚI	Electrica	[...]	182	[...] %	
----------------------	-----------	-------	-----	---------	--

Contracts under investigation

ArcelorMittal Galați	HIDROELECTRICA	[...]	118	[...]	Yes
Electrica	HIDROELECTRICA	[...]	132	[...]	Yes
Energy Holding	HIDROELECTRICA	[...]	107	[...]	Yes
Alpiq RomEnergie	HIDROELECTRICA	[...]	116	[...]	Yes
Electromagnetica	HIDROELECTRICA	[...]	132	[...]	Yes
EURO-PEC	HIDROELECTRICA	[...]	144	[...]	Yes
Alro	HIDROELECTRICA	[...]	93	[...]	Yes
Luxten-Lighting	HIDROELECTRICA	[...]	146	[...]	Yes
EFT	HIDROELECTRICA	[...]	148	[...]	Yes
ELSID	HIDROELECTRICA	[...]	147	[...]	No
Electrocarbon	HIDROELECTRICA	[...]	148	[...]	No

Note: Prices are rounded up to the nearest RON/MWh.

Source: Calculations based on the regression analysis and on the data submitted by the Romanian authorities.

The prices of electricity in contracts between Hidroelectrica and Luxten-Lighting, Electrocarbon and Elsid are still found not to be in line with the benchmark price. The percentage price differences are considerably higher for the contracts with Luxten-Lighting for the years 2008 and 2009 and with Electrocarbon and Elsid for the period 2007-2010. In addition, two other contracts appear, namely with Alro in 2008 and Energy Holding in 2009. The percentage price difference in both cases is very close to the percentage price difference of the MDD contract. The observed price for the 2008 contract with Alro is [...] % lower than its estimated price, whereas the percentage price difference in relation to the MDD contract was [...] % in 2008. The observed price for the 2009 contract with Energy Holding is [...] % lower than its estimated price, whereas the percentage price difference in relation to the MDD contract was [...] % in 2009. Overall, these two contracts should be considered to be in line with the benchmark price.

In addition to the main sensitivity analysis performed by defining the MDD as a percentage difference in relation to the benchmark price, which confirms the validity of the results, further sensitivity tests of the results obtained from the preferred definition of MDD in absolute values were carried out, as follows:

- an arbitrary 10 % mark-up was deducted from the absolute value of the MDD: the modified MDD does not affect the conclusion for the contracts under investigation from 2008, 2009 and 2010. For 2007, a difference of 2,5 RON/MWh below the applied price of [...] RON/MWh would appear for EFT (i.e. the benchmark-compliant price would have been [...] RON/MWh); this difference, not observed for EFT prices in 2008, 2009 and 2010, is deemed to be negligible,
- likewise, use of the second downward deviation (2nd DD) as reference would capture only two more contracts (Luxten-Lighting and EFT) for 2007, but this does not mean that any other of the contracts under investigation in the period analysed would appear as being below the benchmark prices or that the contract with EFT would appear as being below the benchmark price for 2008, 2009 and 2010,
- regression data from 2011, not initially tested, was introduced: even if the values shown in Tables 2 to 5 change slightly, the qualitative results remain unchanged,
- investigated contract prices deemed to be in line with the benchmark price were reintroduced in the regression as dataset (in-sample): in this case too, the conclusion for the contracts under investigation does not change.

It follows that these additional sensitivity tests relating to the main approach confirm the robustness of the results of the econometric analysis.

COMMISSION DECISION (EU) 2017/502**of 21 October 2015****on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks***(notified under document C(2015) 7143)***(Only the Dutch text is authentic)****(Text with EEA relevance)**

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provisions cited above ⁽¹⁾ and having regard to their comments,

Whereas:

1. PROCEDURE

- (1) By letter dated 30 July 2013, the Commission requested the Dutch authorities to provide information on the tax ruling practice in the Netherlands as well as all rulings related to Starbucks Coffee EMEA BV (hereinafter: 'Starbucks Coffee BV') and Starbucks Manufacturing EMEA BV (hereinafter: 'SMBV'), both companies indirectly controlled by Starbucks Corporation. Starbucks Corporation and all the companies controlled by that corporation are referred to hereinafter collectively as 'Starbucks' or the 'Starbucks group'.
- (2) By letter dated 2 October 2013, the Dutch authorities submitted the requested information to the Commission, including the advance pricing agreement (hereinafter 'APA') ⁽²⁾ concluded in 2008 between the Dutch tax administration and Starbucks Coffee BV (hereinafter: the 'Starbucks Coffee BV APA'), the APA concluded in 2008 between the Dutch tax administration and SMBV (hereinafter: the 'SMBV APA') and supporting documents. Those documents concern, in particular, a transfer pricing report supporting the request for the two aforementioned APAs (hereinafter: the 'transfer pricing report') and other exchanges between the Dutch tax administration and the tax advisor of Starbucks Corporation, [the tax advisor] ^(*), (hereinafter: 'the tax advisor') on behalf of Starbucks Coffee BV and SMBV ⁽³⁾.
- (3) On 9 January 2014, in preparation of a meeting to be held on 15 January 2014, the Commission sent an email to the Dutch authorities listing a number of questions concerning, among others, the transfer pricing arrangement agreed upon in the Starbucks Coffee BV APA and the SMBV APA concluded by the Dutch tax administration.
- (4) On 15 January 2014, a meeting was held between the Commission services and representatives of the Dutch tax administration in which the Commission services sought, among others, further clarifications on the adjustments made to the cost base in the transfer pricing report as regards the SMBV APA and the fluctuating royalty payments made by SMBV.

⁽¹⁾ OJ C 460, 19.12.2014, p. 11.

⁽²⁾ Throughout the decision, the terms 'tax ruling' and 'APA' are used synonymously.

^(*) Parts of this text have been hidden so as not to divulge confidential information; those parts are enclosed in square brackets. Profit margins and mark-ups of SCTC concerning the green coffee beans are rounded to the closest multiple of 3 %.

⁽³⁾ A previous tax ruling concluded between the Dutch tax administration and Starbucks Coffee BV and SMBV in 2001 was also submitted as part of the supporting documents.

- (5) By letter dated 28 January 2014, in response to the questions posed in the meeting of 15 January 2014, the Dutch authorities provided information on the comparability adjustments, the choice of the comparable companies and the fluctuating royalty. Further information on the documents provided is described in recitals 59 to 62 of the Opening Decision as mentioned in recital 9.
- (6) By letter dated 7 March 2014 ⁽⁴⁾, the Commission informed the Dutch authorities that it was considering whether the APAs in favour of Starbucks Coffee BV and SMBV could constitute new State aid within the meaning of Article 107(1) of the Treaty and invited the Dutch authorities to comment on the compatibility of such aid. The Commission invited the Dutch authorities to provide any additional information relating to the Starbucks Coffee BV and SMBV APAs, as well as the tax returns of Starbucks Coffee BV and SMBV and companies related to those two companies in the Netherlands.
- (7) By letter dated 21 March 2014, the Dutch authorities responded to the letter of 7 March 2014 and provided the requested tax returns. The Dutch authorities also confirmed that all relevant documents regarding the APAs submitted previously to the Commission had already been provided to the Commission.
- (8) On 6 May 2014, a meeting was held between the Commission services and representatives of the Dutch tax administration.
- (9) On 11 June 2014, the Commission adopted the decision to open the formal investigation procedure under Article 108(2) of the Treaty on the SMBV APA on the grounds that that APA could constitute State aid within the meaning of Article 107(1) of the Treaty (hereinafter 'the Opening Decision') ⁽⁵⁾.
- (10) By letter dated 16 July 2014, the Dutch authorities submitted their comments on the Opening Decision. The submission included, among others, the Roasting Agreement between Alki Limited Partnership (hereinafter: 'Alki LP') and SMBV and the Green Coffee Purchase Agreement between SMBV and Starbucks Coffee Trading Company SARL (hereinafter: 'SCTC').
- (11) By letter dated 25 November 2014, the Commission requested the Dutch authorities to provide the information asked for in the Opening Decision which was only partly submitted by the Dutch authorities on 16 July 2014 and to provide additional information necessary to analyse the SMBV APA.
- (12) By letter dated 19 December 2014, the Dutch authorities replied to the letter of 25 November 2014, indicating that part of the requested information is not in the possession of the Dutch authorities.
- (13) On 19 December 2014, the Opening Decision was published in the *Official Journal of the European Union*. The Commission invited interested parties to submit their comments on the measure.
- (14) By letter dated 16 January 2015, Starbucks submitted its observations on the Opening Decision. Comments on the Opening Decision were also submitted by the Dutch Association of Tax Advisors (De Nederlandse Orde van Belastingadviseurs, hereinafter: 'NOB'), the Confederation of Netherlands Employers and Industry (Verbond van Nederlandse Ondernemingen & Nederlands Christelijk Werkgeversverbond, hereinafter: 'VNO-NCW'), ATOZ Tax Advisers Luxembourg, Oxfam International and the Austrian Chamber of Commerce (the Bundesarbeitskammer Österreich, hereinafter: 'BAK').
- (15) By letter dated 8 January 2015, in response to the Commission's letter of 25 November 2014, the Dutch authorities provided the limited partnership deed constituting Alki LP.

⁽⁴⁾ That letter was sent to the Netherlands in the English language on 7 March 2014, followed by a version in Dutch of this same letter sent on 14 March 2014.

⁽⁵⁾ See footnote 1.

- (16) On 12 February 2015, the Commission informed the Netherlands that, in accordance with Article 6a of Council Regulation (EC) No 659/1999 ⁽⁶⁾, it had identified the formal investigation procedure on the SMBV APA as ineffective to date ⁽⁷⁾. By letter dated 6 February 2015 and in accordance with Article 6a(2)(b) of Regulation (EC) No 659/1999, the Commission requested the agreement of the Dutch authorities to contact Starbucks directly to obtain the missing information.
- (17) By letter dated 18 February 2015, the Commission informed the Dutch authorities that it had received observations by a competitor on the value added of the roasting process to green coffee beans and invited the Dutch authorities to comment on this observation. The Dutch authorities submitted their comments on those observations by letter dated 11 March 2015.
- (18) By letter dated 12 March 2015, the Netherlands provided its permission to contact Starbucks directly in response to the Commission's letter of 6 February 2015. Following that permission, by letter dated 16 March 2015, the Commission requested Starbucks, based on Article 6(a)(6) of Regulation (EC) No 659/1999, to provide information on the legal structure, the business model with regard to the Starbucks shops, and the raw material used by SMBV, i.e. the green coffee beans (hereinafter: the 'Starbucks MIT request').
- (19) By letters dated 20 and 26 March 2015, the Dutch authorities submitted their observations on the comments of third parties to the Opening Decision.
- (20) On 7 April 2015, following the adoption of the decision of 12 February 2015 and in accordance with Article 6a(6) of Regulation (EC) No 659/1999, the Commission contacted four competitors of Starbucks to provide market information on their business model and their value creating activities so as to enable the Commission to complete its assessment of the case (hereinafter: the 'competitor MIT request'). Those four competitors included Company Y, Alois Dallmayr Kaffee oHG (hereinafter: 'Dallmayr'), Nestlé SA (hereinafter: 'Nestlé') and Melitta Europa GmbH & Co. KG (hereinafter: 'Melitta'). The Commission simultaneously informed the Dutch authorities that it had sent requests for information to competitors of Starbucks.
- (21) On 13 April 2015, Starbucks submitted the information requested in the Commission's letter of 16 March 2015.
- (22) By letters dated 27 April 2015, Dallmayr and Company Y replied to the Commission's request for market information of 7 April 2015.
- (23) On 29 April 2015, a meeting was held between the Commission services and Starbucks at which the Commission services provided clarifications on how certain questions in the Starbucks MIT request should be understood in the context of the investigation.
- (24) By letter dated 6 May 2015, following the reply of Starbucks of 13 April 2015, the Commission requested Starbucks to provide additional information.
- (25) By letter dated 11 May 2015, the Commission requested Company Y to provide further clarifications on the submitted market information. Those clarifications were provided by Company Y by letter dated 21 May 2015.
- (26) By letters dated 20 May 2015 and 26 May 2015, Nestlé and Melitta replied to the Commission's competitor MIT request of 7 April 2015.

⁽⁶⁾ Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 108 of the treaty on the functioning of the European Union (OJ L 83, 27.3.1999, p. 1). Regulation (EC) No 659/1999 is repealed by Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (OJ L 248, 24.9.2015, p. 9), with effect from 14 October 2015. All the procedural steps taken during the course of the proceedings were adopted under Regulation (EC) No 659/1999. Any reference to Regulation (EC) No 659/1999 may be construed as a reference to Regulation (EU) 2015/1589 and should be read in accordance with the correlation table in Annex II to the latter regulation.

⁽⁷⁾ C(2015) 862, 12.2.2015.

- (27) By letter dated 27 May 2015, the Dutch authorities submitted their comments on the information provided by Company Y and Dallmayr.
- (28) By letter dated 29 May 2015, Starbucks submitted their replies to the Commission's request of 6 May 2015.
- (29) By letter dated 19 June 2015, the Dutch authorities provided their comments on the information submitted by Starbucks on 13 April 2015 and 29 May 2015.
- (30) By letter dated 26 June 2015, the Dutch authorities submitted their comments on the market information provided by Nestlé, Melitta and the clarifications provided by Company Y.
- (31) On 29 June 2015, in addition to its submissions of 13 April 2015 and 29 May 2015, Starbucks provided a further substantiation of the supposed arm's-length nature of the transfer prices applied by SCTC for the supply of green coffee beans.
- (32) By letter dated 24 July 2015, Starbucks spontaneously submitted additional information on the functions performed by SCTC, SMBV and Starbucks US ⁽⁸⁾ and provided new figures relating to Alki LP.
- (33) By letter dated 5 August 2015, the Commission requested Starbucks to provide clarifications and other documents with regard to its submission of 24 July 2015 to be able to fully analyse the new information.
- (34) By letter dated 24 August 2015 and email sent on 26 August 2015, Starbucks partially submitted the information requested by the Commission in its letter of 5 August 2015. The Commission forwarded this information to the Dutch authorities on 28 August 2015.
- (35) By letter dated 10 September 2015 and email sent on 11 September 2015, Starbucks submitted the remaining information to the Commission. By letter dated 23 September 2015, Starbucks complemented the information submitted to the Commission on 10 and 11 September 2015.
- (36) By letters dated 25 September 2015 and 7 October 2015, the Dutch authorities provided their comments on the information submitted by Starbucks on 10, 11 and 23 September 2015.

2. DESCRIPTION OF THE CONTESTED MEASURE

2.1. Description of the beneficiary

- (37) The beneficiary of the measure is SMBV. SMBV is a subsidiary incorporated in the Netherlands of the Starbucks group. The Starbucks group is composed of the Starbucks Corporation and all the companies controlled by that corporation. The Starbucks Corporation is headquartered in Seattle, United States of America (hereinafter 'US'). The corporate structure of the Starbucks group is explained in more detail in recital 27 and Figure 1 of the Opening Decision.
- (38) Starbucks is a roaster, marketer and retailer of specialty coffee, operating in 65 countries. It purchases and roasts coffees that are sold, along with handcrafted coffee, tea and other beverages and fresh food items, through company-operated stores. It also sells a variety of coffee and tea products and licenses its trademark through other channels, such as licensed stores, grocery and national foodservices accounts ⁽⁹⁾. In 2014, the Starbucks group had worldwide net revenues of USD 16 448 million and post-tax earnings of USD 2 067 million ⁽¹⁰⁾.
- (39) SMBV is the only wholly controlled Starbucks group entity outside of the US which roasts coffee.

⁽⁸⁾ Starbucks US refers to all companies that are members of the Starbucks group that are resident in the United States of America.

⁽⁹⁾ This description is based on Starbucks' 2014 Annual Report, p. 2.

⁽¹⁰⁾ See recital 20 of the Opening Decision for more detailed information on the Starbucks Group.

2.2. The contested measure

- (40) This Decision concerns the SMBV APA, an advance pricing agreement concluded by the Dutch tax administration with SMBV on 28 April 2008 (*Vaststellingsovereenkomst* APA). The SMBV APA is binding for 10 years, from 1 October 2007 to 31 December 2017 ⁽¹¹⁾.
- (41) An APA is an agreement between a tax administration and a taxpayer on the application of tax law regarding (future) transactions, i.e. it determines the amount of profit that the taxpayer generates from its activities that are taken into account in that tax jurisdiction. An APA determines, in advance of intra-group transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of an arm's-length pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer.

2.2.1. The SMBV APA

- (42) By concluding the SMBV APA, the Dutch tax administration accepted that the remuneration determined by Starbucks' tax advisor in the transfer pricing report for the functions performed by SMBV in the Netherlands (including risk assumed and assets used) constitutes an arm's-length remuneration ⁽¹²⁾.
- (43) That remuneration consists of a mark-up of [9-12] % of the relevant cost base. The relevant cost base used to calculate that remuneration includes all personnel costs engaged in both manufacturing and supply chain activities, the cost of production equipment (i.e. depreciation) and plant overheads. It does not include the costs of the Starbucks cups, paper napkins, etc., the costs of green coffee beans (cost of raw materials), the logistics and distribution cost for services provided by third parties, the remuneration for activities provided by third parties under so-called 'consignment manufacturing contracts' and the royalty payments to Alki LP.
- (44) In the SMBV APA, the Dutch tax administration further accepted that the level of the royalty payment from SMBV to Alki LP would be determined at the end of each year as the difference between the realised operating profit before royalty expenses and the aforementioned [9-12] % mark-up on operating expenses. The SMBV APA further provides that *'this royalty payment is deductible for corporate income tax purposes and is not subject to Dutch withholding tax'* ⁽¹³⁾.
- (45) The SMBV APA thus endorses a profit allocation to SMBV within the Starbucks group that enables it to determine its corporate income tax liability to the Netherlands on a yearly basis for 10 years. Since the APA entered into force on 1 October 2007, this Decision analyses the SMBV APA under the State aid rules as from that date.

2.2.2. The transfer pricing report

- (46) The remuneration accepted by the Dutch tax administration in the SMBV APA is based on the transfer pricing analysis prepared by Starbucks' tax advisor in the transfer pricing report, which forms an integral part of that APA.
- (47) The objective of the transfer pricing report is to support the proposed profit allocation to SMBV within the Starbucks group as being based on an arm's-length pricing of intra-group transactions. The transfer pricing report presents a company overview, a functional analysis and a selection of transfer pricing methods. The report presents the following relevant information about Starbucks Coffee BV and SMBV ⁽¹⁴⁾:

⁽¹¹⁾ The SMBV APA states that after the sixth accounting year, i.e. end 2013, a half-term check will be made to see whether all the facts and circumstances have remained the same.

⁽¹²⁾ From the original Dutch: '[SMBV] wordt geacht een arm's length vergoeding te ontvangen voor haar activiteiten zoals beschreven [in het transfer pricing report] indien de operationele marge [9-12] % van de relevante kostgrondslag bedraagt.'

⁽¹³⁾ From the original Dutch: 'De jaarlijks door SMBV aan Alki LP te betalen royalty wordt aan het einde van het jaar vastgesteld op het verschil tussen de gerealiseerde operationele winst met betrekking tot de productie en distributie functie als genoemd [in het transfer pricing report], vóór royalty uitgaven ("gerealiseerde operationele winst voor royalty uitgaven") en de hierboven omschreven beloning van [9-12] % cost-plus. Deze royalty betaling is aftrekbaar voor de vennootschapsbelasting en is niet onderworpen aan Nederlandse dividendbelasting.' For an explanation of why the royalty payment is not subject to tax in the Netherlands or in the UK, see recital 28 of the Opening Decision.

⁽¹⁴⁾ Recitals 27 and 28 of the Opening Decision provide a full description of the legal structure of Starbucks as presented in the transfer pricing report.

2.2.2.1. Starbucks Coffee BV

- (48) Starbucks Coffee BV functions as the Starbucks group's head office for the Europe Middle-East and Africa ('EMEA') region, supporting the group's EMEA business operations. Starbucks Coffee BV assists with identifying developers to develop and operate Starbucks retail stores in the EMEA territories. In its capacity as head office, Starbucks Coffee BV licenses certain Starbucks trademarks, technology and know-how ⁽¹⁵⁾ from its shareholder, Alki LP, in return for a royalty payment. Starbucks Coffee BV enters into what is referred to as an 'Area Development and Operation Agreement' (hereinafter: 'ADOA') with related and unrelated operators of Starbucks shops in the EMEA region. Those operators are called Developers, also referred to hereinafter as 'Shops'. Starbucks Coffee BV sublicenses intellectual property (hereinafter: 'IP') rights to the Developers to enable them to develop and operate their shops as Starbucks Shops. For the use of the IP, the Developers pay a royalty and other fees to Starbucks Coffee BV based on a percentage of turnover. According to the submission of the Netherlands of 2 October 2013, both related and unrelated Developers pay the same percentage of turnover as a royalty to Starbucks Coffee BV. Therefore, Starbucks' tax advisor considers that a comparable uncontrolled price method ⁽¹⁶⁾ is applied to determine the arm's-length price of intra-group royalty payments to the EMEA head office Starbucks Coffee BV ⁽¹⁷⁾.

2.2.2.2. SMBV

- (49) Starbucks' tax advisor, when presenting the most important transactions and inter-company flows for SMBV in the transfer pricing report ⁽¹⁸⁾, limits itself to describing that SMBV primarily processes green coffee and sells roasted coffee to affiliated and non-affiliated parties. It also explains that the green coffee beans sourced by SMBV are sourced from an affiliated Starbucks' subsidiary in Switzerland (SCTC). Furthermore, it explains that SMBV operates as an intermediary distribution entity for a variety of non-coffee items. In addition to the supply chain function for its own manufacturing activities, the tax advisor further explains that certain markets also receive some supply chain support from SMBV. The tax advisor does not describe the roasting IP licensing arrangement under which SMBV pays royalties to Alki LP for licensed IP among the most important transactions and inter-company flows, but only shows it in a graph and describes it in a separate section in the transfer pricing report describing the EMEA market and Netherlands operations ⁽¹⁹⁾.
- (50) According to the functional analysis provided in the transfer pricing report ⁽²⁰⁾, the focus of SMBV's activities is its Amsterdam-based roasting facility. The main raw material component of that roasting process is green coffee beans. The actual roasting process for a particular coffee blend depends on the particular type of green coffee bean used in the recipe and the desired flavour profile. SMBV is responsible for executing roasting forecasts provided by Starbucks US and ensuring that the resulting product meets the quality standards of Starbucks US. SMBV buys the green coffee beans from SCTC, a designated supplier ⁽²¹⁾. The beans for the EMEA market are roasted and packaged in the Netherlands by SMBV.
- (51) SMBV licenses a subset of IP from Alki LP, which is not mentioned in the functional analysis, but described in a separate section on the EMEA market and Netherlands operations as 'necessary to utilise the coffee roasting manufacturing process and the right to supply coffee to [D]evelopers. In return [SMBV] remits a royalty to Alki LP for the licensed IP' ⁽²²⁾. That coffee roasting related IP consists, in particular, of roasting curves, which according to the transfer pricing report dictates the temperature and the length of time required to complete the roasting process.

⁽¹⁵⁾ These trademarks, technology and know-how include mainly the Starbucks Shop format and the Starbucks corporate identity.

⁽¹⁶⁾ See recital 71 for a description of the CUP method.

⁽¹⁷⁾ This definition is based on paragraphs 2.13 until 2.20 of the 2010 OECD TP Guidelines. A (external) Comparable Uncontrolled Price is applied if independent third parties under the same circumstances pay the same price for the same product or service as related parties. In this case, the intra-group royalty payments concern the payments made by the EMEA Starbucks-owned Developers to Starbucks Coffee BV.

⁽¹⁸⁾ Section II.G of the transfer pricing report.

⁽¹⁹⁾ Section II.E of the transfer pricing report.

⁽²⁰⁾ Section III.B of the transfer pricing report.

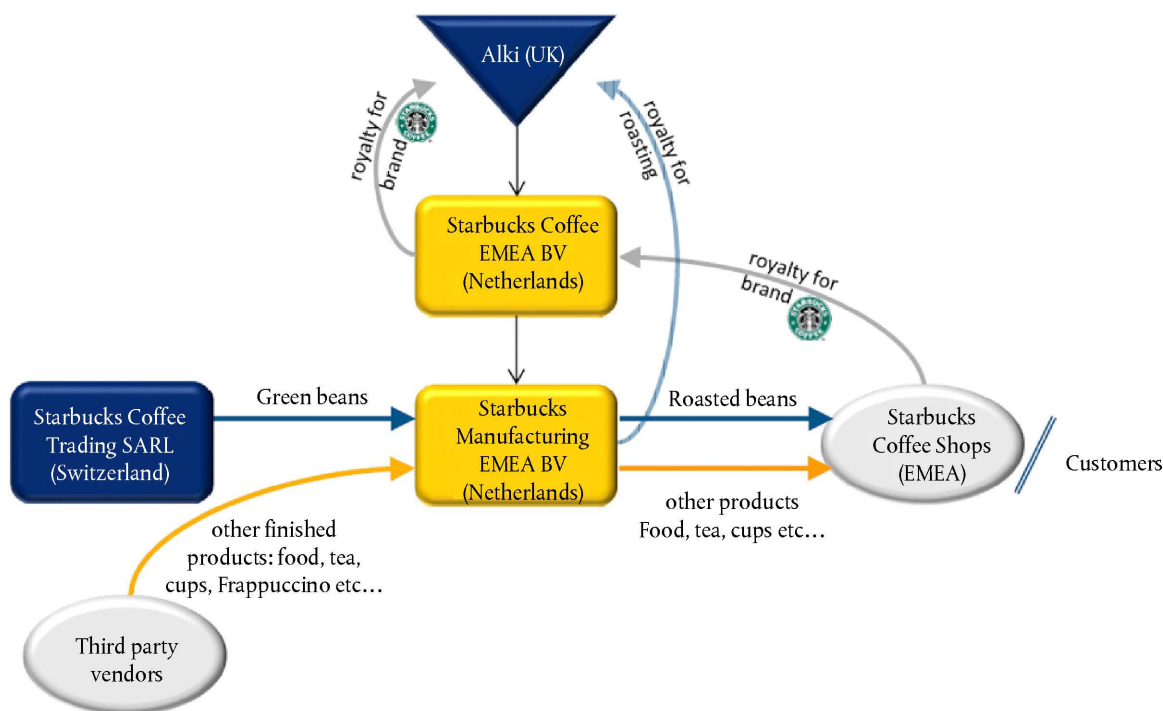
⁽²¹⁾ SCTC buys those beans for the benefit of the entire Starbucks group worldwide and its independent licensees.

⁽²²⁾ See footnote 19.

- (52) According to the transfer pricing report, SMBV employed [40-60] people, of which [20-30] perform supply chain operations including procurement, planning, logistics and distribution planning ⁽²³⁾. SMBV has a distribution centre in the United Kingdom (hereinafter: 'UK') operated under contract by a third party ⁽²⁴⁾. SMBV has a supply and logistics agreement with a third party in the Netherlands, whereby the third party purchases inventory for resale to developers at arranged prices ⁽²⁵⁾. SMBV also engaged another third party to open a distribution centre in Germany during 2006.
- (53) SMBV also has a relationship with a consignment manufacturer, [unaffiliated manufacturing company 1]. [Unaffiliated manufacturing company 1] mainly produces [a trademark registered coffee product] powder for the Starbucks [trademark registered coffee] product. SMBV is responsible ⁽²⁶⁾ for managing this toll manufacturing relationship ⁽²⁷⁾ and sells the majority of the product produced by [unaffiliated manufacturing company 1] to Starbucks' US resident companies.
- (54) Figure 1 is based on the description of the transfer pricing report to illustrate the part of the structure of Starbucks which is relevant for this Decision ⁽²⁸⁾.

Figure 1

Structure of Starbucks based on the description in the transfer pricing report



⁽²³⁾ In 2011, SMBV employed approximately [70-80] people. According to the observations of Starbucks to the Opening Decision [40-50] persons were active in coffee roasting and [30-40] persons in logistic and administrative services.

⁽²⁴⁾ According to information submitted by Starbucks to the Netherlands at the moment of the rulings request, SMBV and Starbucks Corporation entered into an agreement with [unaffiliated logistics company A] in 2003 under which [unaffiliated logistics company A] will provide inventory management services (supporting forecast provided by Starbucks), import coordination and export documentation services, vendor contracts administration and warehousing operations.

⁽²⁵⁾ According to information submitted by Starbucks to the Netherlands at the moment of the rulings request, SMBV entered into a supply chain and coffee operations warehousing services agreement with [unaffiliated logistics company B] in 2004 under which [unaffiliated logistics company B] will perform warehouse services with respect to various Starbucks products including administrative and handling services, vehicle loading and unloading, inspections and storage.

⁽²⁶⁾ According to the transfer pricing report, SMBV is responsible for the contractual relationship with [unaffiliated manufacturing company 1]. The contracts between [unaffiliated manufacturing company 1] and SMBV are however negotiated by Starbucks [...] according to Starbucks.

⁽²⁷⁾ Toll manufacturing is usually understood to mean an arrangement in which a company processes raw materials or semi-finished goods for another company.

⁽²⁸⁾ This graph is not contained in the report, it was produced by the Commission in order to facilitate the reading of this Decision.

- (55) According to the transfer pricing report, the transactional net margin method (hereinafter: 'TNMM' ⁽²⁹⁾) was selected by the tax advisor to estimate an arm's-length remuneration due to SMBV over other transfer pricing methods, because, '*in the specific set of Starbucks' circumstances; the net margin is less affected by transactional differences and functional differences, as in the case with measures employed in standard traditional methods*' ⁽³⁰⁾. For a more detailed description of the choice of the method and of the peer analysis in the transfer pricing report, see recitals 40 to 58 of the Opening Decision.
- (56) In applying the TNMM to SMBV's roasting activities, the tax advisor considered the relevant base ⁽³¹⁾ for the net profit indicator to be the costs of the services rendered by SMBV, in line with the cost plus method, which is considered an appropriate methodology for supply chain and manufacturing services. However, the mark-up is only applied to those costs where, according to the tax advisor, SMBV adds value. The transfer pricing report lists those costs as main operating costs, such as cost of personnel and depreciation, excluding COGS.
- (57) To determine the appropriate arm's-length range of profitability for the activities performed by SMBV, the tax advisor conducted a search to identify companies operating in Europe with similar functions and risks. A comparable companies search in the Amadeus database ⁽³²⁾ using the primary NACE Rev 1.1 code 1586 — Processing of tea and coffee to identify companies engaged in the trade of coffee (the buying and selling of coffee not processed by the company itself were not deemed comparable) followed by elimination through the use of additional financial selection criteria and a manual screening by the tax advisor ⁽³³⁾, ultimately resulted in 20 companies as potentially comparable ⁽³⁴⁾.
- (58) The net profit indicator calculated for each company was a mark-up on total costs, which is defined as operating profit divided by total operating costs. The median of the unadjusted mark-up on total costs for those companies from 2001 to 2005 was estimated at 7,8 %.
- (59) However, according to the tax advisor, this set of comparable companies includes full-fledged manufacturers that typically perform more functions and incur risk relating to their raw materials. To correct for this difference and to allegedly increase the reliability of the comparison, the tax advisor performed a first adjustment to account for the fact that the proposed application of the mark-up to SMBV's cost-base does not include a cost component for green coffee beans.
- (60) Additionally, the comparable companies' returns would, according to the tax advisor, reflect a return on a cost base that includes such raw materials. Therefore, a raw materials cost adjustment was applied by the tax advisor to modify the total cost mark-up ⁽³⁵⁾ obtained from the comparable companies set. The tax advisor indicated that this adjustment is associated with what the tax advisor refers to as 'taking title to the raw materials'. Concretely, the tax advisor subtracted from the profit of each company in the set their estimated price of raw material multiplied by 12-month EURIBOR plus 50 basis points.

⁽²⁹⁾ See recital 72 for a description of the TNMM.

⁽³⁰⁾ Transactional differences refers to differences between the transactions concluded by the company for which the taxable basis is approximated through a transfer pricing method and the transactions concluded between independent companies used to determine the arm's length pricing. In the TNMM method this refers to the transactions concluded by comparable companies used to approximate an arm's length margin. Functional differences refers to differences between the functions performed by the company of which the taxable basis is approximated by a transfer pricing method and the functions performed by comparable companies used to approximate an arm's length margin.

⁽³¹⁾ The report refers in this context to paragraph 3.26 of the 1995 OECD TP Guidelines.

⁽³²⁾ The Amadeus Database is a database of comparable financial information for public and private companies across Europe. It is maintained by Bureau van Dijk, a publisher of company information and business intelligence.

⁽³³⁾ Automated searches in Amadeus resulted in a selection of 240 companies; additional financial selection criteria applied by the tax advisor eliminated 88 companies, reducing the sample to 152 potentially comparable companies.

⁽³⁴⁾ The main elimination criteria were that the companies were engaged in unrelated functions (i.e. distribution, repair, etc.), producing unrelated products (i.e. candies, other food products, etc.) or that the companies belonged to a group. The 20 companies accepted for comparison purposes in the transfer pricing report are presented in appendices to that report and reproduced in Table 5 of the Opening Decision.

⁽³⁵⁾ The tax advisor uses the term mark-up although the calculation of the mark-up is based on the operating profit of the comparable companies divided by a cost basis and not on gross profit.

- (61) The combination of those two adjustments lowered the estimated remuneration from a median of 7,8 % on total costs to an estimated median of 9,9 % on operating costs ⁽³⁶⁾. A (rounded) mark-up of [9-12] % of operating costs was considered on that basis to reflect an arm's-length mark-up for the provision of roasting services and associated supply chain activities by SMBV for its intra-group transactions.

2.3. Description of OECD guidance on transfer pricing

- (62) The Organisation for Economic Cooperation and Development (hereinafter the 'OECD') OECD provides guidance on taxation for its member countries. The OECD's guidance on transfer pricing can be found in its Transfer Pricing Guidelines (hereinafter the 'OECD TP Guidelines'), which is a non-binding legal instrument providing guidance on transfer prices.
- (63) Transfer prices refer to prices charged for commercial transactions between various parts of the same corporate group. Multinational companies have a financial incentive to allocate as little profit as possible to jurisdictions where those profits are subject to higher taxation. This could lead to exaggerated transfer prices which should not be accepted as a basis for calculating taxable income. To avoid this problem, tax administrations should only accept transfer prices between intra-group companies that are remunerated as if they were agreed to by independent companies negotiating under comparable circumstances at arm's length ⁽³⁷⁾. This is known as the 'arm's-length principle'.
- (64) The authoritative statement of the arm's-length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides: '[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'.
- (65) On 27 June 1995, the OECD's Committee on Fiscal Affairs adopted transfer pricing guidelines (hereinafter: the '1995 OECD TP Guidelines' ⁽³⁸⁾) which were the object of a Recommendation of the OECD Council ⁽³⁹⁾. The latest version of the OECD TP Guidelines was adopted in July 2010 (hereinafter the '2010 OECD TP Guidelines') ⁽⁴⁰⁾.
- (66) Given their non-binding nature, the tax administrations of the OECD member countries are simply encouraged to follow the Guidelines. However, in general, the OECD TP Guidelines serve as a focal point and exert a clear influence on the tax practices of OECD member (and even non-member) countries. Moreover, in numerous OECD member countries those Guidelines have been given the force of law or serve as a reference for the purpose of interpreting domestic tax law. To the extent the Commission cites the OECD TP Guidelines in the present Decision, it does so because those guidelines are an existing manual in the area of transfer pricing that are the result of expert discussions in the context of the OECD and elaborate on techniques aimed to address common challenges of the application of the arm's-length principle to concrete situations. The OECD TP Guidelines therefore provide useful guidance to tax administrations and multinational enterprises on the application of the arm's-length principle. They also capture the international consensus on transfer pricing.

2.3.1. Transfer pricing methods

- (67) Both the 1995 and the 2010 OECD TP Guidelines describe five methods to approximate an arm's-length pricing of transactions and profit allocation between companies of the same corporate group: (i) the comparable uncontrolled price method (hereinafter 'CUP'); (ii) the cost plus method; (iii) the resale minus method; (iv) the TNMM and (v) the transactional profit split method. Both Guidelines also draw a distinction between traditional

⁽³⁶⁾ In the case of SMBV, the operating costs represent a small fraction of the total costs. Therefore, although the percentage of mark-up applied is higher, the resulting estimate of tax base is lower.

⁽³⁷⁾ Tax administrations and legislators are aware of this problem and tax legislation generally allows the tax administration to correct tax declarations of integrated companies that incorrectly apply transfer prices, by substituting prices which correspond to a reliable approximation of those agreed to by independent companies negotiating under comparable circumstances at arm's length.

⁽³⁸⁾ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 13 July 1995.

⁽³⁹⁾ Recommendation C(95)126/FINAL of 13 July 1995.

⁽⁴⁰⁾ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 22 July 2010.

transaction methods (the first three methods) and transactional profit methods (the last two methods). Both Guidelines further explain that multinational corporations retain the freedom to apply methods not described in those Guidelines to establish transfer prices, provided those prices satisfy the arm's-length principle.

- (68) The 1995 OECD TP Guidelines declare an express preference for traditional transaction methods, such as the CUP, over transactional methods, such as the TNMM, as a means to establish whether transfer pricing is at arm's length. Paragraph 3.49 of the 1995 OECD TP Guidelines provides: 'Traditional transaction methods are to be preferred over transactional profit methods as a means of establishing whether a transfer price is at arm's length, i.e. whether there is a special condition affecting the level of profits between associated enterprises. To date, practical experience has shown that in the majority of cases, it is possible to apply traditional transaction methods.'
- (69) In this regard, paragraph 2.3 of the 2010 OECD TP Guidelines provides: 'As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method.'
- (70) The CUP and the TNMM are relevant for the present Decision and are therefore described in more detail in recitals 71 to 75.
- (71) The CUP method compares the price charged for the transfer of property or services in a controlled transaction (i.e. a transaction between two enterprises that are associated enterprises with respect to each other) to the price charged for the transfer of property or services in a comparable uncontrolled transaction (i.e. a transaction between enterprises that are independent enterprises with respect to each other), conducted under comparable circumstances.
- (72) The TNMM is one of the 'indirect methods' to approximate an arm's-length pricing of transactions and profit allocation between companies of the same corporate group. It approximates what would be an arm's-length profit for an entire activity, rather than for identified transactions. It does not seek to establish the price of goods sold, but estimates the profits independent companies could be expected to make on an activity, such as the activity of selling goods. It does this by taking an appropriate base ('a profit level indicator'), such as costs, turnover or fixed investment, and applying a profit ratio reflecting that observed in comparable uncontrolled transactions to that base.
- (73) Because the TNMM does not set a price for individual transactions, the taxable profit of an entity estimated using the TNMM might not have a direct effect on the taxable profit of another entity of the same corporate group. The method is therefore different to using, for example, the CUP method, where transfer pricing establishes the price of a specific good or service which is then recorded in the taxable profit for the same amount by the group company selling and the group company buying the particular good or service.
- (74) The use of the TNMM is often associated with paragraph 3.18 of the 2010 OECD TP Guidelines, according to which the 'tested party', i.e. the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested, should, in principle, be the company which has the less complex function. In detail, paragraph 3.18 of the 2010 OECD TP Guidelines provides for the following recommendation: 'When applying a cost plus, resale price or transactional net margin method as described in Chapter II, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis' ⁽⁴¹⁾.
- (75) That paragraph of the 2010 OECD TP Guidelines is often interpreted by tax advisors in situations of transactions between two related companies as allowing to estimate the arm's-length profitability of only one of them, i.e. the less complex one, and attributing any other profit observed in the accounts to the second company, which is

⁽⁴¹⁾ For the 1995 OECD TP Guidelines, see paragraph 3.43, which contains a comparable description.

considered more complex. This is done regardless of whether the company considered as more complex earns an arm's-length remuneration as a result of the transactions between it and the less complex company, and regardless of the fact that the 2010 OECD TP Guidelines themselves do not seem to lift the requirement for resulting transactions to be priced at arm's length when paragraph 3.18 of the 2010 OECD TP Guidelines is relied upon.

2.3.2. Arm's-length range

- (76) The OECD TP Guidelines describe as an acceptable arm's-length outcome from a comparison analysis a range of outcomes rather than one specific outcome ⁽⁴²⁾. In practice, what tax advisors refer to as a 'range' is the interquartile range. Quartiles in a series of data are three points which divide the figures in the set ranked from smallest to largest into three equally populated sets, that is 25 % of the data is in the 25th percentile (also called lower quartile), 50 % of the data is below or equal to the second quartile, which is the median of the set, and 75 % of the data is below or equal to the 75th percentile (also called upper quartile). Such an interquartile range is mentioned in paragraph 3.57 of the 2010 OECD TP Guidelines for situations where comparability defects cannot be fully addressed. According to the 2010 OECD TP Guidelines, in such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis. In practice, tax advisors often consider that any outcome within an interquartile range is acceptable and equally correct.
- (77) Furthermore, when making adjustments to pricing by the taxpayer that is outside a correct range, the tax administration in presence of comparability defects should according to paragraph 3.62 of the 2010 OECD TP Guidelines ⁽⁴³⁾ rely on measures of central tendency (for instance the median, the mean or weighted averages, etc.) to determine the appropriate point in the range.

2.4. Description of main accounting and financial terms used in the transfer pricing analysis

- (78) The transfer pricing analysis in the transfer pricing report included in the SMBV APA request contains a number of accounting concepts and financial profit indicators. A brief overview of financial indicators and accounting concepts frequently used in transfer pricing assessment and relevant for the present case are explained below.

2.4.1. Main profit and loss accounting items (non-financial company)

- (79) A typical profit and loss account first records the income that a company receives from its normal business activities, usually from the sale of goods and services to customers. This accounting item is referred to as 'Sales' or 'Turnover' or 'Revenue'.
- (80) Cost of goods sold (hereinafter: 'COGS') represents mainly the value of material used for the production of goods (raw materials) or the purchase price of goods that have been resold if the company does not process the goods sold. COGS is deducted from sales to calculate gross profit.
- (81) Operating expenses covers principally salary expenses ⁽⁴⁴⁾, energy expenses and other administrative and sales expenses. In the case of SMBV, the royalty paid to Alki LP is classified as an operating expense, but it is excluded from the operating expenses used to calculate the taxable income according to the SMBV APA ⁽⁴⁵⁾.
- (82) Table 1 provides a simplified overview of a profit and loss account ⁽⁴⁶⁾.

⁽⁴²⁾ Paragraphs 1.45 to 1.48 of the 1995 OECD TP Guidelines and paragraphs 3.55 to 3.62 of the 2010 OECD TP Guidelines.

⁽⁴³⁾ Paragraph 1.48 of the 1995 OECD TP Guidelines.

⁽⁴⁴⁾ For completeness it is noted that a portion of the labour costs can be included in COGS, when it is directly associated with the production.

⁽⁴⁵⁾ See recital 56 of the Opening Decision.

⁽⁴⁶⁾ In Table 1, EBITDA stands for the conventional acronym of 'earnings before interest, taxes, depreciation and amortisation' and EBT stands for the conventional acronym of 'earnings before tax'.

Table 1

Simplified profit and loss account

Sales (or Turnover or Revenue)

— Cost of goods sold (COGS)

Gross Profit

— Operating Expense (OpEx)

Operating profit (EBITDA)

— Interest and depreciation

Taxable income (EBT)

— Tax

Net profit

2.4.2. Profit margins

- (83) Performance and profitability is often measured using ratios presented as ‘margins’ or ‘mark-ups’. Margins are also used in peer comparisons in transfer pricing.
- (84) Some margins are conventionally defined. This is the case for gross margins, which are in principle defined as gross profits divided by sales, and for net margins defined in principle as the net profits divided by sales. Net profit margins used in transfer pricing analyses will often use as a starting point (nominator) the taxable income, rather than the net profits, in particular when using the TNMM, which serves to approximate the taxable income of a tested party.

2.5. Description of the Dutch rules on arm’s-length pricing

2.5.1. Article 8b of the corporate income tax 1969

- (85) The SMBV APA was concluded on the basis of Article 8b(1) of the Dutch Corporation Tax Act 1969 (*Wet op de Vennootschapsbelasting 1969*) (hereinafter ‘CIT’).
- (86) Article 8b(1) CIT, which was inserted in the CIT in 2002, lays down the arm’s-length principle in the domestic tax law of the Netherlands and reads as follow: ‘Where an entity participates, directly or indirectly, in the management, control or capital of another entity, and conditions are made or imposed between these entities in their commercial and financial relations (transfer prices) which differ from conditions which would be made between independent parties, the profit of these entities will be determined as if the last mentioned conditions were made’.

2.5.2. Dutch Transfer Pricing Decree 2001

- (87) Guidance as to how the Dutch tax administration interprets the arm’s-length principle laid down in Article 8b(1) CIT is provided in the Dutch Transfer Pricing Decree of 30 March 2001 (hereinafter ‘the Decree’) ⁽⁴⁷⁾. The preamble to the Decree states the following: ‘[...] The policy of the Netherlands on the arm’s-length principle in the field of international tax law is that this principle forms an integral part of the Netherlands’ system of tax law as a result of its incorporation in the broad definition of income recorded in Section 3.8 of the Income Tax Act 2001’ ⁽⁴⁸⁾. In principle, this means that the OECD Guidelines apply directly to the Netherlands under Section 3.8 of the Income Tax Act 2001. There are a number of areas in which the OECD Guidelines provide scope for

⁽⁴⁷⁾ Transfer Pricing Decree 2001 (*Besluit verrekenprijzen*) of 30 March 2001, IFZ2001/295M. The Decree was replaced in 2013 (together with the Decree of 21 August 2004, IFZ 2004/680M which Decree supplemented the 2001 Decree and amended it with respect to certain points. However, the 2004 Decree is not relevant in this case) by the Decree of 14 November 2013, IFZ 2013/184M, International Tax Law. Transfer pricing method, application of the arm’s length principle and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. As the ruling dates from 2007, the Decision will refer to the 2001 Transfer Pricing Decree.

⁽⁴⁸⁾ As in 2001 article 8b was not yet codified in the CIT, transfer pricing adjustments, both for personal as for corporate income tax purposes, were made based on Article 3.8 of the Income Tax Act 2001 (which through article 8 CIT also applied to corporate taxpayers).

individual interpretation by the member countries. In a number of other areas, practical experience has shown that the OECD Guidelines are in need of clarification. This decree explains the Netherlands' position in relation to these particular points and seeks, where possible, to remove any confusion'.

- (88) With regard to the use of a range, the Decree determines under Chapter 1.2: 'In some cases it will be possible to apply the arm's-length principle and arrive at one single figure that is the most reliable to determine the arm's-length character of the transfer prices. Because, however, transfer pricing is not an exact science, a particular transfer pricing method will often generate a range of figures all of which are equally reliable'.
- (89) With regard to the transfer pricing methods, under Chapter 2, the Decree states the following: 'Chapter II of the OECD Guidelines discusses the three traditional transaction methods introduced in Paragraphs 1.68 to 1.70 (i.e. the comparable uncontrolled price method, the resale price method and the cost-plus method), whilst Chapter III examines the methods known as the transactional profit methods (i.e. the profit-split method and the transactional net margin method or TNMM). Depending on the circumstances, a choice of one of these five accepted methods has to be made. The methods can supplement each other. The OECD Guidelines are based on a certain hierarchy of the methods where a preference exists for the traditional transaction methods. On the one hand, transactional profit methods are considered more or less as methods of last resort. On the other hand, the OECD Guidelines state that the tax authorities need to start a transfer pricing audit from the perspective of the method chosen by the taxpayer (see Paragraph 4.9 of the OECD Guidelines).

In accordance with Paragraph 4.9 of the OECD Guidelines, whenever the Netherlands' tax administration undertakes a transfer pricing audit, it should start from the perspective of the method adopted by the taxpayer at the time of the transaction. This complies with Paragraph 1.68 of the OECD Guidelines. The implication is that taxpayers are in principle free to choose a transfer pricing method, provided that the method adopted leads to an arm's-length outcome for the transaction in question. In certain situations, however, some methods will generate better results than others. Although taxpayers may be expected to base their choice of a transfer pricing method on the reliability of the method for the particular situation, taxpayers are definitely not expected to weigh up the advantages and disadvantages of all of the various methods and then explain why the method that was ultimately adopted generates the best results in the prevailing conditions (i.e. the best method rule). Certain situations are also suited for a combination of methods. At the same time, taxpayers are not obliged to use more than one method. The only obligation resting on the taxpayer is to explain why the decision was taken to adopt the particular method that was adopted.'

- (90) Under Chapter 2.1 of the Decree, the CUP method is described. With regard to the preference for the use of this method, the Decree states: '(...) If a comparable price is available, the comparable uncontrolled price method (commonly known as the CUP method) will, in general, be the most direct and the most reliable method in determining the transfer price, so that this method is to be preferred over other methods'.

2.6. Additional information received after the opening of the formal investigation procedure from Starbucks and the Netherlands

- (91) The Netherlands and Starbucks provided complementary information and figures regarding SMBV, Alki LP, the Starbucks Shops and SCTC.

2.6.1. Information on the activities and risks of SMBV

- (92) In the transfer pricing report, SMBV is presented as a low risk manufacturer. The Commission requested information to verify whether the main activity of SMBV was indeed low-risk manufacturing, which in this case would be the roasting of coffee. The Commission also requested information about the structure of SMBV's costs to verify whether the underlying activities generating those costs confirm that the tasks performed by SMBV are indeed routine execution tasks and do not present any degree of complexity, in line with the assumptions in the transfer pricing report. Information on the degree of business risk assumed by SMBV is presented in different sections, where contracts are described.
- (93) In order to analyse what products are the main drivers of SMBV's sales and to verify whether coffee roasting is indeed the main economic activity of SMBV, the Commission requested the breakdown of SMBV's sales by product. Starbucks provided the amounts received from the Shops for the coffee beans (highlighted in Table 2) and separately the amounts of any other payments from the Shops for other activities such as sale of cups, presented in Table 2.

Table 2

Revenues of SMBV by category of products sold

Description	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
REV PASTRY/BAKERY	—	—	[700-800 thousand]	[1-10 million]	[1-10 million]	[20-30 million]	[20-30 million]	[20-30 million]
REV PREPARED FOOD	—	—	—	—	[1-10 million]	[10-20 million]	[10-20 million]	[20-30 million]
REV READY TO DRINK	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[10-20 million]	[10-20 million]
REV PKGD FOOD	[10-20 million]	[10-20 million]	[1-10 million]	[1-10 million]	[1-10 million]	[20-30 million]	[20-30 million]	[20-30 million]
REV PACKAGED COFFEE	[20-30 million]	[20-30 million]	[20-30 million]	[20-30 million]	[40-50 million]	[50-60 million]	[50-60 million]	[60-70 million]
REV SINGLE SERVE PODS-COFFEE	—	—	—	—	—	[1-10 million]	—	[(1-10 thousand)]
REV SINGLE SERVE PODS-VER-ISMO	—	—	—	—	—	[1-10 million]	[10-20 million]	[10-20 million]
REV SOLUBLE COFFEE	—	—	[200-300 thousand]	[1-10 million]	[1-10 million]	[1-10 million]	[10-20 million]	[10-20 million]
REV PACKAGED TEA	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]
REV SERVEWARE	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[10-20 million]	[10-20 million]
REV BREWING EQUIPMENT	[900 thousand-1 mln]	[1-10 million]	[700-800 thousand]	[500-600 thousand]	[600-700 thousand]	[700-800 thousand]	[800-900 thousand]	[600-700 thousand]
REV BREWING EQUIPMENT-VER-ISMO	—	—	—	—	—	[20-30 thousand]	[1-10 million]	[800-900 thousand]
REV TANGIBLE MEDIA	[(1-10 thousand)]	[300-400 thousand]	[200-300 thousand]	[80-90 thousand]	[100-200 thousand]	[100-200 thousand]	[1-10 thousand]	—
REV GIFTPACKS	[100-200 thousand]	[100-200 thousand]	[50-60 thousand]	[1-10 thousand]	—	—	—	—
REV GAMES & TOYS	—	—	[200-300 thousand]	[300-400 thousand]	[100-200 thousand]	[100-200 thousand]	[100-200 thousand]	[30-40 thousand]
REV MISC MERCHANDISE	—	—	[(100-200)]	[400-500]	[1-10 thousand]	[30-40 thousand]	[500-600 thousand]	[500-600 thousand]
REV RAW MATERIALS	—	—	[100-200 thousand]	[1-10 million]	[100-200 thousand]	[200-300 thousand]	[1-10 thousand]	[30-40 thousand]

Description	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
REV PAPER PACKAGING	[10-20 million]	[10-20 million]	[10-20 million]	[10-20 million]	[20-30 million]	[20-30 million]	[20-30 million]	[20-30 million]
REV BLENDED BEVG MIX	[40-50 million]	[40-50 million]	[50-60 million]	[50-60 million]	[40-50 million]	[50-60 million]	[50-60 million]	[60-70 million]
REV FRAP COFFEE BASE	—	—	—	—	[20-30 million]	[30-40 million]	[20-30 million]	[20-30 million]
REV EXTRACT	—	—	—	—	[1-10 million]	[10-20 million]	[10-20 million]	[10-20 million]
REV EQUIPMENT	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[10-20 million]	[20-30 million]
REV SHIPPING	[40-50 thousand]	[30-40 thousand]	[70-80 thousand]	[300-400 thousand]	[300-400 thousand]	[200-300 thousand]	[1-10 million]	[1-10 million]
REV ROYALTIES	—	—	—	—	—	—	—	—
REV MANAGEMENT SERVICE FEE	[1-10 million]	[1-10 million]	[1-10 million]	[800-900 thousand]	[900 thousand-1 mln]	[600-700 thousand]	—	—
REV OTHER REV	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]
SALES DISC	([100-200 thousand])	[80-90 thousand]	([1-10 thousand])	([200-300 thousand])	([500-600 thousand])	([600-700 thousand])	([1-10 million])	([100-200 thousand])
TRADE DISCOUNTS-DIRECT TO MARKET	—	—	—	—	—	([30-40 thousand])	([10-20 thousand])	([1-10 million])
DIRECT TO MARKET COUPON DISCOUNTS	—	—	—	—	—	—	—	([20-30 thousand])
DIRECT TO MARKET SLOTTING COSTS	—	—	—	—	—	—	([20-30 thousand])	([200-300 thousand])
UNSALEABLE RETURNS AND ALLOWANCE	—	—	—	—	—	—	—	([20-30 thousand])
SALES RETURNS/ALLOWANCES	—	—	—	—	—	([1-10 thousand])	([10-20 thousand])	([90-100 thousand])
Rounding	0	(0)	(0)	0	(0)	0	(0)	(0)
Revenues as per Statutory Accounts	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]	[200-300 million]	[300-400 million]	[300-400 million]

- (94) Starbucks indicated that the revenues under the description 'REV PACKAGED COFFEE' in Table 2 relate to SMBV's roasting and packaging function. The remainder of the revenues relate, according to Starbucks, to SMBV's administrative and logistics support function. A small portion of the coffee roasted in the Netherlands is further processed by third-party manufacturers. It concerns: 'REV SINGLE SERVE PODS-COFFEE', 'REV SINGLE SERVE PODS-VERISMO', 'REV SOLUBLE COFFEE', 'REV FRAP COFFEE BASE' and 'REV EXTRACT'. Those revenues should also be classified as administrative and logistics support revenue, as the underlying revenue invoiced to Developers represents the value created by third parties rather than SMBV. In any case, according to Starbucks, those revenues represent only a small portion of the total roasting output of SMBV.
- (95) Regarding the pricing of products, Starbucks provided [...] price list examples for different quarters in 2013 and 2014 that provide prices for coffee and non-coffee products sold by Starbucks. According to Starbucks, [...].
- (96) Regarding the pricing of coffee products, the prices are calculated on the basis of formulas referring to costs and they vary per product. Starbucks provided, as an illustration, the cost build up formula for the item '[certification programme coffee product e]' which is the highest volume item sold by SMBV. The coffee prices charged to Shops by SMBV are calculated based on the costs that SCTC pays for green coffee beans, to which cost [...] of coffee acquisition and coffee [...] are added. To this amount, '[...]' costs are added for [...], as well as a [...] summing up to the roasted coffee price. Finally a licensing fee paid to a third party is paid relating to the [certification programme] designation ⁽⁴⁹⁾.
- (97) Regarding the prices of non-coffee products sold to Shops by SMBV, Starbucks indicated that the prices of the non-coffee products delivered by SMBV to Shops are determined by adding a so-called [cost recovery margin] to the purchase price of the non-coffee products. That [cost recovery margin] is charged by SMBV to recover the [...] expenses. However, it covers not only the [...] expenses of SMBV, but also all the relevant [...] costs of the [...]. In fact, as the final prices for non-coffee products charged by SMBV to Shops are calculated by applying the [cost recovery margin] to the product costs, the profit on non-coffee products that SMBV records corresponds to this [cost recovery margin].
- (98) The most important expense item of SBMV is salary expense, which amounted to EUR [1-10 million] in 2014 out of a total operating expense of EUR 16 124 000 that year. Other large operating expense items of SBMV in 2014 were wage related expenses, payroll tax, property rents and lease payments, equipment depreciation and intangibles amortisation. Although prior to 2013 SBMV did not have intangibles amortisation expenses, it was one of the largest operating expense items in 2014, amounting to EUR 628 000, which was a larger expense in that year than equipment repair and maintenance, electricity, bad debt, office and computer supplies and others (for example software licence expenses, which are recorded as a separate item). The intangible amortisation expense seems to relate to an IP right first recorded in the financial accounts in 2012, which would have been acquired for more than EUR 4 million. Additionally, in 2014, a large operating expense item was represented by 'Market research' amounting to EUR [100-200 thousand] that year.

2.6.2. Royalty payments

- (99) The taxable profits of SBMV in the Netherlands, which are determined based on the SBMV APA in reference to the operating expense of the company, are reduced by a royalty paid to Alki LP. The Commission requested further information from the Netherlands and Starbucks on the amount of the royalty payment and the exact calculation of the tax base.
- (100) SBMV's profit and loss account as presented in its financial statements are reproduced in Table 3.

⁽⁴⁹⁾ For example, at the end of [...] this fee represented [1,5-2] % of the price SCTC expected to pay for the purchase of green coffee beans and [0,5-1] % of the price charged to the [...] by SBMV. The [certification programme] designation was used and paid for by Starbucks since [...].

Table 3

SMBV's profit and loss accounts 2001-2014

(EUR)

	2001/2002	2002/2003	2003/2004	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Sales	14 067 934	51 700 060	63 950 312	83 240 391	108 855 325	118 663 171	128 784 681	135 677 607	142 627 243	184 159 097	286 217 379	327 632 453	350 538 852
Direct Cost of sales	(15 398 686)	(41 799 345)	(50 148 768)	(68 349 376)	(85 467 406)	(98 615 765)	(108 107 101)	(115 352 332)	(120 020 824)	(153 275 834)	(252 500 829)	(286 969 488)	(305 831 016)
<i>thereof green beans (*)</i>	[0-10 mil-lion]	[10-20 mil-lion]	[10-20 mil-lion]	[10-20 mil-lion]	[10-20 mil-lion]	[20-30 mil-lion]	[20-30 mil-lion]	[20-30 mil-lion]	[30-40 mil-lion]	[40-50 mil-lion]	[60-70 mil-lion]	[60-70 mil-lion]	[60-70 mil-lion]
Gross Margin	(1 330 752)	9 900 715	13 801 544	14 891 015	23 387 919	20 047 406	20 677 580	20 325 275	22 606 419	30 883 263	33 716 550	40 662 965	44 707 836
General and administrative expenses	(3 150 256)	(8 474 279)	(8 997 548)	(5 086 145)	(7 303 608)	(10 158 687)	(15 221 123)	(16 742 108)	(16 835 153)	(14 303 059)	(17 469 758)	(16 626 967)	(16 124 052)
Foreign currency exchange	219 905	33 743	5 102	24 784	(388 855)	(166 915)	(467 072)	1 849 067	(2 266 492)	(2 089 448)	(8 162 650)	709 539	(2 272 582)
Other expenses (see Note)	4 744 084	526 555	(2 165 152)	(6 336 360)	(11 594 191)	(4 699 336)	(1 698 150)	(2 470 449)	(1 079 817)	(12 352 838)	(5 786 211)	(22 812 962)	(24 285 088)
EBIT	482 981	1 986 734	2 643 946	3 493 294	4 101 265	5 022 468	3 291 235	2 961 785	2 424 957	2 137 918	2 297 931	1 932 575	2 026 114
Interest income	17 328	34 576	27 668	51 766	167 195	248 997	304 939	86 995	45 402	30 073	18 763	14 200	76 209
Interest expense	0	(803 856)	(1 263 915)	(1 272 114)	(817 041)	(2 356 989)	(2 097 056)	(1 345 779)	(817 041)	(737 371)	(735 233)	(411 315)	(434 454)
Result before taxation	500 309	1 217 454	1 407 699	2 272 946	2 763 349	2 914 476	1 499 118	1 703 001	1 653 318	1 430 620	1 581 461	1 535 460	1 667 869
Corporate income tax	(171 805)	(418 774)	(484 408)	(733 370)	(783 194)	(844 309)	(383 909)	(427 159)	(428 611)	(337 599)	(395 365)	(391 220)	(575 812)
Net result for the year	328 504	798 680	923 291	1 539 576	1 980 155	2 070 167	1 115 209	1 275 842	1 224 707	1 093 021	1 186 096	1 144 240	1 092 057

(*) Additionally provided, see Table 8.

- (101) Under the notes to the financial statements, the position 'Other expenses' in Table 3 is defined as follows: 'Other expenses relate to a royalty agreement held with the affiliated company [CV 1], which was assigned to Alki LP on December 13, 2006 and is based on a tax ruling with the Dutch tax authorities'. The APA to which this footnote relates is the SMBV APA and thus indicates that SMBV's auditor interpreted the SMBV APA to determine the royalty payments by SMBV to Alki LP.
- (102) That royalty is calculated as a residual in the profit and loss account. When constructing the profit and loss account of SMBV, all the input figures other than the royalty are either observed or assumed to be priced at arm's length. Based on the pricing agreed in the SMBV APA, a taxable profit (the position 'Result before taxation' in Figure 2) is calculated at approximately [9-12] % of SMBV's operating expenses (the position 'General and administrative expenses' in Figure 2). However, as the position 'Sales' in Figure 2 minus all the accounting costs before the royalty payment ⁽⁵⁰⁾ do not sum up to this taxable profit calculated based on the SMBV APA, the excess profit beyond that [9-12] % mark-up is paid by SMBV in the form of a tax deductible royalty to Alki LP for the coffee roasting related IP (the position 'Other expenses' in Figure 2). Based on SMBV's accounts, the royalty payment thus takes place as determined by the SMBV APA issued by the Dutch tax administration.

Figure 2

	2010/2011 EUR	2019/2010 EUR
Sales	184 159 097	142 627 243
Direct Cost of sales	(153 275 834)	(120 020 824)
Gross margin	30 883 263	22 606 419
General and administrative expenses		
Foreign current exchange		
Operating result	14 490 756	3 504 774
Other expenses = Royalty	(12 352 838)	(1 079 817)
Interest income		
Interest expense	(707 298)	(771 639)
Result before taxation	1 430 620	1 653 318
Corporate income tax	(337 599)	(428 611)
Net result for the year	1 093 021	1 224 707

- (103) As the tax base in SMBV's accounts for the period of application of the SMBV APA is equal to but not exactly [9-12] % of each year's 'General and administrative expense', the Commission requested Starbucks to provide the actual costs for each year used to calculate the tax base. Starbucks provided information on the amount of operating expenses used to calculate the taxable income each year on the basis of the SMBV APA and also for the previous accounting periods (since 2001), when a previous APA was in force. For each period of the application of the SMBV APA, the costs taken into account for the calculation of the tax base are lower but close to the amounts reported as 'General and administrative expense'. For example, for the period 2012/2013 those costs are EUR 15 694 137 and for the period 2007/2008 those costs are EUR 15 055 253. In the periods preceding the application of the SMBV APA, the costs taken into account for the calculation of the tax base are much higher, as they would, according to Starbucks, also include the costs charged by [unaffiliated manufacturing company 1].

⁽⁵⁰⁾ In detail, the pre-tax profit before the royalty payment is equal to 'Sales' minus 'Direct Costs of Sales' (which represent the costs of raw material consumed in the production process), minus 'General and Administrative expenses', minus 'Foreign currency exchange', plus 'Interest income', minus 'Interest expense' in Figure 2. For example, for the year 2010/2011, the pre-tax profit before payment of royalty would be equal to EUR 13 783 458. In order to lower the pre-tax to the level agreed in the SMBV APA of around [9-12] % of agreed costs, a tax-deductible royalty of EUR 12 352 838 is paid out to Alki LP, as recorded in the position 'Other expenses'.

For example, for the period 2006/2007, the costs used to calculate the tax base were EUR [30-40 million]. This explains why the corporate tax liability decreased by more than half when the SMBV APA entered into force ⁽⁵¹⁾, i.e. from EUR 844 309 in 2006/2007 to EUR 383 909 in 2007/2008, as shown in Table 3.

2.6.3. Information on Alki LP

- (104) In response to the questions of the Opening Decision, the Netherlands provided a description of the licence rights held by Alki LP to use and sublicense the IP right for which SMBV pays a royalty to Alki LP. In this regard, the Netherlands explained that the IP right includes three categories: (i) trade mark rights ⁽⁵²⁾; (ii) Starbucks system rights ⁽⁵³⁾; and (iii) coffee-related rights ⁽⁵⁴⁾. The Netherlands further explained that the knowledge and information relating to coffee includes the use and applications of confidential information, technology and specific knowledge with regard to the recipes for mixing green coffee beans, the process of roasting green coffee beans and the production of other derived coffee products ⁽⁵⁵⁾.
- (105) The Netherlands further explained that under the Roasting Agreement, further described at recital 142, Alki LP acts as the principal that bears all the company risks and performs the associated activities ⁽⁵⁶⁾. Therefore, according to the Netherlands, the royalty does not solely represent remuneration for the IP right, but also for Alki LP's role as principal.
- (106) Regarding Alki LP, Starbucks specified that Alki LP has no employees on its payroll to perform its role as principal under the Roasting Agreement, nor do its partners have employees on the payroll who perform this role. According to Starbucks, Alki LP performs that role through the guidance, expertise and required functions provided by Starbucks entities in the US pursuant to the [Cost Sharing Agreement] (hereinafter: 'CSA') ⁽⁵⁷⁾. According to Starbucks, and as evidenced by the limited partnership deed constituting Alki LP, SCI UK I, Inc. ⁽⁵⁸⁾ and Starbucks Coffee International, Inc. ⁽⁵⁹⁾ are the partners of Alki LP.
- (107) Starbucks clarified that Alki LP was added to the group structure in December 2006 as part of the expansion of the CSA to cover the entire EMEA region by including the UK market. By adding Alki LP to the structure, Starbucks avoided that the royalty income received by Alki LP would be directly integrated in the income of the partners of Alki LP under US tax law.

2.6.4. Payments by Alki LP to Starbucks Corporation under the Cost Sharing Agreement

- (108) As neither Alki LP, nor its partners, have any employees ⁽⁶⁰⁾, and Starbucks claims that Alki LP is able to perform its role as principal through the CSA, the Commission requested information about the payments under the CSA and the services those payments relate to, as well as the way in which the payments are financed by Alki LP. Starbucks provided the following overview of payments by Alki LP to Starbucks US broken into different types of payment.
- (109) Under the CSA, Alki LP makes royalty payments to Starbucks US for the three categories of IP that Starbucks US licenses to Alki LP. Those royalty payments consist of (i) a buy-in royalty allocated to the brand/trademark rights; (ii) a buy-in royalty allocated to the business format rights; and (iii) a permanent royalty allocated to the coffee knowledge.

⁽⁵¹⁾ Under the previous ruling, SMBV's tax base was calculated as 8 % of the costs taken into account.

⁽⁵²⁾ These include the Starbucks figurative mark and the Starbucks business plan.

⁽⁵³⁾ These include the furnishings and fittings, the exterior and the perception of the Shops, so-called systems relating to the exterior/the 'front' of the Shops and so-called systems for the set-up/rear' of the Shops.

⁽⁵⁴⁾ These include the 'brand curves' and the formula for the coffee mixes.

⁽⁵⁵⁾ Comments of the Netherlands to the Opening Decision, p. 25.

⁽⁵⁶⁾ Comments of the Netherlands to the Opening Decision, p. 27.

⁽⁵⁷⁾ See recitals 145 and 146.

⁽⁵⁸⁾ A company incorporated under the laws of the State of Washington, US (General Partner).

⁽⁵⁹⁾ A company incorporated under the laws of the State of Washington, US (Limited Partner).

⁽⁶⁰⁾ See recital 106.

- (110) The amount of the royalty payment is calculated on the basis of a formula that takes as a starting point the residual profit pool. The residual profit pool is the sum of the royalties paid by SMBV and Starbucks Coffee BV to Alki LP ⁽⁶¹⁾ and income that Alki LP receives from Starbucks Corporation ⁽⁶²⁾. From that amount, an arm's-length return for routine functions performed by Alki LP is deducted ⁽⁶³⁾. [...]. In this respect, a difference is made between the IP rights for the brand/trademark and the business format, on the one hand, and the coffee knowledge, on the other. That difference is explained by the fact that Alki LP holds the beneficial ownership of the business format related intangibles and the trademark/brand for the EMEA region, whilst the legal and beneficial ownership of the coffee knowledge rights are held by Starbucks US.
- (111) The beneficial ownership of the business format related intangibles and the trademark/brand for the EMEA region was transferred from Starbucks Corporation in 2002 to [CV 1] and assigned to Alki LP since 2006. For the beneficial ownership, [CV 1] and Alki LP made buy-in royalty payments, where the percentage of the US share of the cost which Alki LP needed to pay to Starbucks US digressively reduced from [65-70] % in 2002 to [0,5-1] % in 2010 and onwards for the trademark, and [70-75] % in 2002 to [0-0,5] % in 2010 and onwards for the business format IP. With those buy-in payments, the beneficial ownership rights for these two categories of IP for the EMEA region are deemed to be paid off by Alki LP. With regard to the coffee knowledge IP, Alki LP pays a permanent royalty of [70-75] % of the residual profit allocated to this IP category to Starbucks US.
- (112) Starbucks submitted an overview of the permanent royalty and the buy-in payments by [CV 1] and Alki LP for the period 2005-2014. With regard to the buy-in payments, [CV 1] paid a total of EUR [1-10] million as buy-in payments for the trademark and business format IP to Starbucks Corporation ⁽⁶⁴⁾ ⁽⁶⁵⁾. In December 2006, the CSA was assigned by [CV 1] to Alki LP. From 2007 to 2014, Alki LP paid EUR [1-10] million for the trademark and EUR [20-30] million for the business format IP ⁽⁶⁶⁾. This means that, in total, EUR [10-20] million was paid as buy-in payments for the trademark and EUR [20-30] million for the business format IP. In 2014, Alki LP transferred the beneficial ownership of the IP rights to Starbucks EMEA Ltd for which it recorded a gain of EUR [1-1,5] billion as other operating income in its profit and loss account. With regard of the permanent royalty, Alki LP paid on average EUR [1-10] million a year (EUR [70-80] million in total) over the period 2005–2014 to Starbucks Corporation for the coffee knowledge IP ⁽⁶⁷⁾.
- (113) In addition to the buy-in and permanent royalty, Alki LP pays service fees for services provided by Starbucks Corporation and cost sharing payments for the development of certain intangible assets ⁽⁶⁸⁾. Over the period 2008–2014, Alki LP paid on average EUR [1-10] million per year on cost sharing payments and EUR [1-10] million per year on service fees.

⁽⁶¹⁾ For the period 2008-2014, Alki LP received in total EUR [400-500] million in licence fees from Starbucks Coffee BV & SMBV. Out of this EUR [400-500] million, EUR [300-400] million ([80-85] %) was received from Starbucks Coffee BV and EUR [60-70] million ([15-20] %) from SMBV.

⁽⁶²⁾ According to Starbucks, this payment from Starbucks US to Alki LP concerns a global cost adjustment intended to compensate Alki LP for the lower licence fees received from SMBV as a result of Starbucks' pricing policy for roasted coffee on a global basis.

⁽⁶³⁾ This 'arm's-length return' is calculated under US transfer pricing rules and is determined for all the activities of Starbucks Coffee BV and SMBV.

⁽⁶⁴⁾ Starbucks could not provide a breakdown of the buy-in payments for the brand or for the business format for the years 2005 and 2006. There are also some discrepancies between the licence fee and buy-in payments by [CV 1] as provided in the overview by Starbucks and the profit & loss statements of [CV 1]. Starbucks has not been able to establish the exact cause of these discrepancies.

⁽⁶⁵⁾ No buy-in payments were made before 2005 to Starbucks Corporation as [CV 1] was loss-making until 2005.

⁽⁶⁶⁾ However, this amount would on average be [...] lower if the income received from Starbucks Corporation would not be taken into account in the calculation of the residual profit pool.

⁽⁶⁷⁾ However, this amount would on average be [...] lower if the income received from Starbucks Corporation would not be taken into account in the calculation of the residual profit pool.

⁽⁶⁸⁾ See recital 146.

2.6.5. *Information on SCTC and on the prices of green coffee beans paid by SMBV*

- (114) Given that green coffee beans are procured by SMBV through a group transaction, more precisely they are purchased from SCTC, the Commission requested information about how the prices for this intra-group transaction are set and about the price set for each year throughout the application of the SMBV APA.
- (115) Starbucks submitted the balance sheet and profit and loss accounts for SCTC since 2005. Table 4 reproduces information contained in those accounts. The calculation of the mark-up on the costs of green coffee beans (COGS) applied by SCTC was added by the Commission for the purpose of this Decision. Based on the accounting information available, which starts at 2005, the average mark-up on the costs of green coffee beans stood at [around 3 %] for the period 2005 to 2010, compared to an average mark-up of [around 18 %] over the period 2011 to 2014.
- (116) Starbucks submitted that from 2011 onwards, Starbucks adjusted the transfer pricing policy applicable to the sale of green coffee beans to increase the mark-up on product costs given the growing importance of SCTC's operations, especially its increasing expertise in coffee procurement and, more importantly, its ownership and operation of the evolving C.A.F.E. Practices Programme.
- (117) The C.A.F.E. Practices Programme was launched in 2004 in conjunction with the opening of SCTC's farmer support centre in Costa Rica to provide an evolving programme where farmers, exporters, and buyers could have an ongoing conversation to (i) improve coffee quality; (ii) provide economic accountability for payments along all levels of the supply chain; (iii) encourage social responsibility in working conditions, protection of workers' rights, and adequate living conditions; and (iv) inspire environmental leadership for growing and processing green coffee beans.
- (118) In order to verify whether the growing operations, which Starbucks invokes to explain the increased mark-up, are confirmed in the accounts, Table 4 also presents the assets of SCTC. Although the total assets have indeed grown significantly since 2010, this is mainly due to increased cash holding. Operating assets net of cash have increased by less than a third over the four years from 2010 to 2014.
- (119) The annual reports of SCTC submitted by Starbucks also do not describe in the accompanying notes any difference in risks, functions or assets from 2010 to 2011. The activities and risks are described in identical terms over this period, i.e. the principal activity of SCTC is according to both annual reports the purchase and sale of high-quality green coffee beans and related activities of quality assurance and operations (logistics, warehousing, blending, decaffeinating, etc.).

Table 4

Financial data of SCTC

(CHF)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
SCTC Sales	[500-600 million]	[600-700 million]	[600-700 million]	[600-700 million]	[600-700 million]	[500-600 million]	[900-1 000 million]	[1,5-2 billion]	[1-1,5 billion]	[900-1 000 million]
SCTC COGS	[500-600 million]	[500-600 million]	[600-700 million]	[600-700 million]	[600-700 million]	[400-500 million]	[800-900 million]	[1-1,5 billion]	[800-900 million]	[700-800 million]
gross margin (Sales — COGS)	[20-30 million]	[30-40 million]	[40-50 million]	[30-40 million]	[40-50 million]	[30-40 million]	[100-200 million]	[200-300 million]	[100-200 million]	[100-200 million]
gross margin on COGS	[4,5-7,5] %	[4,5-7,5] %	[4,5-7,5] %	[4,5-7,5] %	[4,5-7,5] %	[4,5-7,5] %	[16,5-19,5] %	[16,5-19,5] %	[19,5-22,5] %	[16,5-19,5] %
OpEx (excl. provisions)	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]
profit before tax	[10-20 million]	[20-30 million]	[20-30 million]	[20-30 million]	[30-40 million]	[20-30 million]	[100-200 million]	[200-300 million]	[100-200 million]	[100-200 million]
Tax	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[1-10 million]	[10-20 million]	[10-20 million]	[10-20 million]	[10-20 million]
net profit	[10-20 million]	[20-30 million] (*)	[20-30 million] (*)	[20-30 million]	[20-30 million]	[10-20 million]	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]
Total assets	[200-300 million]	[200-300 million]	[200-300 million]	[200-300 million]	[200-300 million]	[100-200 million]	[300-400 million]	[500-600 million]	[600-700 million]	[700-800 million]
Total assets net of cash and cash equivalent (incl. marketable securities)	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]	[100-200 million]	[300-400 million]	[100-200 million]	[100-200 million]	[100-200 million]

(*) Including an extraordinary post tax profit of [1-10 million] CHF and a loss of [800-900 thousand] CHF in 2006 and 2007 respectively.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
mark-up on COGS	[1,5-4,5]	[1,5-4,5]	[1,5-4,5]	[1,5-4,5]	[4,5-7,5]	[1,5-4,5]	[16,5-19,5]	[13,5-16,5]	[19,5-22,5]	[16,5-19,5]

(%)

(120) As Starbucks invoked the C.A.F.E. Practices Programme to explain the increase in the margin charged by SCTC, the Commission requested Starbucks to provide the costs of that programme and the Farmer Support Centres costs. Starbucks provided estimations of the yearly costs of (i) the C.A.F.E. Practices Programme; and of (ii) the Farmer Support Centres, presented in Table 5.

Table 5

Direct and indirect costs of C.A.F.E. Practices Programme and Farmer Support Centres

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
(1) Allocated C.A.F.E. Practices Expenses	N/A	N/A	N/A	N/A	N/A	N/A	[500 000-600 000]	[100 000-200 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]
(2) Farmer Support Centers costs	[800 000-900 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]
(3) Other C.A.F.E. Practices related costs	N/A	N/A	[60 000-70 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[200 000-300 000]	[700 000-800 000]	[400 000-500 000]	[60 000-70 000]	[200 000-300 000]	[1 000 000-10 000 000]
Total	[800 000-900 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]	[1 000 000-10 000 000]

(USD)

(121) Over the period 2011-2014, the combined costs of the C.A.F.E. Practices Programme and the Farmer Support Centres present at most [0,5-1] % of the value of the green coffee beans purchased by SCTC ⁽⁶⁹⁾.

⁽⁶⁹⁾ Value in 2014, calculated by comparison of the total estimated costs of the C.A.F.E. Practices Programme and Farmer Support Centres Programme with the COGS of SCTC, adjusted by the USD:CHF exchange rate.

- (122) In response, Starbucks indicated that the C.A.F.E. Practices Programme should be considered IP of which the value is unrelated to underlying costs.
- (123) The Commission requested Starbucks to provide the transfer pricing report covering the pricing of green coffee beans sold by SCTC to SMBV. According to Starbucks, historically, no transfer pricing documentation has been prepared that covers the relationship between SCTC and SMBV. For the purpose of responding to the Commission's request, Starbucks provided an ad hoc report on the SCTC transfer prices to the Commission on 13 April 2015.
- (124) According to the ad-hoc transfer pricing report provided, SCTC determines the prices to its affiliates by applying a mark-up to the product costs associated with the green coffee beans sourced by it.
- (125) In addition, to determine a current arm's-length mark-up on product costs for SCTC for green coffee beans procurement, three separate components were identified:
- Intellectual Property — C.A.F.E. Practices Programme: SCTC manages the C.A.F.E. Practices Programme and uses valuable know-how that, when incorporated into Starbucks' business operations, ensures consistent supply and supports the Starbucks brand for sustainability. Starbucks analysed this transaction using comparable licensing agreements relating to food and agricultural technologies.
 - Procurement: SCTC provides procurement functions for green coffee beans. Starbucks analysed this transaction using comparable sourcing agreements between third parties.
 - Financing: SCTC should generate a return for financing costs it incurs when holding unsold inventory and net receivables for green coffee beans. Starbucks analysed an appropriate return for financing that should be returned to SCTC.
- (126) Combining the results for each separate component analysed by SCTC would yield a combined result for green coffee beans overall from 2005 through 2014 as demonstrated in Table 6:

Table 6

Mark-up on product costs

(%)			
Component	Markup on product costs Lower Quartile	Markup on product costs Median	Markup on product costs Upper Quartile
Intellectual Property – C.A.F.E. Practices Program	1,4	4,2	9,9
Procurement	4,7	6,0	8,0
Financing	[1,5-4,5]	[1,5-4,5]	[1,5-4,5]
Total % markup on product costs	[7,5-10,5]	[10,5-13,5]	[19,5-22,5]

- (127) The combined arm's-length range for the total mark-up on product costs charged by SCTC for the coffee sold to SMBV is according to the ad hoc transfer pricing report between a lower quartile of [around 9 %] and an upper quartile of [around 21 %], with a median of [around 12 %], for the overall period 2005 through 2014.
- (128) According to Starbucks, SCTC's actual realised gross margin ⁽⁷⁰⁾ falls squarely within the arm's-length range. This would be evidenced by the fact that the gross margin over Sales of SCTC stood at [around 12 %] for the years 2005 through 2014, based on a weighted average.

⁽⁷⁰⁾ Gross margin is gross profit (i.e. Sales minus COGS) divided by Sales, see recital 84.

- (129) The Commission requested Starbucks to provide the data and the components of the mark-up used to establish the quartile and median figures for the period 2005 through 2014, submitted to the Commission. Starbucks indicated that this data is not available.
- (130) Starbucks submitted information on 29 June 2015 to substantiate the pricing of green coffee beans in the ad hoc transfer pricing report provided and in particular the figures presented in Table 6 for which the Commission requested the underlying data.
- (131) Contrary to what was indicated in the table provided by Starbucks on 13 April 2015, the values in the table regarding the C.A.F.E. Practices Programme 1,4 % and 9,9 % are not the lower quartile (25th quartile) and the upper quartile (75th quartile). Rather, they would be the two extreme values, i.e. lowest value and highest value, of a comparison of licence agreements. In its submission of 29 June 2015, Starbucks identified eleven licence agreements relating to technology licensing, which they consider comparable to the C.A.F.E. Practices Programme. Those agreements relate to food and beverage products. The range of percentages that Starbucks arrives to is presented in Table 7. Starbucks explained that 'Percentage Mark-up on Product Cost' in Table 7 'is calculated by the average of each observation divided by one minus the average of the observation', although there is no explanation as to why that step was taken to calculate a mark-up on product costs in complete absence of information or consideration on the costs of the companies to the respective agreements.

Table 7

Explanation by Starbucks of previously provided data on C.A.F.E. Practices Programme pricing interquartile range of 1,4 % to 9,9 %

	Average Observation	Percentage Markup on Product Cost
Highest Observed Value	9,0 %	9,9 %
Upper Quartile	6,0 %	6,4 %
Median	4,0 %	4,2 %
Lower Quartile	2,7 %	2,8 %
Lowest Observed Value	1,4 %	1,4 %
Observations	11	11

- (132) In its submission of 29 June 2015, Starbucks also provided a pricing of the procurement function of SCTC estimated by using comparable transactions identified by Starbucks using the PowerK database and LIVEDGAR database. Thirteen agreements whereby buying agency services are provided by a third-party buying agent are considered consistent with the procurement services that SCTC provided to SMBV.
- (133) The results of the analysis are presented as percentages of 'Free on Board' product costs, which is the costs charged to the client for delivered products. The median of the observations presented is 6 %. Starbucks presents the result in terms of an interquartile range of product costs from 4,7 % to 8,0 %.
- (134) In detail, the observations used refer to agreements with the following principals and the commissions as percentage of Free on Board rates specified in the brackets: Aeropostale, Inc. (5 %); Ateca Production International, Inc. (7 %); BELL SPORTS CORP. (6 %), COLUMBIA SPORTSWEAR CO. (1,5 %); Designs Apparel Inc. (5 %); F.I.S. Inc. (10 %); He-Ro Industries Incorporated (10 %); JONES APPAREL GROUP INC/NINE WEST GROUP INC. (10 %); Mannesmann Pipe&Steel Corporation (2 %), Skin Shoes LLC (8 %); Skin Inc. (6 %); TI Sportswear Inc. (4,7 %) and WW Mexicana (1 %). The interquartile range on these observations is 4 % to 8,5 %. As in the case of the C.A.F.E. Practices Programme pricing, Starbucks indicated that 'percent of sales is calculated as the percent of FOB divided by one plus the percent of FOB' ⁽⁷¹⁾. This modification of the figures from the comparative analysis is not explained and does not seem to correspond to any customary financial adjustment.

⁽⁷¹⁾ FOB refers to Free on Board.

- (135) Finally, Starbucks calculates the pricing of what is presented as a financing function and which SCTC should earn as a return according to Starbucks for 'holding green coffee and financing of net receivables for its own risk and account'. This return is calculated by Starbucks by applying a weighted average cost of capital ("WACC") to the account receivables and inventory stock of SCTC for 2014 and is on this basis set at [around 3 %].
- (136) Finally, to calculate the profits that SMBV generated on the roasting of the green coffee beans purchased from SCTC, the Commission requested Starbucks for the price paid by SMBV to SCTC. Starbucks provided an overview of the average prices (per pound) charged by SCTC to SMBV and the amounts paid by SMBV to SCTC, which are presented in Table 8. No other payments have been made by SMBV to SCTC.

Table 8

Amounts paid by SMBV to SCTC for the purchase of green coffee beans

Purchases from SCTC

FY	Purchase value in EUR	Purchase volume in Pounds	Unit price in EUR/lbs
2002	—	—	
2003	[10 000 000 — 20 000 000]	[10 000 000 — 20 000 000]	[1,0000 — 1,5000]
2004	[10 000 000 — 20 000 000]	[10 000 000 — 20 000 000]	[1,0000 — 1,5000]
2005	[10 000 000 — 20 000 000]	[1 000 000 — 10 000 000]	[1,0000 — 1,5000]
2006	[10 000 000 — 20 000 000]	[10 000 000 — 20 000 000]	[1,0000 — 1,5000]
2007	[20 000 000 — 30 000 000]	[20 000 000 — 30 000 000]	[1,0000 — 1,5000]
2008	[20 000 000 — 30 000 000]	[10 000 000 — 20 000 000]	[1,0000 — 1,5000]
2009	[20 000 000 — 30 000 000]	[10 000 000 — 20 000 000]	[1,0000 — 1,5000]
2010	[30 000 000 — 40 000 000]	[20 000 000 — 30 000 000]	[1,0000 — 1,5000]
2011	[40 000 000 — 50 000 000]	[20 000 000 — 30 000 000]	[2,0000 — 2,5000]
2012	[60 000 000 — 70 000 000]	[20 000 000 — 30 000 000]	[2,0000 — 2,5000]
2013	[60 000 000 — 70 000 000]	[30 000 000 — 40 000 000]	[1,5000 — 2,0000]
2014	[60 000 000 — 70 000 000]	[40 000 000 — 50 000 000]	[1,5000 — 2,0000]

2.6.6. Information and figures on Starbucks Shops

- (137) The products distributed by SMBV, either produced by SMBV or bought by SMBV from other suppliers, are sold to Shops. Some of the Shops are independent and some are owned by Starbucks. The Commission requested information to verify whether there is a difference in the commercial conditions applied to Shops owned by the group and independent Shops.
- (138) With regard to the Starbucks Shops, Starbucks provided information on the different licensee programmes and eligibility criteria to develop Starbucks Shops in the EMEA region, an overview of the stores in the EMEA region, and figures regarding the turnover of the Shops and the licence fees paid in 2012 by those Shops to Starbucks Coffee BV. According to this information, the licence fees percentage over turnover paid by the three different types of licence programmes (independent geographic licensees, company-owned geographic licensees and channel licensees –the three different types of licence programmes) varies across countries with percentage ranges from [5 to 10] %.

2.6.7. Information on the profitability of other roasting facilities operated by Starbucks

- (139) The Commission requested from Starbucks financial information on the profitability of any other roasting facility operated by the group and, in particular, Starbucks Manufacturing Corporation (hereinafter 'SMC'), which was identified from publicly disclosed information as belonging to the Starbucks group. The Commission requested this information because the 2010 OECD TP Guidelines recommend the use of internal data to test the arm's-length nature of the division of profits ⁽⁷²⁾. Starbucks indicated that SMC was the only roasting facility operated by the group other than SMBV. As SMC does not have audited accounts, Starbucks provided pro-forma accounts based on the internal reporting of the company.
- (140) The data provided by Starbucks is presented in Table 9. The ratios of profits over sales and profits over operating expense ⁽⁷³⁾ were added by the Commission for the purpose of this Decision, considering a ratio of [9-12] % of profits over operating expense is agreed in the SMBV APA as an arm's-length remuneration of SMBV. For SMC, this ratio stood at around 500 % over the past four accounting periods.

Table 9

Financial information on US manufacturing company Starbucks Manufacturing Corporation

	2011	2012	2013	2014
Sales of Starbucks Manufacturing Corporation	[700 000 000 – 800 000 000]	[1 000 000 000 – 1 500 000 000]	[1 000 000 000 – 1 500 000 000]	[1 000 000 000 – 1 500 000 000]
Cost of Goods Sold	[(500 000 000) – (600 000 000)]	[(800 000 000) – (900 000 000)]	[(800 000 000) – (900 000 000)]	[(700 000 000) – (800 000 000)]
Other income and gain	[100 000 – 200 000]	[600 000 – 700 000]	[300 000 – 400 000]	[1 000 000 – 10 000 000]
Deductions	[(40 000 000) – (50 000 000)]	[(60 000 000) – (70 000 000)]	[(70 000 000) – (80 000 000)]	[(80 000 000) – (90 000 000)]
Thereof salaries and wages	[(10 000 000) – (20 000 000)]	[(20 000 000) – (30 000 000)]	[(20 000 000) – (30 000 000)]	[(30 000 000) – (40 000 000)]
Thereof depreciation	[(10 000 000) – (20 000 000)]	[(10 000 000) – (20 000 000)]	[(10 000 000) – (20 000 000)]	[(10 000 000) – (20 000 000)]
Total Income	[100 000 000 – 200 000 000]	[400 000 000 – 500 000 000]	[300 000 000 – 400 000 000]	[500 000 000 – 600 000 000]
Profit margin (income/sales)	[20 % – 25 %]	[30 % – 35 %]	[30 % – 35 %]	[35 % – 40 %]
Profit on Operating Expense (income/deductions)	[400 % – 450 %]	[650 % – 700 %]	[500 % – 550 %]	[550 % – 600 %]

2.7. Description of the various contracts setting out the roles and responsibilities of SMBV

- (141) When SMBV was set up in the Netherlands, it entered into various agreements that set out the contractual divisions of the roles and responsibilities of SMBV and its counterparties. The three agreements relevant for this Decision are the Roasting Agreement between SMBV and Alki LP, the Green Coffee Purchase Agreement between SMBV and SCTC, and the Supply Agreement between SMBV and the Shops.

⁽⁷²⁾ See paragraph 2.141 of the 2010 OECD TP Guidelines: 'Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the conditions outlined in this section and in particular at points 2.116-2.117 and 2.132. They will frequently be extracted from the taxpayers' cost accounting or financial accounting'.

⁽⁷³⁾ The amount reported under 'Deductions' is taken as presenting operating expenses, as it is mainly constituted of labour costs and the cost of depreciation and repair.

- (142) The Roasting Agreement, which entered into force on 1 January 2002, governs the manufacturing process. Under the Roasting Agreement, Alki LP acts as the principal and SMBV as the owner of the roasting facility. SMBV pays a licence to Alki LP in exchange for which Alki LP grants SMBV access to the IP rights and takes over the entrepreneurial risk in the business of SMBV such as cost overruns and the sale of the products. SMBV will roast the green coffee beans and make the roasted coffee and other coffee related products available to the Shops (according to the Supply Agreement discussed below and the ADOA ⁽⁷⁴⁾). As owner of the facility, SMBV has to ensure that the correct equipment is used, the correct processes are carried out and the goods are produced in line with the specifications provided by Alki LP. SMBV will be the owner of the purchased products, which it has to buy from suppliers designated and/or approved by Alki LP. SMBV has to ensure that the products at the time of delivery comply with Alki LP's product specifications and SMBV is obliged to promptly replace any quantity of defective or non-performing products at its own expense. Alki LP however bears the risks relating to losses which may be incurred as a result of the production, sale, transport, storage, treatment or other use of the products and has to indemnify SMBV against any compensation claims.
- (143) The Green Coffee Purchase Agreement entered into force on 22 April 2002 and stipulates the conditions for the sale of green whole-bean coffee from SCTC to SMBV. SCTC will sell the beans to SMBV at prices set forth on price lists issued by SCTC. SMBV will issue a purchase order for coffee on the basis of purchasing forecasts. SCTC will deliver the beans [...].
- (144) The Supply Agreement sets out the responsibilities in the supply of essential Starbucks goods between SMBV and the Shops. The Shops commit to purchase all branded roasted coffee and other essential coffee-related products as defined in that agreement exclusively from SMBV or approved suppliers at prices which are either determined under a formula attached to that agreement (for coffee and coffee-related products) or pursuant to a [...] price list (for other goods). The Shops must provide SMBV with a [periodic] purchase forecast ⁽⁷⁵⁾ whereas SMBV guarantees to the Shops that at the time when the coffee and other goods leave SMBV's warehouse, they are free from defects and, where this is not the case, SMBV replaces free of charge any defective product or grants a credit to the Shops ⁽⁷⁶⁾.

2.8. Cost Sharing Agreement

- (145) The CSA between Alki LP and Starbucks Corporation of 1 August 2006 determines the direct rights of Alki LP to license and sublicense to third parties the right to: (i) [...] operate Starbucks stores [...], (ii) [...] operate [...] and (iii) manufacture and/or distribute products using the Trademarks and Technology and Know-How.
- (146) Under the CSA, Alki LP is to pay Starbucks Corporation a royalty, service fees for services provided by Starbucks Corporation, and cost sharing payments for the development of certain intangible assets. The royalty payments consist of: (i) a buy-in royalty allocated to the trademark and business format IP and a (ii) permanent royalty allocated to the coffee knowledge IP. Payments under this agreement are detailed in recitals 112 and 113.

2.9. Contracts between Starbucks and third parties relating to the manufacturing and the sale of coffee

- (147) In order to compare the commercial conditions fixed between SMBV and the Starbucks group and in particular the royalty payment for the roasting IP, on the one hand, with commercial conditions fixed between the Starbucks group and third parties, on the other, the Commission requested from Starbucks all contracts whereby Starbucks licenced IP and all contracts where Starbucks outsourced the roasting of coffee. The Commission also requested information about the commercial conditions applied between Starbucks Corporation and its group roasting company located in the US.
- (148) In response to the Commission's request, Starbucks provided contracts with:
- [Unaffiliated manufacturing company 2], ('[unaffiliated manufacturing company 2]'), [...]. Starbucks entered into two types of agreements with [unaffiliated manufacturing company 2] to subcontract the roasting of coffee, which have been amended at several instances. In a technology licence agreement of [before 2008], an affiliate of Starbucks, [...], grants a non-exclusive licence to [unaffiliated manufacturing company 2] to use, amongst others, the technology and know-how of Starbucks to produce and sell roasted coffee to selected

⁽⁷⁴⁾ Under this agreement, Starbucks Coffee BV has the right to grant third parties a licence to develop, own and operate Starbucks stores operating under the Trademarks and using the Technology and Know-How.

⁽⁷⁵⁾ According to the Supply Agreement, [...].

⁽⁷⁶⁾ Starbucks specified that the Supply Agreements are contracted by Starbucks [...] and that these are standardised agreements where the underlying terms and conditions are determined by Starbucks [...], cf. observations of Starbucks, recital 6.14.

third parties with which Starbucks has entered into supply agreements, such as [unaffiliated manufacturing company 5] [...]. [Unaffiliated manufacturing company 2] has to perform the services so that the Roasted Coffee is of high quality, for which [unaffiliated manufacturing company 2], among others, has to comply with certain quality assurance standards established by Starbucks. The technology licence agreement stipulates that [unaffiliated manufacturing company 2] does not have to pay any fees for the licence ⁽⁷⁷⁾. A green coffee supply agreement stipulates that [unaffiliated manufacturing company 2] has the obligation to buy green coffee beans exclusively from Starbucks for a fixed fee [per a certain quantity].

- [Unaffiliated manufacturing company 3], ('[unaffiliated manufacturing company 3]'), [...]. Under a roasting licence agreement of [after 2008], [unaffiliated manufacturing company 3] provides coffee roasting services which it sells to Starbucks and a joint-venture between [unaffiliated manufacturing company 3] and Starbucks called [unaffiliated manufacturing company 3-Starbucks joint-venture] that operates the Starbucks coffee stores in [a certain country]. [Unaffiliated manufacturing company 3] pays a roasting fee to Starbucks [...] of USD [...] [per a certain quantity] of green coffee produced and sold to the [unaffiliated manufacturing company 3-Starbucks joint-venture].
- [Unaffiliated manufacturing company 4], ('[unaffiliated manufacturing company 4]'), [...]. In order to subcontract the roasting of coffee [unaffiliated manufacturing company 4] entered into three types of agreements, of which only the [...] purchase agreement of [after 2008] was submitted. Accordingly Starbucks appoints [unaffiliated manufacturing company 4] to manufacture, package, produce and supply coffee product. The agreements do not provide for any fee or royalty to be paid to Starbucks. The manufacturing has to take place under certain product specifications and standards provided by Starbucks. The agreement stipulates that [unaffiliated manufacturing company 4] shall sell the products to Starbucks and its affiliates for a price set at the level of the green coffee beans (according to Starbucks, the green coffee beans are therefore just a pass-through cost for [unaffiliated manufacturing company 4]) and supply cost to which a conversion fee is added. This conversion fee includes fees for roasting [...]. The pricing formula is then translated into a sales price [per a certain quantity] of roasted coffee. Starbucks claims that this results in a margin of [5-10] % on total conversion costs, without further indications on how this alleged mark-up was arrived to.
- [Unaffiliated manufacturing company 5] ('[unaffiliated manufacturing company 5]'), [...]. Starbucks entered into three types of agreements with [unaffiliated manufacturing company 5] on [before 2008]. In a supply agreement, Starbucks takes the obligation to supply to [unaffiliated manufacturing company 5] roasted coffee beans, concentrate and other coffee ingredients for a price based on a formula used to develop coffee ingredient pricing for [Starbucks'] retail coffee shop business, [...]. The [...] agreement, which is a manufacturing and distribution agreement, grants [unaffiliated manufacturing company 5] the right to exclusively distribute certain pre-packed, ready-to-drink beverages under the Starbucks Trademark in a specific territory. The manufacturing has to take place under certain product specifications and standards provided by Starbucks. The [...] agreement does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 5] to Starbucks. The trademark and technology licence agreement allows [unaffiliated manufacturing company 5] to use the trademark of Starbucks as well as its technology and know-how for the purpose of manufacturing the agreed products. [Unaffiliated manufacturing company 5] pays a licence fee of [10-15] % of net sales subject to an adjustment mechanism, which according to Starbucks results in a fee of approximately [10-15] % on net sales of ready-to-make drinks ⁽⁷⁸⁾.
- [Unaffiliated manufacturing company 6] ('[unaffiliated manufacturing company 6]'), [...]. Starbucks entered into three types of agreements with [unaffiliated manufacturing company 6] on [before 2008], which have subsequently been amended. In a supply agreement, Starbucks takes the obligation to supply to [unaffiliated manufacturing company 6] roasted coffee beans, concentrate and other coffee ingredients for a price based on a formula used to develop coffee ingredient pricing for Starbucks' [...] retail coffee shop business, [...]. The manufacturing and distribution agreement grants [unaffiliated manufacturing company 6] the right to exclusively distribute certain pre-packed, ready-to-drink beverages under the Starbucks Trademark in [a certain country]. The manufacturing has to take place under certain product specifications and standards provided by Starbucks. The manufacturing and distribution agreement does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 6] to Starbucks. The trademark and technology licence agreement allows [unaffiliated manufacturing company 6] to use the trademark of Starbucks as well as its

⁽⁷⁷⁾ [...].

⁽⁷⁸⁾ [...].

technology and know-how for the purpose of manufacturing the agreed products. [Unaffiliated manufacturing company 6] pays a licence fee depending on the product. According to Starbucks, this fee amounts to between [5 and 10] % of net sales of ready-to-make drinks ⁽⁷⁹⁾.

- [Unaffiliated manufacturing company 7] ('[unaffiliated manufacturing company 7]'), [...]. Starbucks entered into three types of agreements with [unaffiliated manufacturing company 7] on [after 2008], which have subsequently been amended. In a supply agreement, Starbucks takes the obligation to supply to [unaffiliated manufacturing company 7] coffee ingredients, [...], for a price set [per a certain quantity]. The manufacturing and distribution agreement grants [unaffiliated manufacturing company 7] the right to exclusively distribute certain pre-packed, ready-to-drink beverages under the Starbucks Trademark in a specific territory. The manufacturing has to take place under certain product specifications and standards provided by Starbucks. The manufacturing and distribution agreement does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 7] to Starbucks. The trademark and technology licence agreement allows [unaffiliated manufacturing company 7] to use the trademark of Starbucks as well as its technology and know-how for the purpose of manufacturing the agreed products. [Unaffiliated manufacturing company 7] pays a licence fee depending on the territory of between [10 and 20] % of net sales.
- (149) The contracts that Starbucks has with [unaffiliated manufacturing company 5], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 7] listed above were classified in three categories: (i) supply agreements, similar to the Supply Agreement between SMBV and Developers described at recital 144; (ii) manufacturing and distribution agreements, similar to the agreement between SMBV and Alki LP; and (iii) trademark and technology licence agreements, similar to the ADOA between Starbucks Coffee BV and the Shops described at recital 48. Of the three types of agreement between Starbucks and [unaffiliated manufacturing company 5], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 7], only the last category of agreements requires Starbucks' counterparties to pay a royalty.
- (150) In addition, four other roasting agreements with [unaffiliated manufacturing company 8], [unaffiliated manufacturing company 1], [unaffiliated manufacturing company 9], and [unaffiliated manufacturing company 10] were provided by Starbucks to the Commission.
- The [unaffiliated manufacturing company 8] manufacturing and supply agreement dates from [after 2008] and stipulates that [unaffiliated manufacturing company 8] is to produce flavoured coffee for Starbucks for a specified price ⁽⁸⁰⁾. [...] stipulates that [unaffiliated manufacturing company 8] must strictly comply with a technical manual regarding, among others, the manufacturing of the products. [...] stipulates that Starbucks grants [unaffiliated manufacturing company 8] a royalty-free licence for the use of the know-how in connection with the manufacturing process.
 - The [unaffiliated manufacturing company 1] manufacturing and supply agreement is dated [after 2008] and provides that [unaffiliated manufacturing company 1] shall produce certain coffee products for Starbucks for a specified price ⁽⁸¹⁾. [...] stipulates that [unaffiliated manufacturing company 1] must strictly comply with a technical manual regarding, among others, the manufacturing of the products. The agreement does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 1] to Starbucks.
 - The [unaffiliated manufacturing company 9] manufacturing and supply agreement is dated [after 2008] and provides that [unaffiliated manufacturing company 9] shall produce flavoured coffee for Starbucks for a specified price ⁽⁸²⁾. [...] stipulates that [unaffiliated manufacturing company 9] must strictly comply with a technical manual regarding, among others, the manufacturing of the products. The [manufacturing and supply agreement] does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 9] to Starbucks. The agreement also refers to a technology and trademark licence agreement, which was however not submitted.
 - The [unaffiliated manufacturing company 10] manufacturing agreement is dated [after 2008] and concerns the manufacturing and roasting of green coffee beans for Starbucks by a [...] roaster who sources its coffee

⁽⁷⁹⁾ *Ibid.*, [...].

⁽⁸⁰⁾ [...].

⁽⁸¹⁾ [...].

⁽⁸²⁾ [...].

beans directly. The agreement does not provide for any fee or royalty to be paid by [unaffiliated manufacturing company 10] to Starbucks. [...] of the agreement clarifies that Starbucks owns the IP rights in the coffee blend, the time temperature curve of the roast progression and the roaster end point, etc. Starbucks pays a fee to [unaffiliated manufacturing company 10] for the coffee [per a certain quantity], following a specific formula which charges less for roasting than for packaging.

2.9.1. Arguments presented by Starbucks regarding the agreements with third parties and with Starbucks Manufacturing Corp.

- (151) In addition to the contracts listed in recital 148, Starbucks supplied an analysis of the comparability of those contracts with the royalty payments made by SMBV to Alki LP.
- (152) Among the agreements whereby Starbucks licensed out intangibles (trademarks and certain specific coffee related know-how) for exploitation by a third party, Starbucks distinguishes between (i) third-parties that utilised those intangibles to manufacture products containing Starbucks coffee ingredients in roasting agreements ([unaffiliated manufacturing company 3] and [unaffiliated manufacturing company 2]), and (ii) third parties which distributed such manufactured products directly to customers ([unaffiliated manufacturing company 7], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 5]). [Unaffiliated manufacturing company 7], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 5] use the intangibles to produce ready-to-drink coffee, which they sell to retailers (mainly supermarkets). Starbucks considers the royalties paid by [unaffiliated manufacturing company 7], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 5] to be comparable to the royalties paid by SMBV, which it estimates to represent [5-10] % of sales ⁽⁸³⁾.
- (153) More generally, Starbucks made a distinction among all agreements concluded with third parties since 2002. To the best of Starbucks' knowledge, the main categories would be the following:
- (1) Agreements whereby third parties exploit Starbucks intangibles (coffee related intangibles and trademarks) on the market:
 - The roasting licence agreements with [unaffiliated manufacturing company 2] and [unaffiliated manufacturing company 3].
 - The trademark and technology licence agreements with [unaffiliated manufacturing company 7], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 5] for the exploitation of the Starbucks trademark and certain specific coffee related know-how.
 - (2) Various agreements which grant third parties access to Starbucks intangibles (technology, know-how and trademarks) under a royalty-free licence due to the specific nature of these agreements:
 - Various co-manufacturing and co-packaging agreements where the IP licence merely serves to enable the third party to produce in accordance with Starbucks' specifications and to protect Starbucks' IP rights. Starbucks' co-manufacturing or co-packaging partners typically supply the products back to Starbucks and do not exploit the intangibles on the market.
 - Various distribution agreements where the IP licence merely serves to allow the distributor to resell Starbucks branded products and to protect Starbucks' IP rights. The distributor does not exploit the Starbucks intangibles on the market.

⁽⁸³⁾ This estimation is based on the sum of royalties paid to Alki LP over the period 2008-2014, divided by EUR [900-1 000] of revenues from all products, which are recorded in Table 5 under the categories 'REV READY TO DRINK', 'REV PACKAGED COFFEE', 'REV SINGLE SERVE PODS-COFFEE', 'REV SINGLE SERVE PODS-VERISMO', 'REV SOLUBLE COFFEE', 'REV PACKAGED TEA', 'REV BLENDED BEVG MIX', 'REV FRAP COFFEE BASE' and 'REV EXTRACT'. Although Starbucks has indicated in their submissions that 'REV SINGLE SERVE PODS-COFFEE', 'REV SINGLE SERVE PODS-VERISMO', 'REV SOLUBLE COFFEE', 'REV FRAP COFFEE BASE' and 'REV EXTRACT' should also be classified as administrative and logistics support revenue as the underlying revenue invoiced to Developers represents the value created by third parties rather than SMBV and that in any case, this only represents according to Starbucks a small portion of the total roasting output of SMBV. Additionally categories 'REV PACKAGED TEA', 'REV BLENDED BEVG MIX' have not been indicated to contain a coffee by Starbucks.

- (3) Licence agreements with Developers to enable them to exploit the Starbucks system and operate Starbucks coffee stores.

2.9.2. Commercial arrangement between Starbucks US and the Starbucks Manufacturing Corp.

- (154) Starbucks indicated that SMC⁽⁸⁴⁾, the only other company ensuring roasting activities within the Starbucks group, does not pay any royalty to Starbucks for the use of the IP relating to the roasting technology and know-how or any other IP. According to Starbucks, this would be the case because SMC does not have separate audited accounts and because for US tax purposes SMC is consolidated with other Starbucks US entities.

3. GROUNDS FOR INITIATING THE PROCEDURE

- (155) The Commission decided to initiate the formal investigation procedure because it took the preliminary view that the SMBV APA, which accepts the remuneration proposed by Starbucks' tax advisor for the functions performed by SMBV in the Netherlands, concluded by the Dutch tax administration in 2008 appeared to constitute State aid within the meaning of Article 107(1) of the Treaty that is incompatible with the internal market.
- (156) In particular, the Commission expressed doubts that the remuneration agreed for the functions performed by SMBV complied with the arm's-length principle.
- (157) More specifically, in the Opening Decision, the Commission raised the following three doubts as regards compliance of the SMBV APA with the arm's-length principle:
- (1) Whether the Dutch tax administration correctly accepted SMBV's classification as a low-risk toll manufacturer when it concluded the SMBV APA;
 - (2) Whether the Dutch tax administration was right to accept adjustments made by Starbucks' tax advisor when it concluded the SMBV APA; and
 - (3) Whether the Dutch tax administration was right to accept SMBV's interpretation as regards the calculation of royalties in its profit and loss accounts, insofar as the level of those royalties is not linked to the value of the IP in question.
- (158) In more detail, under first doubt the Commission questioned the tax advisor's assumption in the transfer pricing report that SMBV does not bear any risk and that it should therefore be classified as a toll or contract manufacturer. In particular, the Commission referred to the evidence of inventory risk recorded in the financial accounts of SMBV that would call this assumption into question.
- (159) Under the second doubt, the Commission questioned two consecutive adjustments by the tax advisor, which seem both to have the same purpose of addressing one comparability concern. The first adjustment consists in reducing the cost base retained to calculate SMBV's taxable base to operating expense. The tax advisor considered this appropriate because SMBV would be a toll or contract manufacturer. A second adjustment, designated a 'Conversion Mark-up Adjustment' in the transfer pricing report, deducts a multiple of COGS from the profit of companies used as comparables for transfer pricing purposes. That second adjustment, presented by the Netherlands as a 'working capital adjustment', reduces SMBV's taxable base in the Netherlands, but neither the adjustment nor the methodology used by the tax advisor seemed justified.
- (160) Finally, under its third doubt, the Commission questioned the arm's-length nature of the royalty paid by SMBV to Alki LP, since the amount of the royalty did not seem related to the value of the IP it is meant to remunerate. Due to the use of the TNMM in the transfer pricing analysis, the royalty corresponds in reality to the residual profit of SMBV, i.e. any profit recorded by SMBV above [9-12] % of operating expense is transformed into a tax deductible royalty (see Figure 2).

⁽⁸⁴⁾ See recital 140 for the financial data of the company.

4. COMMENTS FROM THE NETHERLANDS

- (161) The Netherlands submitted its comments to the Opening Decision on 16 July 2014. They focus, first, on why the remuneration agreed upon in the SMBV APA is at arm's length and why the method chosen by the tax advisor is the appropriate method to determine that remuneration. Second, they focus on why the SMBV APA does not confer a selective advantage to SMBV.

4.1. Comments on transfer pricing

- (162) According to the Netherlands, the remuneration agreed upon in the SMBV APA is at arm's length and the TNMM is the appropriate method to reach an arm's-length outcome in this case. The Netherlands argues that transfer pricing is not an exact science and that there is therefore a range of figures within which the transfer price can lie.
- (163) The Netherlands submits that, according to the OECD TP Guidelines, compensation for transactions between two independent companies will usually reflect the functions that each company performs and that therefore the functional analysis should be at the centre of the assessment of the arm's-length nature of the remuneration of SMBV. Pursuant to the OECD TP Guidelines, the contractual conditions are the starting point when it comes to determining whether the arm's-length principle has been applied correctly.
- (164) According to the Netherlands, the IP assigned by Starbucks to Alki LP in respect of the knowledge and information relating to coffee includes the use of technology and knowhow regarding the recipe for blending coffee beans, the process of roasting coffee and the production of other derived coffee products.
- (165) The Netherlands notes that the Roasting Agreement between Alki LP and SMBV cannot be considered a simple IP licence agreement. That agreement, a fifty-year manufacturing agreement, relates to the roasting of green coffee beans by SMBV. The Roasting Agreement is a contract between a client and a contractor, which also governs the provision of an IP right.
- (166) Alki LP is not based in the Netherlands and, in accordance with the international apportionment of taxation powers, is not liable to pay tax in the Netherlands. The activities carried out by the employees of SMBV are, and have always been:
- (1) Manufacture/coffee roaster activities: these activities are performed by production staff, coffee roasting technicians, maintenance staff, quality control staff and warehousing staff.
 - (2) Logistics and administrative support activities.
- (167) The Netherlands states that Starbucks intention has always been to set up an operating, low-risk coffee roasting plant and that the facts and circumstances have not changed significantly over the years. They argue that as SMBV was not involved in any business restructuring, the Commission cannot cite passages from Chapter 9 of the 2010 OECD TP Guidelines, as the 2010 OECD TP Guidelines were not yet available when the SMBV APA was agreed upon. The use of hindsight should be avoided under the OECD TP Guidelines.
- (168) According to the Netherlands, SCTC is responsible for purchasing the green coffee beans. It further argues that SMBV is not involved in the sourcing of raw materials as, according to the Roasting Agreement, SMBV can only source raw materials from parties which have been designated by Alki LP. SMBV only performs an administrative role in the management of stocks and does not bear the ultimate stock risk.
- (169) More specifically with regard to the administrative role, the Netherlands states that although under the Green Coffee Purchase Agreement it is SMBV that has to provide the information required with regard to the green coffee beans to be bought, this information is obtained by SMBV from Alki LP and, in a manner prescribed by Alki LP, from the Developers. The specifications are therefore only passed on by SMBV once it has obtained the information required for this purpose. According to the Netherlands, this combination results in a situation in which the role of the raw materials is comparable with that of providing goods on a consignment basis.
- (170) With regard to the ultimate stock risk, the Netherlands adds that, although SMBV retains the legal title to all products and materials used for the production activities, and it has put in place provisions for losses in the value of stock, the costs for which those provisions have been put in place are ultimately not born by SMBV. Given the way the royalty payment is determined under the Roasting Agreement, those costs are ultimately borne by Alki LP.

- (171) According to the Netherlands, no employees of SMBV are involved in business negotiations with Starbucks's developers/buyers. Regarding the price-setting, the Netherlands argues that Starbucks [...] determines the global pricing formulae. The accounting team at Starbucks [...] provides SMBV with the price list ('[...] Price List') by way of Alki LP and those prices are calculated using the globally adopted pricing formulae on which the Supply Agreements between SMBV and the Developers are based. The purchase price for green coffee beans paid by SMBV is derived from a pricing formula which includes aspects such as [...]. If the underlying costs rise or fall, the cost base applied to set the prices between SMBV and its Developers is also amended. Moreover, Developers are obliged to purchase coffee and essential goods under the ADOA concluded between Starbucks Coffee BV and Developers.
- (172) According to the Netherlands, SMBV does not operate under a toll manufacturer contract. The contractual relationship results in a situation where the green coffee beans are being purchased legally, but without a functional contribution, from SCTC and invoiced to the buyers. Despite the lack of functionality as regards the purchase and sale, the stocks need to appear on SMBV's balance sheet in line with accounting standards.
- (173) The contractual relationships between SMBV, Alki LP, SCTC and the Developers described above lead, according to the Netherlands, to the conclusion that SMBV is a manufacturer with a low-risk profile and that conclusion is further supported by the functional analysis. SMBV is therefore to be regarded by the Netherlands as the 'least complex entity' (tested party) whose arm's-length remuneration must be determined using a benchmarking study.
- (174) According to the Netherlands, the databases used to carry out a benchmarking study do not provide any details such as the transaction prices or terms and conditions. The information available is limited to a comparison of operational results for the entity as a whole. The TNMM is the most commonly used method internationally. According to the Netherlands, this is confirmed in the 2010 OECD TP Guidelines as well as the 1995 OECD TP Guidelines, which applied when the SMBV APA was concluded.
- (175) In view of the production functionality of SMBV, a cost-oriented profit level indicator is used by SMBV (TNMM method with a profit mark-up on the costs). In this respect, the Netherlands stresses that, in accordance with paragraph 4.9 of the OECD TP Guidelines ⁽⁸⁵⁾, the Dutch tax administration always begins its investigation into transfer prices from the perspective of the method used by the taxpayer. Chapter 2 of the Decree also states that the Netherlands does not apply a 'best method-rule'. This starting point, which is, according to the Netherlands, in line with the OECD TP Guidelines, is also used in the SMBV APA and has resulted in the acceptance of the TNMM with the profit level indicator proposed by SMBV.
- (176) In view of SMBV's role as a toll manufacturer, the relevant costs to determine the cost basis used to calculate the profit mark-up are the costs which have resulted in added value. In the case of SMBV, the operational costs are, according to the Netherlands, the relevant costs with added value to which a profit mark-up is applied. Thus, based on the benchmark, the profit mark-up is [9-12] % of the operational costs. SMBV has a low risk profile and no added value with regard to the raw materials and plays a supporting role for the non-coffee-related products. The operational costs associated with these limited support activities are included in the cost base. As a result, these activities are also paid with a [9-12] % profit mark-up.
- (177) With regard to the comparability adjustments, the Netherlands argues that at the time that the transfer pricing report was drawn up on which the SMBV APA is based, there was no indication on how to deal with manufacturers with a low risk profile. It acknowledges that the 2010 OECD TP Guidelines do contain more instructions on comparability adjustments, including working capital adjustments, but argue that those examples are only guidelines and that this means that other positions can also result in an arm's-length result. Moreover, the Netherlands argues that the assessment of whether the SMBV APA is in line with the arm's-length principle must be based on the knowledge and existing OECD TP Guidelines that were available at the time, i.e. the 1995 OECD TP Guidelines. Therefore, also the Annex to Chapter III of the 2010 OECD TP Guidelines, which shows a working example of a comparability adjustment, could not be applied.
- (178) The Netherlands has also performed a sensitivity analysis on the arm's-length range, calculated according to the methodology in the transfer pricing report, if some of the parameters are modified. The Netherlands modified the

⁽⁸⁵⁾ However, paragraph 4.9 of the 1995 OECD TP Guidelines (and also paragraph 4.9 of the 2010 OECD TP Guidelines) refer to situations where 'because of the complexity of the facts to be evaluated, even the best-intentioned taxpayer can make an honest mistake'.

time period of the comparison and recalculated ranges considered as arm's length for periods 2008-2012 and 2003-2012, compared to the range of 2001-2005 in the transfer pricing report. Additionally the Netherlands recalculated the range if the percentage of COGS deducted from the remuneration under the second adjustments would not be EURIBOR plus 50 basis points, but rather EURIBOR minus 50 basis points and finally if it would be what the Netherlands designate as 'current account rate'. The Netherlands also calculated the margin achieved by SMBV as a percentage of operating cost and raw material costs (excluding the cost associated with tea and other COGS with an intermediary nature) for the periods 2008-2012 and 2003-2012 and compared this with the mark-up on the total cost for the comparable companies on both EBT and EBIT level for the same time periods. On the basis of those simulations, the Netherlands' conclusion is that if any of the doubts raised by the Commission were to be accepted, this would still result in a remuneration within the arm's-length range. In accordance with the OECD TP Guidelines, no corrections are permitted to be made when the remuneration falls within the arm's-length range.

- (179) Finally, on a more general note, the Netherlands disputes the allegation that it failed to request the underlying contracts from which it could be shown that the level of risk carried by SMBV was limited, arguing that this is not necessary as every APA always includes a critical assumption that the facts and circumstances presented appear to be correct and that, in case the facts were not presented correctly, the APA can be terminated. Moreover, the Netherlands argues that, as it had at its disposal the historical background of how the roasting plant was set up, it did not need to request all the contracts ⁽⁸⁶⁾.

4.2. Comments on the application of Article 107(1) of the Treaty

- (180) The Netherlands further submits that no selective advantage is being conferred on SMBV and that no State aid is involved within the meaning of Article 107(1) of the Treaty.
- (181) The Netherlands explains that the arm's-length principle has been incorporated into Article 8b(1) CIT and elaborated further in the Decree, which is fully in line with Article 9 of the OECD Model Tax Convention. The Netherlands reiterates what is also stated in the Decree itself, that the Decree is specifically aimed at aspects which the OECD TP Guidelines leave open to interpretation or where there is a lack of clarity.
- (182) In particular, the Netherlands argues that, in situations relating to transfer pricing, a selective advantage can only be involved if it is demonstrated that the OECD TP Guidelines and Decree are expressly deviated from and that obvious errors of judgment are made in the application of the arm's-length principle or if an established national policy is being deviated from. The tax authorities' discretion in assessing and approving methods and results in individual cases does however not imply any selectivity in any way or arbitrary treatment. Given that the Netherlands considers the result of the SMBV APA as an acceptable approximation of a market price, they do not consider it to confer an advantage to SMBV.
- (183) The Netherlands further argues that the reference system applied by the Commission, which is the ordinary tax system based on the difference between profits and losses of an undertaking carrying on its activities under normal market conditions, is not correctly identified. According to the Netherlands, the correct reference system should be the corporate income tax law which includes the arm's-length principle under Article 8b(1) CIT and the Decree that provides further guidance on the application of the arm's-length principle. The Netherlands argues that as long as the SMBV APA does not deviate from Article 8b(1) CIT and the Decree, there cannot be a selective advantage.
- (184) With regard to the TNMM method used, the Netherlands argues that on the basis of the Decree every taxpayer is in principle free to choose a transfer pricing method, provided the method chosen leads to an arm's-length outcome for the specific transaction. Therefore, the doubts about the use of the TNMM which were raised by the Commission go beyond the doubts that the Dutch tax administration could have expressed under the Decree with regard to this transfer pricing method. Further, the Netherlands insists that the Decree requires only that a transfer pricing analysis results in a range of arm's-length results and not in a precise arm's-length price.

⁽⁸⁶⁾ They refer in this context also to a non-binding Commission Communication on the work of the EU Joint Transfer Pricing Forum (cf. COM(2007)71) where it is stated that 'tax administrations should make every effort to keep the burden of the evaluation to a minimum by requiring only pertinent information'.

- (185) In addition, the Netherlands argues that the decision does not appear to take into account the fact that affiliated and unaffiliated companies are not always in a similar legal and factual situation. There are always differences between affiliated and unaffiliated companies which is something, according to the Netherlands, also acknowledged in the Commission's *Groepsrentebox* decision ⁽⁸⁷⁾.
- (186) Finally, the Netherlands observes that if the Commission were to impose its own interpretation of tax principles of the Member States, it would encroach on the sovereignty of the Netherlands.

5. COMMENTS FROM INTERESTED PARTIES

5.1. Comments by Starbucks to the Opening Decision and the MIT request

- (187) Starbucks sent its comments to the Opening Decision on 16 January 2015. In addition, Starbucks sent market information to the Commission by letters dated 13 April 2015, 29 May 2015, 10 September 2015 and 23 September 2015. Starbucks's comments largely resemble those of the Netherlands, in as much as both argue that the remuneration in the SMBV APA was at arm's length and did not confer a selective advantage to SMBV.
- (188) First, Starbucks argues that SMBV only performs limited, low-risk functions in support of the worldwide Starbucks organisation serving the EMEA region. In support of that argument, [...]. According to Starbucks, the primary responsibility of SMBV consists in the roasting and packaging of coffee, as well as logistic and administrative activities to ensure a smooth and efficient delivery of the various goods to the Developers.
- (189) With regard to the structure chosen, Starbucks argues that a roasting arrangement on a consignment basis was considered, but that this would have been unpractical and would have resulted in administrative complexities and too many inter-company transactions. To align the administrative and legal structure with the physical flow of the goods and for efficiency reasons, Starbucks decided to use SMBV as the contracting and invoicing entity. A consequence of that structure is that the inventories (for green coffee beans, non-coffee products and non-strategic goods) appear on the balance sheet of SMBV, since accounting standards and practice follow the legal product flow. However, Starbucks argues that SMBV's role as contracting and invoicing entity is just of an administrative nature and does not result in any transfer of risks or commercial responsibilities to it as under the Roasting Agreement it is rather Alki LP, supported by Starbucks US, that bears all the economic risk of SMBV, including the inventory risk. Moreover, even though SMBV is the contracting party with the Developers, this is done on the basis of standardised agreements and underlying terms and conditions that are determined by Starbucks US. Finally, as SMBV acquires the legal ownership, the inventory would also have to appear in its balance sheet, which according to Starbucks also explains why SMBV took provisions for inventory obsolescence, which it is compensated for under the SMBV APA.
- (190) As regards the transfer pricing method chosen, although not present in the transfer pricing report, Starbucks sets out the role of Alki LP against the role of SMBV. Starbucks argues that since SMBV is only engaged in routine execution activities in the areas of roasting, packaging and supporting logistic and administrative services, while Alki LP licenses the valuable intellectual property and bears the entrepreneurial risk, SMBV is the least complex entity. Therefore, the TNMM constitutes the most appropriate transfer pricing method. Starbucks argues that, because there are no comparable transactions similar to the arrangement between Alki LP and SMBV, the CUP method would not have been suitable for transfer pricing purposes. In any event, the Dutch tax administration has to start the transfer pricing examination on the basis of the methodology selected by the taxpayer.
- (191) Starbucks recalls that the application of any transfer pricing method typically produces a range of figures, which could be equally defensible, since transfer pricing is not an exact science and that any transfer pricing analysis will inherently result in a range of arm's-length outcomes and a conclusion on *an* arm's-length price and not *the* arm's-length price.
- (192) As regards the adjustments, the purpose of the adjustments is to account for important differences in the functional profiles of SMBV and the comparable companies included in the sample to arrive at an appropriate arm's-length remuneration. According to Starbucks, those adjustments were appropriate, in certain respects conservative, and certainly did not understate SMBV's remuneration for the functions performed. To further substantiate the reasonableness of the [9-12] % mark-up, Starbucks asked [the tax advisor] to make a comparison

⁽⁸⁷⁾ Commission Decision 2009/809/EC of 8 July 2009 on the *groepsrentebox* scheme which the Netherlands is planning to implement (C4/07(ex N 465/06)) (OJ L 288, 4.11.2009, p. 26).

between the actual results realised by SMBV with the actual results realised by the comparable companies in the period 2008–2012. This backward looking analysis demonstrates that the [9-12] % mark-up has remained comfortably within the appropriate ranges. That further confirms the arm's-length nature of the applied transfer pricing methodology for SMBV as agreed upon in the APA concluded with the Dutch tax authorities. Starbucks also requested [a law firm] to provide a second opinion on whether the 2007 transfer pricing report properly applied the arm's-length principle. [The law firm] did not conduct an own factual investigation but reviewed the transfer pricing report and the documents available to the tax advisor. It concluded that the arm's-length principle had been reasonably applied to SMBV's intragroup transactions.

- (193) Similarly to the Netherlands, Starbucks further argues that the Commission did not correctly identify the reference framework. Starbucks argues that the reference system should be the Dutch system of corporate taxation and more specifically Article 8b(1) CIT, the Decree and the administrative practice of the Dutch tax authorities. According to both parties, there could only be a State aid concern if the SMBV APA deviates from the normal interpretation and application of the arm's-length principle in the Netherlands. Moreover, Starbucks argues that an identification of a benchmark group of taxpayers is missing and argues that related and unrelated companies are not always in a comparable legal and factual situation⁽⁸⁸⁾. Finally, Starbucks criticises the Commission's approach for being at odds with the Dutch tax administration's 'substance over form approach'.
- (194) In its submissions in response to the Commission's Starbucks MIT request, Starbucks expressed views presented in recitals 151 to 154. Starbucks further indicated that the Commission cannot use information which post-dates the SMBV APA for its assessment.
- (195) On 24 July 2015, Starbucks submitted a report by [a management consulting firm], produced in response to its request to analyse remuneration models for manufacturing and logistic/administrative services. Starbucks claims that that report supports Starbucks' position regarding the remuneration model and profit level indicator chosen⁽⁸⁹⁾.

5.2. Nederlandse Orde van Belastingadviseurs

- (196) The NOB argues that the determination whether a particular tax treatment of a taxpayer under an APA constitutes State aid should be based on Dutch legislation, administrative practice and application of the arm's-length principle at the time that that APA was entered into. It also argues that under the Decree, the Dutch tax administration does not apply 'a best-method rule' (that is, it does not require that the best method is used for tax base calculation) and that the application of the arm's-length principle usually results in an arm's-length range instead of a single arm's-length price. The NOB notes that the reference to the prudent independent market operator in the Opening Decision seems to introduce a new sort of EU standard above and beyond the OECD TP Guidelines for assessing the arm's-length nature of the underlying arrangement. It asks for a confirmation that the Commission will use the domestic legal system as a reference framework and no other standard. It further argues that taxpayers should have legitimate expectations that APAs that are concluded on the basis of a national interpretation of the domestic laws do not constitute State aid.

5.3. VNO-NCW

- (197) VNO-NCW expresses its worries on the application of the prudent independent market operator test and urges for the use of the nationally applied transfer pricing rules as the benchmark for assessing selectivity. It argues that the application of the arm's-length principle usually results in an arm's-length range instead of a single arm's-length price.

⁽⁸⁸⁾ Relying again on Decision 2009/809/EC.

⁽⁸⁹⁾ According to the report, a margin on COGS is only warranted in cases where the service provider is responsible for areas such as product development/R & D, strategic supply chain planning, strategic procurement and revenue generating activities (i.e. marketing, pricing and demand generation) and also incurs and manages the associated risks. According to Starbucks, SMBV does not perform these functions. The report further states that functions such as day-to-day planning, non-strategic procurement, conversion, order processing, warehousing/logistics and invoicing without commercial risks in relation to the products involved only warrant a margin on the service provider's own operating costs.

5.4. ATOZ

- (198) ATOZ's main argument relates to the legal basis for the Opening Decision. According to ATOZ, the decision does not distinguish whether the pricing agreement in the SMBV APA diverges from Dutch administrative practice, from any other tax authorities' habitual practice or from OECD standards, but merely concludes that it does not respect the arm's-length principle. ATOZ argues that it seems that the Commission takes the view that there is an objective arm's-length standard, based on OECD principles and somehow enshrined in EU law, which transcends Member States' national law and practice. However, according to ATOZ, the Commission should consider whether the SMBV APA is consistent with Dutch law. ATOZ argues that the Commission's approach creates, amongst others, legal uncertainty among multinationals.

5.5. Oxfam

- (199) Oxfam in its comments expressed support for the Commission's investigation, encouraging the Commission to increase its investigation capacity also in view of the fact that it may be better placed than national bodies to structurally assess the tax ruling practices of the Member States. It calls on the Commission to ensure that adequate sanctions are adopted in cases where selective advantages are confirmed and that harmful tax practices are phased out quickly.

5.6. BAK

- (200) The BAK supports the Commission's arguments from the Opening Decision and argues that, in general, those sorts of agreements and legal structures lower the worldwide taxes paid, which has negative consequences for consumers and employees.

6. OBSERVATIONS BY COMPANY X

- (201) Company X, which does not want its identity to be disclosed, presented observations to the Commission in response to the Opening Decision. According to that company, based on its evaluation as a competitor of Starbucks, the value added by the roasting process (roasting and packing, not considering the cost for packaging materials) to green coffee would be on average equal to 13-17 % of the green coffee cost, in case of roast and ground coffee or coffee in beans. According to that company, those levels would be applicable to all distribution channels.

7. INFORMATION SUPPLIED BY STARBUCKS' COMPETITORS IN RESPONSE TO THE MIT REQUEST

7.1. Companies contacted by the Commission in the context of the MIT request

- (202) As explained in recital 20, the Commission contacted four competitors of Starbucks to provide market information on their business model and their value creating activities so as to enable the Commission to complete its assessment of the SMBV APA. The four competitors concerned are Company Y, Dallmayr, Nestlé and Melitta. The choice of the four companies was based on the consideration that all companies are active in the coffee roasting segment and, being group companies, could provide insight into the organisation of coffee roasting activities within an integrated company.

7.2. Dallmayr

- (203) By letter of 27 April 2015, Dallmayr replied to the request for market information by the Commission.
- (204) Dallmayr informed the Commission that coffee roasting is either performed as a stand-alone business or vertically integrated within a company. Larger companies usually perform roasting in-house. The sourcing function is typically integrated with the roasting function. Dallmayr does not outsource the roasting function.
- (205) Dallmayr considers the payment of a royalty by a third party that provides the roasting services rather unusual. In fact, Dallmayr would expect the customer to pay the roaster, not the other way around.

7.3. Nestlé

- (206) By letter of 20 May 2015, Nestlé replied to the Commission's request for market information. Nestlé indicated that the three elements important in the value creation for coffee are the quality (the type of bean), the darkness (achieved by roasting), and the grind size. They also indicated that they do not and would not outsource the roasting function due to the importance of roasting to the flavour development of the product.

7.4. Melitta

- (207) By letter of 26 May 2015, Melitta replied to the Commission's request for market information. Melitta indicated situations in which they could outsource the roasting of coffee beans. These situations are: (i) when machinery is not available in its factory to produce specific types of products, such as specific packaging formats or soft pads; (ii) when machinery is not available in its factory to produce soluble coffee; and (iii) when sales exceed the available roasting and packaging capacities at its factory. In that last case, when roasting and packaging is outsourced due to capacity constraints, green coffee beans from Melitta are sent to the supplier who roasts and packs the coffee to a finished product. That finished product is then delivered to Melitta. Such a contract was in place with the same supplier for a number of years.
- (208) To assure the quality and taste of the finished product, Melitta either provides roasting curve prescriptions or defined taste profiles to the third party to whom the roasting is outsourced.
- (209) The contractual arrangement does not foresee any royalties paid to Melitta when outsourcing the roasting activity.

7.5. Company Y

- (210) By letter of 27 April 2015, Company Y replied to the Commission's request for market information. The Commission requested a clarification by a letter of 11 May 2015, to which Company Y replied on 21 May 2015.
- (211) Company Y does not outsource the coffee roasting function to third parties. The roasting is ensured by a group company designated as a toll manufacturer by Company Y. This coffee roasting company does not pay any royalty for the use of the intellectual property or the know-how used in the roasting process.
- (212) The company pays licence fees for the use of IT systems. For the remuneration of the group company, classified by Company Y as a toll-manufacturer, the cost base is the production costs, excluding raw material costs. The production costs are particularly energy, depreciations on machines (as for example roasting and packaging line), personnel costs, IT costs and maintenance of equipment.

8. COMMENTS FROM THE NETHERLANDS ON THIRD PARTIES' COMMENTS, ON COMMENTS BY COMPANY X AND THE REPLIES TO THE MIT REQUEST

8.1. The Netherlands' comments on third parties' comments

- (213) By letters dated 20 and 26 April 2015, the Netherlands expressed their complete agreement to the observations of Starbucks, the NOB, VNO-NCW and ATOZ. With regard to the comments of Oxfam, the Netherlands indicated that this concerns an observation on detrimental tax competition in general and does not examine the SMBV case in particular. The Netherlands considers the claims made by BAK incorrect and refrains therefore from commenting on them.

8.2. The Netherlands' comments on Company X's comments

- (214) By letter dated 11 March 2015, the Netherlands stated that they cannot provide any substantive reply to the comments by company X, as the Netherlands were not provided with the functional analysis and benchmark of the anonymous competitor.

8.3. The Netherlands' comments on Dallmayr's and Company Y's comments

- (215) By letter dated 27 May 2015, the Netherlands provided its comments to the market information provided by Dallmayr and Company Y. As a general comment, the Netherlands states that the functional analysis and the contractual arrangements are missing and that making a comparison is therefore very difficult as both parties do not outsource the roasting function to an independent third party.
- (216) With regard to Dallmayr, the Netherlands states that Dallmayr's definition of roasting includes more than just coffee roasting, as the sourcing function is integrated with the roasting function. Furthermore, the Netherlands argues that SMBV does not perform sales activities with regard to coffee and non-coffee items but that it seems that Dallmayr has been differently organised on this point. Furthermore, under Dallmayr's client — contractor relationship, the Netherlands argue that the remuneration takes place on the weight and price of green coffee beans which puts the occupation degree risk on the contractor where this is not the case with SMBV.
- (217) With regard to Company Y, the Netherlands states that coffee roasting is considered a routine function and that the roasting facility is remunerated on a cost plus margin, where the green coffee bean cost does not form part of the cost base. According to the Netherlands, this approach is fully in line with the SMBV APA.

8.4. The Netherlands' comments on Nestlé's comments

- (218) With regard to Nestlé, the Netherlands states that the three elements that create value for coffee according to Nestlé are all performed by other foreign companies of the Starbucks group, not by SMBV (sourcing and quality control of the beans is performed by SCTC, the roasting curves are provided by Alki LP, and the Starbucks coffee Shops perform the grinding).

8.5. The Netherlands' comments on Melitta's comments

- (219) With regard to Melitta, the Netherlands states that the three situations described by Melitta where the coffee roasting function is outsourced is in some ways different to the situation of SMBV. In situation 1 and 3, similarity lies in the fact that the sourcing function is also not performed by the producer, but according to the Netherlands the difference is the length of the roasting contract (annual contract compared to the 50 year valid roasting agreement) and the occupation degree risk (which would be at the level of Alki LP according to the Netherlands compared to at the level of Melitta). The second situation the Netherlands considers too different to be able to make a comparison, as it not only concerns the roasting of coffee beans but also the production of all-inclusive products.

8.6. The Netherlands' comments on Starbucks' letters of 13 April, 29 May 2015, 10 and 11 September 2015 and 23 September 2015

- (220) By letter dated 19 June 2015, the Netherlands provided its comments to the market information provided by Starbucks. In those comments, the Netherlands repeated its statement that they consider that the correct reference framework should be the Dutch national tax system and, in particular, Article 8b of the CIT 1969 and the Decree. It argues that Article 8b and the Decree always apply for intra-group transactions, whether a company asked for an APA or not. Moreover, the Netherlands states that the TNMM is internationally the most commonly used method and that the Netherlands does not apply a best method rule. It also argues that an advantage of the TNMM is that a country only has to consider the transfer price unilaterally and that a possible higher or lower transfer price for the green coffee beans would not affect the tax base of SMBV, as the cost of the beans are excluded from the cost base to which the margin is applied.
- (221) In their letter of 25 September 2015, the Netherlands repeat their statements that based on the transfer pricing report, the contractual relationships between SMBV and its counterparties, as well as the actual behaviour of SMBV, SMBV should be considered as a manufacturer with a low risk profile. The Netherlands further argue that it is common practice in the Netherlands that unique functions such as a combination of holding intangible assets and taking on entrepreneurial risks cannot be benchmarked and that it is therefore logic that the royalty payments is calculated as a residual. According to the Netherlands, their statement that the SMBV's APA is at arm's length and fully in line with the OECD TP Guidelines is supported by the second opinion performed by [a law firm] (previously submitted, see recital 192), the submission of Company Y ⁽⁹⁰⁾, the sensitivity analysis

⁽⁹⁰⁾ In the case of Company Y, the mark-up is also only applied on operational expenses.

performed by the Netherlands (previously submitted see recital 178) and by various articles by tax experts. Moreover, although according to the Netherlands a CUP could not be applied to the situation of SMBV, a CUP type of analysis of the contracts between Starbucks and third parties on coffee roasting or co-manufacturing of coffee products, see (recital 152) show according to the Netherlands that the royalty payments from SMBV to Alki LP were not too high ⁽⁹¹⁾.

- (222) In its letter of 7 October 2015, the Netherlands repeats its argument that the CUP method is not applicable to the royalty payment by SMBV to Alki LP. In addition, the Netherlands indicates that the price paid for green coffee beans by SMBV to SCTC would be at arm's length, based on the fact that [unaffiliated manufacturing company 2] was paying a higher price for green coffee beans than SMBV under its contract with Starbucks. Finally, the Netherlands provided financial information on 11 companies from different Union Member States, all registered under the NACE code 'Processing of tea and coffee', indicating that on balance all these companies have a similar or lower profitability than SMBV and that some of those companies even have been loss-making over several financial periods.

9. ASSESSMENT OF THE CONTESTED MEASURE

9.1. Existence of aid

- (223) According to Article 107(1) of the Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the provision of certain goods shall be incompatible with the internal market, in so far as it affects trade between Member States.
- (224) According to settled case-law, for a measure to be categorised as aid within the meaning of Article 107(1) of the Treaty, all the conditions set out in that provision must be fulfilled ⁽⁹²⁾. It is thus well established that, for a measure to be categorised as State aid within the meaning of that provision, there must, first, be an intervention by the State or through State resources; second, the intervention must be liable to affect trade between Member States; third, it must confer a selective advantage on an undertaking and, fourth, it must distort or threaten to distort competition ⁽⁹³⁾.
- (225) As regards the first condition for a finding of aid, the SMBV APA was concluded by the Dutch tax administration (*Belastingdienst*), which is part of the public administration of the Netherlands. That APA entails an acceptance by the Dutch tax administration of a profit allocation proposed by Starbucks on the basis of which SMBV determines its corporate income tax liability to the Netherlands on a yearly basis. The SMBV APA is therefore imputable to the Netherlands.
- (226) As regards the measure's financing through State resources, the Court of Justice has consistently held that a measure by which the public authorities grant to certain undertakings a tax exemption which, although not involving a positive transfer of State resources, places the persons to whom it applies in a more favourable financial situation than other taxpayers constitutes State aid ⁽⁹⁴⁾. Below, the Commission will demonstrate that the SMBV APA results in a lowering of SMBV's tax liability in the Netherlands by deviating from the tax that SMBV would otherwise have been obliged to pay under the general Dutch corporate tax system. Consequently, the SMBV APA should be considered to give rise to a loss of State resources, since any reduction of tax for SMBV results in a loss of tax revenue that would otherwise have been available to the Netherlands.
- (227) As regards the second condition for a finding of aid, SMBV is part of the Starbucks group, a globally active entity operating in all Member States of the Union, so that any aid in its favour is liable to affect intra-Union trade.

⁽⁹¹⁾ According to the Netherlands, although most of the third parties perform other specific activities apart from the roasting activity, carry entrepreneurial risk or own self developed IP, the fees that those third parties pay to Starbucks (either in the form of a higher purchase price for coffee beans or in the form of a royalty on revenue) are at similar levels as those of SMBV. However, according to the Netherlands, lower fees or prices could have been expected because of the more complex profile of some of the third parties.

⁽⁹²⁾ Case C-399/08 P *Commission v Deutsche Post* ECLI:EU:C:2010:481, paragraph 38 and the case-law cited.

⁽⁹³⁾ Case C-399/08 P *Commission v Deutsche Post* ECLI:EU:C:2010:481, paragraph 39 and the case-law cited.

⁽⁹⁴⁾ See Joined Cases C-106/09 P and C-107/09 P *Commission v Government of Gibraltar and United Kingdom*, ECLI:EU:C:2011:732, paragraph 72 and the case-law cited.

Similarly, a measure granted by the State is considered to distort or threaten to distort competition when it is liable to improve the competitive position of the recipient compared to other undertakings with which it competes ⁽⁹⁵⁾. To the extent the SMBV APA relieves SMBV of a tax liability it would otherwise have been obliged to pay under the general Dutch corporate income tax system, that APA distorts or threatens to distort competition by strengthening its financial position, so that the fourth condition for a finding of aid is also fulfilled in the present case.

- (228) As regards the third condition for a finding of aid, the Commission will demonstrate from recital 252 onwards why it considers the SMBV APA to confer a selective advantage upon Starbucks, in so far as it results in a lowering of SMBV's tax liability in the Netherlands by deviating from the tax SMBV would be due under the general Dutch corporate income tax system, therefore fulfilling all the conditions for a finding of aid under Article 107(1) of the Treaty.

9.2. Existence of a selective advantage

- (229) According to settled case-law, 'Article 107, paragraph 1 of the Treaty requires it to be determined whether, under a particular statutory scheme, a State measure is such as to favour 'certain undertakings or the production of certain goods' in comparison with others which, in the light of the objective pursued by the scheme in question, are in a comparable legal and factual situation. If it is, the measure concerned fulfils the condition of selectivity' ⁽⁹⁶⁾.
- (230) In fiscal cases, the Court of Justice has devised a three-step analysis to determine whether a particular tax measure is selective ⁽⁹⁷⁾. First, the common or normal tax regime applicable in the Member State is identified: the 'reference system'. Second, it is determined whether the tax measure in question constitutes a derogation from that system, in so far as it differentiates between economic operators who, in light of the objectives intrinsic to the system, are in a comparable factual and legal situation. If the measure constitutes a derogation from the reference system, it is then established, in the third step of the analysis, whether that measure is justified by the nature or the general scheme of the reference system. A tax measure which constitutes a derogation to the application of the reference system may be justified if the Member State concerned can show that that measure results directly from the basic or guiding principles of that tax system ⁽⁹⁸⁾. If that is the case, the tax measure is not selective. The burden of proof in that third step lies with the Member State.

9.2.1. Determination of the reference system

9.2.1.1. Reference system composed of the general Dutch corporate tax system

- (231) As a general rule, for the purposes of the selectivity analysis a reference system is composed of a consistent set of rules that apply on the basis of objective criteria to all undertakings falling within its scope as defined by its objective.
- (232) In the present case, the Commission considers the reference system to be the general Dutch corporate income tax system which has as its objective the taxation of profits of all companies subject to tax in the Netherlands ⁽⁹⁹⁾. Companies established in the Netherlands are resident taxpayers ⁽¹⁰⁰⁾; they are subject to corporate income tax on their worldwide income ⁽¹⁰¹⁾. Companies that are not established in the Netherlands (non-resident companies) are

⁽⁹⁵⁾ Case 730/79 *Phillip Morris* ECLI:EU:C:1980:209, paragraph 11. Joined Cases T-298/97, T-312/97, etc. *Alzetta* ECLI:EU:T:2000:151, paragraph 80.

⁽⁹⁶⁾ C-172/03 *Heiser* ECLI:EU:C:2005:130, paragraph 40.

⁽⁹⁷⁾ Joined Cases C-78/08 to C-80/08 *Paint Graphos*, ECLI:EU:C:2009:417.

⁽⁹⁸⁾ Joined Cases C-78/08 to C-80/08 *Paint Graphos* ECLI:EU:C:2009:417, paragraph 65.

⁽⁹⁹⁾ See also C-78/08 to C-80/08 *Paint Graphos* ECLI:EU:C:2009:417, paragraph 50.

⁽¹⁰⁰⁾ Article 2 CIT 1969.

⁽¹⁰¹⁾ The standard CIT rate is 25 %. There are two taxable income brackets. A lower rate of 20 % applies to the first income bracket, for taxable income up to EUR 200 000.

subject to tax with regard to income from Dutch sources ⁽¹⁰²⁾. Whether a company is deemed to be established in the Netherlands for tax purposes is assessed on the basis of factual circumstances. Important factors for this assessment include the place of actual management and the head office location. Under the CIT, all companies incorporated under Dutch law are deemed to be residents of the Netherlands ⁽¹⁰³⁾.

- (233) According to Article 3.25 of the Income Tax Act 2001 (*Wet inkomstenbelasting 2001*), which through article 8 CIT 1969 also applies to corporate taxpayers, the taxable yearly profits must be determined on the principles of sound business practice and in a consistent manner independently of the likely outcome ⁽¹⁰⁴⁾. According to sound business practice, for example, allowances may be made for unrealised losses, while profits not yet realised may be disregarded.
- (234) In general, the taxable profits correspond to the accounting profits as reflected in the company's profit and loss accounts. However, adjustments can be made based on specific tax provisions, such as applicable tax incentives, the participation exemption, corrections to the tax result from transactions not executed at arm's length and the application of different depreciation rules under tax and accounting rules ⁽¹⁰⁵⁾.
- (235) While the determination of taxable profits in the case of non-integrated/domestic standalone companies that transact on the market is rather straightforward, as it is based on the difference between income and costs in a competitive market, the determination of taxable profits in the case of integrated group companies like Starbucks requires the use of proxies. Standalone, non-integrated companies can take their accounting profits as a starting point for determining the tax base to which the Dutch corporate income tax applies, since those profits are dependent on prices dictated by the market for the inputs acquired and the products and services sold by the company. By contrast, an integrated company that transacts with companies of the same corporate group will first have to estimate the prices applied to those intra-group transactions for determining their taxable profits, that estimate being determined by the same company controlling the group instead of being dictated by the market.
- (236) However, this difference in determining the taxable profits of non-integrated companies, i.e. those not belonging to a corporate group and thus 'standalone', and integrated companies, i.e. those belonging to a corporate group, has no bearing on the objective of the Dutch corporate income tax system which aims to tax profits of all companies subject to tax in the Netherlands, whether non-integrated or integrated. Since under the general Dutch corporate income tax system, the profits of all companies resident in the Netherlands are taxed in the same manner without any distinction as to group and uncontrolled companies, both types of companies should be considered to be in a similar factual and legal situation in light of the intrinsic objective of that system ⁽¹⁰⁶⁾. Indeed, since the aim of the SMBV APA is to determine the tax base of SMBV for the purpose of levying corporate income tax under that system, it is the general Dutch corporate income tax system that constitutes the reference system against which that APA should be examined to determine whether Starbucks has benefitted from a selective advantage. Accordingly, the different manner in which the taxable profit is necessarily arrived at for integrated and non-integrated companies has no relevance for determining the reference system for the selectivity analysis in the present case.
- (237) This is also confirmed by Article 8b(1) CIT and the Decree that implements the OECD's arm's-length principle into Dutch tax law. In its introduction, the Decree states: 'The policy of the Netherlands on the arm's-length principle in the field of international tax law is that this principle forms part of the Netherlands' system of tax law as a result of its incorporation in the broad definition of income recorded in Section 3.8 of the Income Tax Act 2001.' Section 3.8 of the Income Tax Act 2001 reads: '[t]he profit from a business enterprise is the amount

⁽¹⁰²⁾ Article 3 CIT 1969 and Chapter III of the CIT 1969, according to which non-resident companies are taxed on: (1) business income derived from a Netherlands permanent establishment or permanent representative, (2) income and capital gains derived from immovable property located in the Netherlands, (3) income and capital gains from rights related to the exploration for or exploitation of natural resources situated in the Netherlands or the Netherlands part of the continental shelf, (4) all remuneration derived from a directorship of a resident entity, (5) income from rights to the profits of an enterprise (bonds and shares excluded) the management of which is situated in the Netherlands and (6) income and capital gains, from debt claims related to a substantial shareholding.

⁽¹⁰³⁾ Article 2, paragraph 4, CIT 1969.

⁽¹⁰⁴⁾ From the original Dutch: 'De in een kalenderjaar genoten winst wordt bepaald volgens goed koopmansgebruik, met inachtneming van een bestendige gedraglijn die onafhankelijk is van de vermoedelijke uitkomst. De bestendige gedraglijn kan alleen worden gewijzigd indien goed koopmansgebruik dit rechtvaardigt.'

⁽¹⁰⁵⁾ Chapter II and III of the CIT 1969.

⁽¹⁰⁶⁾ In general, all undertakings having an income are considered to be in a similar legal and factual situation from the perspective of direct company taxation.

of the aggregate benefits that, under whatever name and in whichever forms, are derived from a business enterprise'. Thus, the Decree, through its reference to Section 3.8 of the Income Tax Act 2001 and the concepts of income and profit 'under whatever name and in whichever form derived from a business enterprise', does not make any distinction between income and profits derived by a group company or a standalone company.

- (238) According to the Netherlands and Starbucks, the Commission has previously decided, in its decision on *Groepsrentebox* ⁽¹⁰⁷⁾, that groups and uncontrolled companies do not belong to the same reference system ⁽¹⁰⁸⁾. They thereby seem to imply that the reference system to assess selectivity can only include companies being subject to transfer pricing rules, i.e. group companies.
- (239) At the outset, the Commission recalls that it is not bound by its decisional-practice. Each potential aid measure must be assessed on the basis of its own merits under the objective criteria of Article 107(1) of the Treaty, so that even if a contrary decisional practice were shown to exist, that could not affect the findings of the present decision ⁽¹⁰⁹⁾.
- (240) In any event, contrary to what the Netherlands and Starbucks claim, the *Groepsrentebox* decision does not confirm that where a tax measure is granted in favour of an integrated company, the reference system must necessarily be limited to those types of companies. Moreover, the objective of the tax measure at the basis of the *Groepsrentebox* decision is not comparable to the present case and therefore, the conclusions the Netherlands and Starbucks draw from that decision are not applicable to the present case.
- (241) The *Groepsrentebox* scheme was set up at the time by the Dutch authorities to reduce the difference in tax treatment between the provision of equity capital and loan capital in a group context and, as such, to reduce arbitrage between these two forms of intra-group financing ⁽¹¹⁰⁾. The Commission observed in its final decision that given the objective of the measure, which was to reduce the difference in tax treatment between the provision of equity capital and loan capital in a group context and, as such, to reduce arbitrage between these two forms of intra-group financing, it is 'only group companies, [and not stand-alone companies,] that are confronted with arbitrage between equity capital and loan capital within their group' ⁽¹¹¹⁾. It was in the light of that observation, as well as of the objective of the scheme which was 'to reduce incentives for arbitrage between financing through a capital injection and a loan, and ensuring tax neutrality in this regard' ⁽¹¹²⁾, that the Commission considered the reference system in that case to include only companies subject to corporation tax and engaged in intra-group financing transactions ⁽¹¹³⁾.
- (242) By contrast, the objective of the SMBV APA is to determine SMBV's tax base to calculate the tax due for the purposes of levying the Dutch corporate income tax on that amount. First, while it could be argued that the objective underlying the *Groepsrentebox* decision is only valid in a group context (such as the fact that stand-alone companies are not faced with the issue of arbitrage between different forms of financing), the determination of the tax base for the computation of the annual corporate income tax liability is equally relevant and applicable to entities that are part of a group as well as stand-alone companies.
- (243) Second, while it is true that SMBV provides services to other companies of the group and thus operates in a group context, the transaction it carries out could also be carried out outside a group context. SMBV is a coffee roaster and distribution company. As the contracts submitted by Starbucks demonstrate, other companies of the Starbucks group outsource this function to third parties ⁽¹¹⁴⁾. Moreover, the answers to the MIT request by the competitors further demonstrate that roasting is outsourced to non-group companies ⁽¹¹⁵⁾. Thus, the activities of SMBV can be carried out by independent companies and not only in a pure intra-group setting ⁽¹¹⁶⁾.

⁽¹⁰⁷⁾ Decision 2009/809/EC.

⁽¹⁰⁸⁾ Observations of SMBV to the Opening Decision, Section 2.20.

⁽¹⁰⁹⁾ C-138/09 *Todaro Nunziatina & C.* ECLI:EU:C:2010:291, paragraph 21.

⁽¹¹⁰⁾ The scheme provided that the positive balance between interest received on group loans and interest paid in the context of intra-group financing transactions was not taxed at the standard corporate tax rate of 25,5 % at the time but taxed in a 'group interest box' at the rate of 5 %.

⁽¹¹¹⁾ *Groepsrentebox* decision, recital 85.

⁽¹¹²⁾ *Groepsrentebox* decision, recital 101.

⁽¹¹³⁾ *Groepsrentebox* decision, recital 107.

⁽¹¹⁴⁾ See recitals 148 to 150.

⁽¹¹⁵⁾ Cf. the answer of Melitta at recitals 207 to 209.

⁽¹¹⁶⁾ It should be noted, however, that even if SMBV were engaged in financing transactions, the Commission would not consider the *Groepsrentebox* decision as applicable given the different objective pursued by the group interest scheme on the one hand and the determination of SMBV's taxable base on the other hand.

- (244) The Commission therefore concludes that the reference system against which the SMBV APA should be examined is the general Dutch corporate tax system in the form of the Dutch corporate income tax rules (CIT). In particular, that reference system is composed of a consistent set of rules that apply on the basis of objective criteria for the taxation of profits of stand-alone companies, where the determination of the taxable profit usually coincides with the accounting profit (subject to certain adjustments based on tax law) and of group companies, which resort to transfer prices to allocate profits, alike. In light of the intrinsic objective of that system, both types of companies — non-integrated and integrated companies — should be considered to be in a similar factual and legal situation.

9.2.1.2. Article 8b(1) CIT and the Decree do not constitute the appropriate reference system

- (245) The Netherlands considers that the reference system should be the Decree and consequently that SMBV should be considered in a similar factual and legal situation only to group companies that fall under the Decree ⁽¹¹⁷⁾. Accordingly, the existence of selectivity would require evidence that SMBV has received a different treatment as compared to other group entities tax resident in the Netherlands falling under the Decree.
- (246) The Commission does not accept this line of reasoning.
- (247) As explained in recital 236, the objective of the Dutch corporate income tax system is to tax the profits of all companies that fall under its tax jurisdiction, irrespective of whether those companies are integrated or non-integrated companies. As explained in recital 232, Dutch corporate income tax is levied on the worldwide profits of companies resident in the Netherlands (unless a tax treaty applies), while non-resident companies, including Dutch branches of foreign companies, are only taxed on specific Dutch-sourced income.
- (248) By considering, as the Netherlands does, that the reference system only includes group companies, since only they need to revert to the arm's-length principle as required by Article 8b CIT and the Decree when allocating profit, an artificial distinction is introduced between companies based on their company structure for the purpose of determining their taxable profits that the general Dutch corporate income tax system does not recognise when taxing profits of companies falling within its tax jurisdiction. Indeed, the Decree is meant precisely to ensure that group and stand-alone companies are treated in a similar manner under the general Dutch corporate income tax system and taxed on profits that derive from their activities, whether those activities are carried out in an intra-group context or not.
- (249) The Commission considers that the purpose of the Decree is and cannot be to establish special rules for related companies, but to clarify the application of the arm's-length principle under Article 8b(1) CIT in light of the OECD TP Guidelines given that the purpose of the Decree is, as acknowledged by the Netherlands, 'specifically aimed at aspects which the OECD TP Guidelines leaves open to interpretation or where there is a lack of clarity'. The rules laid down in the Decree are therefore meant to align the tax treatment of related companies with the treatment of unrelated companies to the extent that transactions between related parties should be priced at arm's length and therefore mirror the situation of unrelated parties for the purposes of levying corporate income tax on their profits.
- (250) In any event, the Commission observes that if the reasoning of the Netherlands and Starbucks were accepted that the Decree does establish special rules for integrated companies, the existence of those special rules could, in itself, lead to a finding of selectivity. In fiscal cases, selectivity exists when a Member State exempts a (certain category of) undertaking(s) from a general rule that applies to all undertakings in a comparable factual and legal situation. It also exists when a special regime is set up that deviates from that general rule for the benefit of certain but not all undertakings in a comparable factual and legal situation. Thus, considering the Commission concludes that integrated and non-integrated companies are in a comparable factual and legal situation as regards the imposition of Dutch corporate income tax to profits, the creation of a special regime that applies only to integrated companies, which deviates from the general Dutch corporate income tax rules, is in itself selective in nature, so that any benefit granted on the basis of that regime is selective in nature.

⁽¹¹⁷⁾ The Netherlands' observations under Section 3.2 to the Opening Decision.

- (251) The Commission therefore concludes that, in the present case, the reference system against which the SMBV APA should be examined is the general Dutch corporate income tax system, irrespective of whether corporate income tax under that system is imposed on group or stand-alone companies.

9.2.2. *Selective advantage due to a derogation from the general Dutch corporate income tax system*

- (252) Having determined that the general Dutch corporate income tax system constitutes the reference system against which the SMBV APA should be assessed, it is necessary to establish whether that APA constitutes a derogation from that reference system, leading to unequal treatment between companies that are factually and legally in a similar situation.
- (253) In relation to that second step of the selectivity analysis, whether a tax measure constitutes a derogation from the reference system will generally coincide with the identification of the advantage granted to the beneficiary under that measure. Indeed, where a tax measure results in an unjustified reduction of the tax liability of a beneficiary who would otherwise be subject to a higher level of tax under the reference system, that reduction constitutes both the advantage granted by the tax measure and the derogation from the system of reference.
- (254) According to the Court, in the case of an individual aid measure, as opposed to a scheme, ‘the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective’ ⁽¹¹⁸⁾. In the present case, the individual aid measure from which SMBV benefits is the SMBV APA, which endorses a methodology for determining its taxable profit in the Netherlands for the functions it performs within the Starbucks group, which are subsequently taxed under the general Dutch corporate income tax system.

9.2.3. *Selective advantage resulting from a deviation from the arm’s-length principle*

- (255) In principle, the function of an APA is to establish in advance the application of the ordinary tax system to a particular case, given a set of facts and circumstances specific to that case, for a certain period of time and provided that there is no material change over the application of the APA in that specific set of facts and circumstances. Where an APA is based on a method of assessment that deviates from what would result from a normal application of the ordinary tax system without justification, that APA will be considered to confer a selective advantage upon its beneficiary in so far as that selective treatment results in the lowering of that beneficiary’s tax liability in the Member State concerned as compared to companies in a similar legal and factual situation.
- (256) An advantage pursuant to Article 107(1) of the Treaty is any economic benefit that an undertaking would not have obtained under normal market conditions, i.e. in the absence of the State intervention ⁽¹¹⁹⁾. Thus, whenever the financial situation of an undertaking is improved as a result of a State intervention, an advantage is present. Such improvement is shown by comparing the financial situation of the undertaking as a result of the contested measure with the financial situation of that undertaking had the measure not been granted ⁽¹²⁰⁾. An advantage can consist both in the granting of positive economic advantages as well as in the mitigation of charges normally included in the budget of an undertaking ⁽¹²¹⁾.
- (257) As explained in recital 42 et seq., by concluding the SMBV APA, the Netherlands accepted a methodology for determining SMBV’s taxable profit in the Netherlands, as proposed by the Starbucks’ tax advisor in the transfer pricing report, which allows SMBV to determine its corporate income tax liability in the Netherlands on a yearly basis for the duration of which that APA is valid. More specifically, the transfer pricing report endorsed by the SMBV APA determines, in the absence of transactions dictated by the market as would exist for a non-integrated independent company, the profit to be allocated to that company of the Starbucks group resulting from the transactions it concludes with the other group companies of the Starbucks group.

⁽¹¹⁸⁾ Case C-15/14 P *Commission v MOL* ECLI:EU:C:2015:362, paragraph 60; See also, Case T-385/12 *Orange v Commission* ECLI:EU:T:2015:117.

⁽¹¹⁹⁾ Case C-39/94 *SFEI and Others* ECLI:EU:C:1996:285, paragraph 60; Case C-342/96 *Spain v Commission* ECLI:EU:C:1999:210, paragraph 41.

⁽¹²⁰⁾ Case 173/73 *Italy v Commission* ECLI:EU:C:1974:71, paragraph 13.

⁽¹²¹⁾ See, for instance, Case C-387/92 *Banco Exterior de Espana*, ECLI:EU:C:1994:100.

- (258) The Court of Justice has already held that a reduction in the taxable base that results from a tax measure that enables a taxpayer to employ transfer prices in intra-group transactions that do not resemble prices which would be charged in conditions of free competition between independent undertakings negotiating under comparable circumstances at arm's length confers a selective advantage on that taxpayer, by virtue of the fact that its tax liability under the ordinary tax system is reduced as compared to independent companies which rely on their accounting profits as a basis to determine their taxable base ⁽¹²²⁾.
- (259) In its judgment on the Belgian tax regime for coordination centres ⁽¹²³⁾, the Court of Justice assessed a challenge to a Commission decision which concluded, inter alia, that the method for determining taxable income under that regime conferred a selective advantage on those centres ⁽¹²⁴⁾. Under that regime, taxable profits were set at a flat-rate amount which represented a percentage of the full amount of operating costs and expenses, from which staff costs and financial charges were excluded. According to the Court, 'in order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centres confers an advantage on them, it is necessary, [...], to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition.' The Court then held that 'the effect of the exclusion of [staff costs and the financial costs] from the expenditure which serves to determine the taxable income of the centres is that the transfer prices do not resemble those which would be charged in conditions of free competition', which the Court found to '[confer] an advantage on the coordination centres' ⁽¹²⁵⁾.
- (260) The Court has thus accepted that a tax measure which results in a group company charging transfer prices that do not reflect those which would be charged in conditions of free competition, that is prices negotiated by independent undertakings negotiating under comparable circumstances at arm's length, confers an advantage on that group company in so far as it results in a reduction of its taxable base and thus its tax liability under the ordinary corporate income tax system.
- (261) The principle that transactions between intra-group companies should be remunerated as if they were agreed to by independent companies negotiating under comparable circumstances at arm's length is generally referred to as the 'arm's-length principle'. In the Belgian coordination centres judgment, the Court of Justice endorsed the arm's-length principle as the benchmark for establishing whether a group company receives an advantage for the purposes of Article 107(1) of the Treaty as a result of a tax measure that determines its transfer pricing and thus its taxable base.
- (262) The purpose of the arm's-length principle is to ensure that transactions between group companies are treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by independent companies. Otherwise, group companies would benefit from a favourable treatment under the ordinary corporate income tax system when it comes to the determination of their taxable profits that is not available to independent companies, leading to unequal treatment between companies that are factually and legally in a similar situation in light of the objective of such a system, which is to tax the profits of all companies falling under its tax jurisdiction.
- (263) The Commission's assessment of whether the Netherlands granted a selective advantage to SMBV must therefore consist in verifying whether the methodology accepted by the Dutch tax administration by concluding the APA for the determination of SMBV's taxable profits in the Netherlands departs from a methodology that results in a reliable approximation of a market-based outcome and thus from the arm's-length principle. In so far as the methodology the Netherlands accepted by the SMBV APA results in a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profit under that system is determined by the market, that APA will be deemed to confer a selective advantage to SMBV for the purposes of Article 107(1) of the Treaty.

⁽¹²²⁾ Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v Commission*, ECLI:EU:C:2006:416.

⁽¹²³⁾ Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v Commission*, ECLI:EU:C:2006:416.

⁽¹²⁴⁾ Commission Decision 2003/757/EC of 17 February 2003 on the aid scheme implemented by Belgium for coordination centres established in Belgium (OJ L 282, 30.10.2003, p. 25).

⁽¹²⁵⁾ Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v Commission*, ECLI:EU:C:2006:416, paragraphs 96 and 97.

- (264) The arm's-length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the Treaty of tax measures granted to group companies independently of whether a Member State has incorporated this principle into its national legal system. It is used to establish whether the taxable profits of a group company for corporate income tax purposes has been determined on the basis of a methodology that approximates market conditions, so that that company is not treated favourably under the general corporate income tax system as compared to non-integrated companies whose taxable profit is determined by the market. Thus, for any avoidance of doubt, the arm's-length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded ⁽¹²⁶⁾.
- (265) Consequently, in response to the Netherlands' argument that the Commission, in undertaking such an assessment, replaces the national tax administration in its interpretation of their national law ⁽¹²⁷⁾, the Commission recalls that it is not examining whether the SMBV APA complies with the arm's-length principle as laid down in Article 8b(1) of the CIT or the Decree, but whether the Dutch tax administration conferred a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty by concluding an APA that endorses a profit allocation that departs from the amount of profit that would have been taxed under the general Dutch corporate income tax system if the same transactions had been executed by independent companies negotiating under comparable circumstances at arm's length.
- (266) In response to the argument invoked by the Netherlands and Starbucks that because transfer pricing is not an exact science, the assessment by the Commission of the transfer pricing arrangement agreed in the SMBV APA should necessarily be limited ⁽¹²⁸⁾, the Commission recalls that the approximation component of transfer pricing has to be viewed in the light of its objective. While the 2010 OECD TP Guidelines do indeed acknowledge that transfer pricing is not an exact science in paragraph 1.13 thereof, that same paragraph first explains that '[i]t is important not to lose sight of the objective to find a reasonable estimate of an arm's-length outcome based on reliable information'. The objective of the OECD TP Guidelines is to develop, for the benefit of tax administrations and multinational enterprises, the most appropriate methods for estimating arm's-length prices of cross-border transactions between associated enterprises for taxation purposes. The pursuit of that objective would be impossible if the approximative nature of the transfer pricing exercise could be used to disregard the consensus on appropriate transfer pricing methodologies which those guidelines represent. The approximative nature of the arm's-length principle can therefore not be invoked to justify a transfer pricing analysis that is either methodologically inconsistent or based on an inadequate comparables selection.
- (267) In conclusion, if it can be shown that the methodology accepted by the Dutch tax administration, by concluding the SMBV APA, for the determination of SMBV's taxable profits in the Netherlands departs from a methodology that leads to a reliable approximation of a market-based outcome and thus from the arm's-length principle, that APA will be found to confer a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty in so far as it leads to a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose tax base is determined by the profits they generate under market conditions.

9.2.3.1. Methodological choices, parameters and adjustments underlying the SMBV APA

- (268) The SMBV APA accepts a methodology for determining a profit allocation to SMBV within the Starbucks group, which is based on a transfer pricing report prepared by Starbucks' tax advisor that calculates a remuneration for a function performed by SMBV (roasting/manufacturing).

⁽¹²⁶⁾ Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v Commission*, ECLI:EU:C:2006:416, paragraph 81.

⁽¹²⁷⁾ See recital 186.

⁽¹²⁸⁾ See recital 162 and 191.

- (269) In calculating the remuneration due to SMBV, the tax advisor proceeds to successive methodological choices in the transfer pricing report:
- (i) the choice to use the TNMM to estimate a taxable profit;
 - (ii) the choice of operating expenses as profit level indicator for use in the application of the TNMM ⁽¹²⁹⁾; and
 - (iii) the application of a working capital adjustment to address differences between SMBV and the comparables used to estimate an arm's-length mark-up ⁽¹³⁰⁾.
- (270) The transfer pricing report concludes on a remuneration for the roasting function SMBV performs equal to a mark-up of [9-12] % of its operating expense, which is accepted by the Dutch tax administration as constituting an arm's-length remuneration in the SMBV APA. The Dutch tax administration further accepts in the SMBV APA that any profit generated by SMBV in excess of that level of remuneration will be paid out as a royalty to Alki LP.
- (271) In the following sections, the Commission will explain why it considers that several of the methodological choices underlying the transfer pricing report should not have been accepted by the Dutch tax administration in the SMBV APA, because their acceptance results in a taxable profit for SMBV that cannot be regarded to constitute a reliable approximation of a market-based outcome and results in a reduction of SMBV's tax liability as compared to non-integrated companies whose taxable profits is determined by the market.
- (272) First and foremost, the transfer pricing report fails to identify or analyse SMBV's controlled and uncontrolled transactions ⁽¹³¹⁾, which is a necessary first step in assessing the arm's-length nature of commercial conditions applicable between related parties for transfer pricing purposes. More specifically, the transfer pricing report fails to examine whether the royalty payment made by SMBV to Alki LP for the licensing of the roasting IP, which is the intra-group transaction for which the SMBV APA was effectively requested and granted ⁽¹³²⁾, is at arm's length. As the Commission will demonstrate, a transfer pricing analysis of the arm's-length value of that royalty based on comparable uncontrolled transactions leads to the conclusion that no royalty should be due for the roasting IP licensed by Alki LP to SMBV ⁽¹³³⁾. The transfer pricing report also fails to examine whether the price charged for the green coffee beans by SCTC to SMBV is at arm's length. As the Commission will demonstrate, no market-based justification exists for the substantial increase in that price from 2011 onwards, which resulted in a reduction of SMBV's accounting profits from that year onwards ⁽¹³⁴⁾.
- (273) In addition, and without prejudice to the preceding recital, the transfer pricing report fails to analyse the complexity of the functions of all group companies involved in controlled transactions, in particular Alki LP, when accepting that SMBV is to be regarded as the 'least complex function' and, thus, the 'tested party' for the purpose of applying the TNMM ⁽¹³⁵⁾.
- (274) Finally, and without prejudice to the preceding two recitals, the transfer pricing report misidentifies SMBV's main functions to be remunerated and inappropriately seeks to estimate that remuneration on the basis of operating expenses ⁽¹³⁶⁾.

9.2.3.2. The transfer pricing report fails to examine the intra-group transaction for which the SMBV APA was effectively requested and granted

- (275) The SMBV APA agrees to a taxable remuneration for SMBV for its roasting function. It also agrees that any profits generated by SMBV in excess of that level of remuneration will be paid out as a royalty to Alki LP which is not taxed in the Netherlands.

⁽¹²⁹⁾ Referred to as the 'first adjustment' in recitals 49, 97 and 100 of the Opening Decision.

⁽¹³⁰⁾ Referred to as the 'second adjustment' in recital 52 of the Opening Decision. Whereas the first two choices are discussed in the OECD Guidelines, the subsequent choice of applying a working capital adjustment is not covered by the OECD Guidelines in the manner applied by the tax advisor in this case.

⁽¹³¹⁾ A controlled transaction is a transaction between two enterprises that are associated enterprises with respect to each other, while an uncontrolled transaction is a transaction between enterprises that are independent enterprises with respect to each other.

⁽¹³²⁾ Section 9.2.3.2.

⁽¹³³⁾ Section 9.2.3.3 (a) to (e).

⁽¹³⁴⁾ Section 9.2.3.3 (f).

⁽¹³⁵⁾ Section 9.2.3.4.

⁽¹³⁶⁾ Section 9.2.3.5.

- (276) In other words, by concluding the SMBV APA, the Dutch tax administration expressly accepts that the tax advisor's methodology for calculating the taxable remuneration due to SMBV for its roasting function directly determines the level of the royalty paid by SMBV to Alki LP for the roasting IP licensing arrangement between them. It also expressly accepts that the actual level of profits generated by SMBV in the Netherlands is to be reduced for tax purposes by that royalty payment, resulting in a lower taxable profit than that actually recorded. Indeed, if SMBV's accounting profits are higher than the level of remuneration agreed to in the SMBV APA, the royalty payment to Alki LP will be increased by the difference between that level of remuneration and SMBV's accounting profits.
- (277) Thus, the royalty is an adjustment variable determined by combining SMBV's accounting profits and the remuneration agreed in the SMBV APA. As such, the roasting IP licensing arrangement between Alki LP and SMBV is the transaction for which the SMBV APA was effectively requested and the methodology for determining the level of that royalty as an adjustment variable is the transaction effectively being priced by the SMBV APA.
- (278) Nevertheless, the transfer pricing report upon which that APA is based only proposes a remuneration for SMBV by analysing a function performed by it (roasting/manufacturing) through the application of the TNMM; it does not identify the royalty payment as the adjustment variable in constructing that proposed remuneration. Consequently, that report fails to identify or analyse the roasting IP licensing arrangement for which that royalty is paid as the transaction effectively being priced and therefore fails to establish a methodology for ensuring that that royalty payment is in line with the arm's-length principle.
- (279) The purpose of a transfer pricing exercise, however, is to establish whether the conditions of controlled transactions are consistent with the arm's-length principle.
- (280) That focus on transactions for the purposes of transfer pricing is clearly expressed in paragraph 1.6 of the 2010 OECD TP Guidelines, which clarifies from the outset that 'because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's-length principle' ⁽¹³⁷⁾.
- (281) In other words, commercial transactions between related and unrelated parties must first be clearly identified before being assessed for comparability. That focus on transactions is equally supported under Dutch tax law by the requirement not to allow for deductions of expenses which are not in line with the arm's-length principle ⁽¹³⁸⁾.
- (282) It is only if it is impossible to compare a particular intra-group transaction for which an APA is being sought (taking into account the functions performed) to similar uncontrolled transactions, that resorting to a comparison of functions performed is justified. In this vein, paragraph 1.41 of the 2010 OECD TP Guidelines explains that 'before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction' ⁽¹³⁹⁾. This also explains the preference for the CUP method over all other transfer pricing methods expressed both in paragraph 2.14 of the 2010 OECD TP Guidelines and in paragraph 2.7 of the 1995 OECD TP Guidelines, both of which state: 'Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's-length principle. Consequently, in such cases the CUP method is preferable over all other methods'.
- (283) Similarly, both the 1995 and 2010 OECD TP Guidelines favour traditional transactional methods over transactional profit methods as a means of establishing whether a transfer price is at arm's length ⁽¹⁴⁰⁾. The 1995 OECD TP Guidelines even exclude automatically resorting to transactional profit methods such as the TNMM for transfer pricing purposes, stating in paragraph 3.50 thereof: 'There are, however, cases where traditional

⁽¹³⁷⁾ See, also, Paragraph 1.6 of the 1995 OECD TP Guidelines.

⁽¹³⁸⁾ See recital 234.

⁽¹³⁹⁾ The focus on transactions is again stated in paragraph 1.33 of the 2010 OECD TP Guidelines clarifying that '*application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.*'

⁽¹⁴⁰⁾ See recitals 68 and 69.

transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. These would be considered cases of last resort. (...) However, even in a case of last resort, it would be inappropriate to automatically apply a transactional profit methods without first considering the reliability of that method'.

- (284) The Netherlands' observation that its tax administration is not bound by a best method rule does not relieve that administration of the obligation to confirm that the transfer pricing method the taxpayer selects results in a reliable approximation of an arm's-length price before accepting an APA request based on that method. That obligation is even reflected in the provision of the Decree to which the Netherlands refers in this regard. Indeed, paragraph 3.1 of the Decree provides '[t]he Dutch Tax and Customs Administration should always begin its investigation into the transfer prices from the perspective of the method used by the taxpayer at the time of the transaction. This means that the taxpayer is, in principle, free to choose a transfer pricing method, provided the selected method results in an arm's-length result for the specific transaction. The taxpayer must demonstrate its choice'. In other words, the method proposed by the taxpayer should be the starting point of the tax administration's examination of the APA request. However, whatever method chosen must ensure an arm's-length result for the specific transaction being priced, so that the tax administration remains free to question the appropriateness of the method chosen by the taxpayer. Finally, given that that provision requires the appropriateness of the transfer pricing method chosen to be reasoned by the taxpayer and given the Decree's own express preference for the CUP method where comparable transactions are available ⁽¹⁴¹⁾, the absence of a best method rule does not relieve the tax administration from ensuring, before it agrees to the APA request, that the transfer pricing method selected by the taxpayer is able to provide for a reliable approximation of a market-based outcome in line with the arm's-length principle.
- (285) As will be shown in the following section, since the transfer pricing report failed to provide any information on uncontrolled transactions similar to the roasting IP licensing arrangement between SMBV and Alki LP and, thus, since it failed to examine the only intra-group transaction that was effectively being priced by the transfer pricing analysis, the transfer pricing methodology proposed by Starbucks' tax advisor and accepted by the SMBV APA cannot be considered to result in a reliable approximation of a market-based outcome in line with the arm's-length principle. Indeed, since the transfer pricing report engages in an analysis of an arm's-length remuneration for SMBV based on an incorrect point of departure (its roasting function), it results in a remuneration which is improperly estimated on the basis of the TNMM. Rather, recourse should have been had to more reliable comparisons to available information on similar transactions between unrelated parties for transfer pricing purposes, which was in the possession of Starbucks at the time that the APA request was made and should have been requested by the Dutch tax administration to ensure the royalty payment being priced by the SMBV APA was at arm's length.

9.2.3.3. The royalty payment to Alki LP resulting from the SMBV APA is not priced at arm's length

- (286) The IP for which the royalty payment is made covers the roasting know-how and the roasting curves licensed by Alki LP to SMBV. That royalty payment does not relate to the value of the Starbucks' brand, since the right to use that brand is paid for by the Shops to Starbucks Coffee BV.
- (287) In the Opening Decision, the Commission expressed doubts on the arm's-length nature of the royalty payment ⁽¹⁴²⁾. In particular, the Commission explained that the fact that the level of the royalties due by SMBV to Alki LP is dependent on the difference between the remuneration established in the SMBV APA and the accounting pre-tax profit before the payment of the royalty ⁽¹⁴³⁾ leads to a situation in which that royalty payment is calculated as profit in excess of the SMBV APA and does not reflect the arm's-length value of that IP ⁽¹⁴⁴⁾. The Commission referred, in that respect, to paragraph 6.16 of the 2010 OECD TP Guidelines, according to which, 'a royalty would ordinarily be a recurrent payment based on the user's output, sales, or in some rare circumstances, profits' ⁽¹⁴⁵⁾. In the SMBV APA, the royalty payment to Alki LP is not related to the output, sales, or profits of SMBV. The Commission further indicated, in recital 120 of its Opening Decision, its doubts on the arm's-length level of the royalty payment, considering the royalty is disconnected through the pricing method from the economic value of any underlying IP, the value to SMBV of the roasting intangibles.

⁽¹⁴¹⁾ See recital 90.

⁽¹⁴²⁾ See, in particular, recitals 120 and 122 of the Opening Decision.

⁽¹⁴³⁾ As explained in recital 102.

⁽¹⁴⁴⁾ See recital 115 of the Opening Decision.

⁽¹⁴⁵⁾ See paragraph 6.16 of the 1995 OECD TP Guidelines which presents the same consideration.

- (288) To compare the value of the royalty payment to royalty levels observed on the market set in terms of percentage of turnover, the Commission calculated the amount of the royalty paid by SMBV to Alki LP as a percentage of the sales of roasted coffee by SMBV to the Shops each year. According to those calculations, the royalty payment varies between [1-10] % to [30-40] % of SMBV's revenues from sales of coffee over the life of the SMBV APA, confirming the Commission's doubts about the fluctuation of the royalty ⁽¹⁴⁶⁾. Moreover, for three of those years the resulting levels were above [30-40] %, as presented in Table 10:

Table 10

Fluctuation of the royalty payment over the life of the SMBV APA

(EUR)

	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Royalty paid by SMBV	4 699 336	1 698 150	2 470 449	1 079 817	12 352 838	5 786 211	22 812 962	24 285 088
Revenue from sales of coffee	[20-30 million]	[20-30 million]	[20-30 million]	[20-30 million]	[40-50 million]	[50-60 million]	[50-60 million]	[60-70 million]
Net result for the year	[20-30 %]	[1-10 %]	[1-10 %]	[1-10 %]	[30-40 %]	[10-20 %]	[30-40 %]	[30-40 %]

- (289) In this specific context, the variable nature of the royalty payment gives a first indication that the level of that payment bears no relation to the value of the IP for which it is being paid.

- (290) For the reasons explained in recitals 291 to 338, the Commission considers that a comparison to comparable uncontrolled transactions using the CUP method, in particular the IP licensing arrangements in several roasting and manufacturing and distribution agreements Starbucks has concluded with third parties, demonstrates that the arm's-length value of the royalty paid by SMBV to Alki LP for the roasting IP should be zero. In other words, no royalty should be due for that IP in that specific relationship, since SMBV does not derive any benefit from the use of the roasting IP licensed from Alki LP.

- (a) Comparison to roasting agreements concluded by Starbucks with third parties and comparison to similar arrangements on the market

- (291) Certain roasting and manufacturing contracts concluded by Starbucks group companies with third parties, listed in recitals 148 to 150, were provided by Starbucks to the Commission during the investigation. For the reasons explained in recitals 292 to 298, the Commission considers those transactions to constitute a direct comparable for determining the level of the royalty payment due by SMBV to Alki LP under the roasting IP licensing arrangement.

- (292) Paragraph 1.38 of the 2010 OECD TP Guidelines provides the following guidance on the comparability examination 'the examination of the [...] comparability factors is by nature two-fold i.e. it includes an examination of the factors affecting the taxpayer's controlled transactions and an examination of the factors affecting uncontrolled transactions. Both the nature of the controlled transaction and the transfer pricing method adopted [...] should be taken into account when evaluating the relative importance of any missing piece of information on possible comparables [...]'.⁽¹⁴⁶⁾

⁽¹⁴⁶⁾ For illustration, an analysis using RoyaltyStat, at 2Q 2015, shows that out of the 168 agreements available through the database across sector whereby only technology was licenced, the median value of the royalty was 5 % of sales (based on 143 of these agreements where the licence fee was determined as a percentage of the value of sales rather than amount paid per unit sold). Among all the contracts available through the RoyaltyStat database, no contract was identified whereby remuneration was paid for coffee roasting technology licenced on the market. Such technology was only licenced out in certain instances in combination with trademarks.

- (293) Paragraph 1.36 of the 2010 OECD TP Guidelines lists five comparability factors ⁽¹⁴⁷⁾ which ‘include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.’
- (294) The Commission observes, first, that the characteristics of the property transferred under the roasting IP arrangement between Alki LP and SMBV is identical to the property transferred in the transactions between Starbucks and the third parties in the roasting agreements listed in recitals 148 to 150. Both sets of transactions consist of roasting technology, coffee blends and roasting curves.
- (295) Second, while not all of those third parties roast coffee (some are engaged in the production of ready-to-drink beverages or other products and ingredients for drink preparation), in those transactions where the third parties do roast coffee, the function of the third party relates to the exact same product as SMBV’s roasting function in its contractual relationship with Alki LP. In particular, Starbucks contractual arrangements with [unaffiliated manufacturing company 2], [unaffiliated manufacturing company 3], [unaffiliated manufacturing company 4] and [unaffiliated manufacturing company 10] all pertain to the roasting of green coffee.
- (296) Third, in none of those transactions was the role of Starbucks more limited than the role of Alki LP. In some of those transactions, Starbucks assumed more functions vis-à-vis the third parties than Alki LP vis-à-vis SMBV. In particular, most contractual arrangements were associated with the sourcing of the coffee by Starbucks ⁽¹⁴⁸⁾. Moreover, in some of those arrangements, Starbucks also buys the roasted coffee from the third party. Therefore, the remuneration of Starbucks in those arrangements presents a maximum arm’s-length remuneration for the licensing arrangement, if any remuneration were in fact due to Alki LP.
- (297) Fourth, there is no indication that the economic circumstances of the third parties affect their arrangement with Starbucks. In particular, as Starbucks provided many roasting IP licensing arrangements of which none could be identified as containing a royalty paid to Starbucks for the roasting IP, this cannot be related to the specific economic circumstances of an individual third party. The arrangements cover different geographic regions, including the Union and Switzerland, which was considered as a relevant geographic delimitation for the comparables search in the transfer pricing report.
- (298) Fifth, the business strategies of the third parties are discussed below. The arrangements differ principally depending on whether the third party exploits the IP directly on the market by selling products to end customers or not.
- (299) Accordingly, with those uncontrolled transactions, the level of an arm’s-length royalty payment between SMBV and Alki LP can be determined using the CUP method, that is, comparing the payment due in a controlled transaction (from SMBV to Alki LP) to the payment due in comparable uncontrolled transactions (from third parties to other Starbucks group companies), conducted under comparable circumstances.
- (300) In this regard, the Commission notes that under similar agreements concluded by Starbucks with [unaffiliated manufacturing company 2], [unaffiliated manufacturing company 3], [unaffiliated manufacturing company 4], [unaffiliated manufacturing company 9], [unaffiliated manufacturing company 8], [unaffiliated manufacturing company 1] and [unaffiliated manufacturing company 10], third parties do not pay a royalty under their licensing arrangements with Starbucks if they do not exploit the roasting IP directly on the market.
- (301) Indeed, [unaffiliated manufacturing company 3] only pays a royalty to Starbucks when it sells its production to the [unaffiliated manufacturing company 3- Starbucks joint-venture]. In that case, [unaffiliated manufacturing company 3] directly exploits the roasting IP on the market through a related party, so that the royalty payment appears to cover the distribution of Starbucks’ branded products to third parties by the joint venture. This conclusion is confirmed by the fact that when [unaffiliated manufacturing company 3] resells the roasted coffee to the Starbucks group, rather than to the joint venture, and the distribution and exploitation on the market of the brand is ensured by the Starbucks group, no royalty is paid by [unaffiliated manufacturing company 3] to Starbucks for the roasting IP.

⁽¹⁴⁷⁾ See also paragraph 1.17 of the 1995 OECD TP Guidelines.

⁽¹⁴⁸⁾ This is, however, not the case for [unaffiliated manufacturing company 10].

- (302) As regards [unaffiliated manufacturing company 2], while Starbucks claims that the higher mark-up on the green coffee beans purchased for Starbucks in the contract with [unaffiliated manufacturing company 2] represents a remuneration for roasting IP, this mark-up appears to be passed on to [unaffiliated manufacturing company 5]. Indeed, the price at which [unaffiliated manufacturing company 5] buys coffee from [unaffiliated manufacturing company 2] is also defined as a mark-up to the cost of the acquired green coffee beans. In its relationship with [unaffiliated manufacturing company 2], which would apparently be remunerated through a higher mark-up, Starbucks acts as supplier, which is a different function than the function assumed by Alki LP in its relationship with SMBV. In response to Starbucks' argument that because [unaffiliated manufacturing company 2] is ready to pay a top-up on the price charged for beans by SCTC and that, therefore, SCTC's prices would be arm's length, the Commission considers that the purchase price for green coffee beans cannot be analysed in isolation of [unaffiliated manufacturing company 2]'s obligation under its contracts with Starbucks to sell its production to [unaffiliated manufacturing company 5] and that, therefore, the pricing arrangements between [unaffiliated manufacturing company 5] and [unaffiliated manufacturing company 2] must also be taken into consideration. There are no indications that any mark-up to a purchase price would not be passed on directly to [unaffiliated manufacturing company 5] or otherwise affect the commercial conditions between [unaffiliated manufacturing company 5] and [unaffiliated manufacturing company 2], as this contractual arrangement was not concluded independently of the contractual arrangement between Starbucks and [unaffiliated manufacturing company 5].
- (303) In addition, the Commission observes that in its relationship with [unaffiliated manufacturing company 5], [unaffiliated manufacturing company 6] and [unaffiliated manufacturing company 7], only the trademark and technology licence agreements concluded by Starbucks with those third parties contain a royalty payment. That royalty payment, however, is comparable to the royalty paid by the Shops to Starbucks Coffee BV for the exploitation of the Starbucks' brand IP on the market, since all three companies sell products to final consumers. The master and manufacturing and distribution agreements between the three companies and Starbucks, which concern the manufacturing process, do not provide for a royalty for the Starbucks IP.
- (304) Furthermore, the Commission notes that SMBV outsources the production of [a trademark registered coffee product] and soluble coffee to third parties, in particular, [unaffiliated manufacturing company 1]. Although Starbucks' [trademark registered coffee product] product is a brand-protected product, [unaffiliated manufacturing company 1] does not pay any royalties to SMBV or any other Starbucks company for the blend and other production information. Similarly, although the production of the technology used in the production of the VIA soluble coffee products is advertised as innovative by Starbucks, its production is outsourced to a third party and SMBV does not perceive any royalties from the third party producing VIA. Indeed, the accounts of SMBV evidence that no royalty is perceived by the company for any of its outsourced production ⁽¹⁴⁹⁾.
- (305) Finally, for the purposes of assessing whether SMBV pays an arm's-length remuneration to Alki LP for the roasting IP, the arrangement between Alki LP with SMBV can also be compared to arrangements between Starbucks' competitors with third party roasters.
- (306) For example, in response to the MIT request regarding arm's-length commercial conditions between unrelated parties in which a company is entrusted with the function of roasting green coffee beans, Melitta explained that when outsourcing the roasting of coffee to a third party it does not perceive royalties, although it puts its roasting curves at the disposal of the third party ⁽¹⁵⁰⁾.
- (307) According to the submission of Company Y, which performs a roasting activity through a group company designated as a toll manufacturer, its in-house roasting company also does not pay any royalty to the group either for the IP or the know-how used in the roasting process ⁽¹⁵¹⁾.
- (308) The same is also true of Dallmayr, which indicated that it considers the payment of a royalty by a company providing roasting as unusual, since it would rather expect the customers to pay the roaster, not the other way around ⁽¹⁵²⁾.

⁽¹⁴⁹⁾ See Table 3.

⁽¹⁵⁰⁾ See recital 209.

⁽¹⁵¹⁾ See recitals 211 to 212.

⁽¹⁵²⁾ See recitals 203 to 205.

- (309) It follows that, since in the manufacturing agreements Starbucks concluded with third parties, several of which existed at the time the SMBV APA request was being considered by the Dutch tax administration, no royalty is required for the use of the roasting IP, the Commission considers that a transfer pricing analysis of the arm's-length value of the royalty paid by SMBV to Alki LP for roasting IP leads to the conclusion that no royalty should be due for that IP in that specific relationship. This conclusion also follows from a comparison with arrangements between Starbucks' competitors with third party roasters.

(b) SMBV does not capture the value of the roasting IP in its relationship with Alki LP

- (310) Whereas roasting know-how and curves can have a value, in the specific relationship between Alki LP and SMBV that value is not captured by the roaster. That is because the importance of the roasting know-how and curves lies, in the case of the Starbucks structure, in ensuring a consistent taste associated with the brand and individual products. Accordingly, the value of Starbucks' roasting know-how and curves is only exploited when Starbucks products are sold under the Starbucks brand by the Shops. On their own, the roasting know-how and curves do not generate value for the roaster on an on-going basis if they cannot be exploited on the market.
- (311) That conclusion is supported by the submission of Starbucks, according to which licence agreements in which the IP licence merely serves to enable third parties to produce in accordance with Starbucks' specification and to protect Starbucks' IP rights, but where third parties do not exploit the intangibles on the market, are not associated with any royalty payments by those third parties to Starbucks ⁽¹⁵³⁾.
- (312) In addition, in the case of SMBV, the roasting know-how and curves appear to constitute a technical specification according to which the roasting should proceed due to a preference or a choice of the purchasing company. Roasting curves are described by Starbucks in the transfer pricing report as being dictated to SMBV. They allow SMBV and the third parties, with whom roasting agreements and manufacturing and supply agreements have been concluded, to meet the requirements of Starbucks. Roasting preferences are imposed on manufacturers, for example through the roasting standards requirements and quality assurance standards. Such specifications are part of each roasting or manufacturing and supply agreement.
- (313) In this regard, the Roasting Agreement indicates that SMBV must adopt roasting processes provided by Alki LP and employ proper equipment, machinery and production methods to ensure that the products meet the product specifications prescribed by Alki LP ⁽¹⁵⁴⁾. SMBV does not seem to derive any benefit from the use of the product specification in that relationship. The fact that the specifications laid down by Alki LP regarding the roasting process and, in particular, the roasting curves allow SMBV to roast coffee that is sold under the Starbucks brand does not bring any benefit to SMBV in terms of increased sales or sales price, considering that SMBV does not, in principle, sell its production to final customers which value the Starbucks brand. SMBV sells virtually all its production to Starbucks franchised Shops, which all pay a royalty to the group for exploiting the Starbucks IP on the market, representing a value for their distribution business. SMBV does not exploit the roasting IP directly on the market; the Shops are the interface with final customers who value the consistent taste associated with the Starbucks brand.
- (314) Finally, based on the financial information provided in Table 2 and Table 8, Figure 3 presents SMBV's profit margin on its coffee roasting activities, which is obtained by subtracting the price paid by SMBV to SCTC for green coffee beans from the revenues of roasted coffee recorded under the description 'REV PACKAGED COFFEE' for each year ⁽¹⁵⁵⁾.

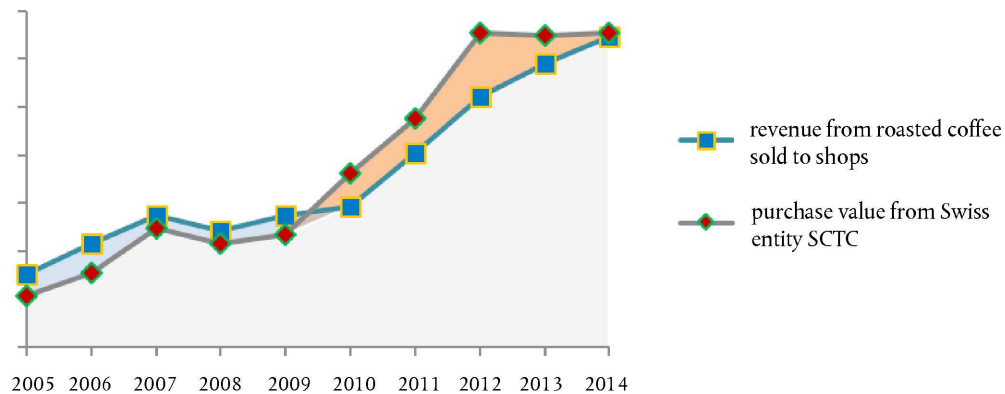
⁽¹⁵³⁾ See recitals 148 to 150 and 300 to 304.

⁽¹⁵⁴⁾ See recital 142.

⁽¹⁵⁵⁾ Starbucks indicated that the revenues under the description 'REV PACKAGED COFFEE' relate to SMBV's roasting and packaging function and that revenues from other items which could cover products processed partially on the basis of coffee roasted by SMBV represent a small portion of the total roasting output of SMBV, see recital 94.

Figure 3

Losses generated from SMBV's roasting activities since 2010
(revenues and purchase price of coffee in EUR)



- (315) Figure 3 demonstrates that, since 2010, SMBV is loss-making on its roasting activities, when the margin on green coffee beans required by SCTC increased. Taking that fact into account, along with the data in Table 10 that show the percentage of royalty paid by SMBV to Alki LP over the revenue from sales of coffee, the roasting know-how and curves do not appear to create positive value for SMBV. For example, in 2013, although SMBV seems to have recorded a gross loss (before operating expense is deducted) of around EUR [1-10] million on its roasting activities, it paid a royalty of EUR 22,8 million to Alki LP for the roasting IP.
- (316) In other words, the royalty payment from SMBV to Alki LP is financed through the other activities of SMBV ⁽¹⁵⁶⁾. While it is conceivable that an economic operator would bear losses to finance a royalty that could lead to future increased profits, the loss-bearing nature of the activity is related to the increase in the price of green coffee beans by SCTC and does not seem to offer any prospects of future profits ⁽¹⁵⁷⁾. Indeed, SMBV's business strategy appears stable over the lifetime of the APA and there is no concrete actions that SMBV could undertake to return to profitability, in absence of any decisive influence on the sales. Since operating costs represent a small portion of SMBV's total costs, cost cutting would not be sufficient to return to profitability because it would not make up for the financial impact of the increased mark-up on the green coffee beans. The royalty paid by SMBV to Alki LP for the roasting IP in an intra-group context appears to serve structurally the sole purpose of shifting profits derived from SMBV's reselling function to Alki LP.
- (317) The fact that the roasting activity does not generate sufficient profit to allow for royalty payments therefore further confirms, given the specific intra-group relationship between SMBV and Alki LP, that the methodology for determining the level of that royalty as an adjustment variable as accepted by the SMBV APA is not in line with the arm's-length principle.
- (318) Accordingly, in light of the comparison with Starbucks' roasting arrangements with third parties, the Commission considers that a transfer pricing analysis of the arm's-length value of the royalty paid by SMBV to Alki LP for the roasting IP leads to the conclusion that no royalty should be due for that IP, since SMBV does not seem to derive any benefit from the use of the roasting IP in that relationship. None of the arguments advanced by the Netherlands or Starbucks during the investigation invalidate that conclusion.

⁽¹⁵⁶⁾ In fact, according to recital 97, SMBV keeps a margin on non-coffee products covering all the [...] costs of [...]. This margin is recorded on the reselling function.

⁽¹⁵⁷⁾ See also paragraph 3.64 of the 2010 OECD TP Guidelines, according to which: 'An independent enterprise would not continue loss-generating activities unless it had reasonable expectations of future profits.' and paragraph 1.52 of the 1995 OECD TP Guidelines.

(c) The royalty payment does not reflect a remuneration for taking over entrepreneurial risks

- (319) In response to the Commission's doubts on the arm's-length nature of the royalty payment, the Netherlands and Starbucks claimed that that payment does not only reflect a remuneration for the use of the roasting IP, but also a payment for the taking over of entrepreneurial risk by Alki LP ⁽¹⁵⁸⁾. The Netherlands invokes the fact that SMBV would not carry the economic risk of loss of inventory, since, given the way the royalty payment is determined under the Roasting Agreement, those costs are ultimately borne by Alki LP ⁽¹⁵⁹⁾.
- (320) The Commission notes, first, that this claim is not supported by the transfer pricing report supporting the SMBV APA request. Rather, that report clearly contradicts that claim, stating that '[SMBV] licenses a sub-set of IP from Alki LP that is necessary to utilise the coffee roasting manufacturing process and the right to supply coffee to [D] evelopers. In return [SMBV] remits a royalty to Alki LP for the licensed IP' ⁽¹⁶⁰⁾. More important, nowhere in the transfer pricing report is any mention made of the fact that the royalty payment would partly constitute a payment by SMBV to Alki LP for the taking over of entrepreneurial risks. In fact, SMBV retains more risks than presented in the transfer pricing, in particular, inventory risks and certain risks related to the supply of beans and the manufacturing capacity utilisation.
- (321) The Commission observes, second, that the Netherlands appears to consider that the way in which the contractual arrangement under the Roasting Agreement is structured ⁽¹⁶¹⁾ gives legal substance to the actual allocation of risk and responsibilities between Alki LP and SMBV. However, according to SMBV's accounts, the royalty payment is generated by the SMBV APA and not by the contractual arrangement between Alki LP and SMBV.
- (322) Third, and most important, the Commission considers that if the Netherlands' claim were accepted, the business risk of any group company could be eliminated through intra-group reallocation of risks by simple means of contract. For example, a company undertaking all strategic decisions for a group, in particular, investment and R & D decisions, which would in principle be considered as a complex function concentrating entrepreneurial risk, could be considered as 'low risk' and taxed accordingly, so long as an intragroup contract would be put in place setting its remuneration at any random level of operating expense and passing its residual profits to any other group company. Accepting that claim would render the application of the arm's-length principle for the pricing of intragroup transactions meaningless, since contractual arrangements would be considered to trump economic reality.
- (323) The Commission recalls ⁽¹⁶²⁾, in that respect, paragraphs 9.44 to 9.46 of the 2010 OECD TP Guidelines ⁽¹⁶³⁾ which clarify in the context of a business restructuring that 'it is the low (or high) risk nature of a business that will dictate the selection of the most appropriate transfer pricing method, and not the contrary' ⁽¹⁶⁴⁾. Contrary to the views expressed by the Netherlands ⁽¹⁶⁵⁾, this idea that the application of the transfer pricing rules should follow risks and not contractual arrangements when those arrangements do not reflect the underlying business risk, is also valid outside the context of a business restructuring. While it is true that agreeing on a transfer pricing method (i.e. such as the TNMM method based on operating costs) and constructing contractual arrangements such as to adjust the pre-tax profit each year to that arrangement results in limiting the fluctuation of the tax liability of the company over fiscal years, such a structure constructed through contractual arrangements does not, however, necessarily correspond to the economic reality underlying the transactions and the risks associated with the activity of the company. The 1995 OECD TP Guidelines present this consideration in paragraph 1.26, according to which, 'in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk'.

⁽¹⁵⁸⁾ See recital 105.

⁽¹⁵⁹⁾ See recital 170.

⁽¹⁶⁰⁾ See recital 51.

⁽¹⁶¹⁾ In which the transfer pricing arrangement for SMBV is reflected in the calculation of the royalty that needs to be paid to Alki LP, see recital 170.

⁽¹⁶²⁾ See also recital 87 of the Opening Decision.

⁽¹⁶³⁾ These paragraphs are part of chapter 9 of the 2010 OECD TP Guidelines dealing with business restructuring but are nonetheless relevant because of the underlying principle stated in these paragraphs.

⁽¹⁶⁴⁾ Paragraph 9.46 of the 2010 OECD TP Guidelines.

⁽¹⁶⁵⁾ See recital 167.

- (324) Fourth, as regards the Netherlands' and Starbucks' further claim that it is the low risk nature of SMBV's business that in fact dictates the transfer pricing method accepted by the SMBV APA, the Commission observes that the information submitted during the investigation does not support that claim. In recital 113 of the Opening Decision, the Commission expressed doubts on the capacity of Alki LP to bear and control any business risk. When a company assumes a risk, it should be able, on the one hand, to control the risks ⁽¹⁶⁶⁾ and, on the other hand, to financially assume such a risk ⁽¹⁶⁷⁾. The capacity to assume a risk should therefore be analysed before the proposed structure is considered in line with normal competitive conditions. The 2010 OECD TP Guidelines clarify that control should be understood, in this context, as the capacity to make decisions to take on the risk and to manage it. This would require the company to have people who perform those control functions ⁽¹⁶⁸⁾.
- (325) However, according to the information submitted by Starbucks ⁽¹⁶⁹⁾, Alki LP has no employees of its own and while, as a partnership, it cannot in principle be excluded that the partners could contribute to Alki LP's activities while not being employees, according to the information submitted ⁽¹⁷⁰⁾, Alki LP's partners are corporations and none of them has any employees. Consequently, the operating capacity of Alki LP to assume risks appears limited.
- (326) In addition, Alki LP's capacity to bear financial risk is limited to its financial resources and to the financial resources of its partners. According to the information submitted by Starbucks to the Commission ⁽¹⁷¹⁾, the latter do not declare separate accounts, but are themselves limited liability companies. Therefore, the financial capacity of Alki LP is inferior to and cannot be equated to the overall financial capacity of the group.
- (327) In response, Starbucks argues that Alki LP's operating capacity is provided through employees of Starbucks Inc., occasionally contracted to support Alki LP in its tasks ⁽¹⁷²⁾. The Commission finds this argument unconvincing. There is no reason why the hiring of a management support employee should proceed through Alki LP: SMBV could have hired an employee to support the management of the company directly. Since the accountability of outsourced management is weaker than the accountability of direct managers, outsourced management presents increased agency costs from a corporate governance perspective. Given SMBV's activities that include, among others, operating a roasting facility, the management of SMBV requires day-to-day monitoring and cannot be effectively ensured by a part-time employee.
- (328) Therefore, Alki LP cannot ensure the management of SMBV's business risks as effectively as direct employees or managers of SMBV could, and therefore that risk could, at best, be partially mitigated through its contractual transfer to Alki LP.
- (329) That conclusion supports the doubt expressed in recital 89 of the Opening Decision on the economic rationality of the structure, as Alki LP seems superfluous in this structure. Paragraphs 1.64 to 1.66 of the 2010 OECD TP Guidelines refer ⁽¹⁷³⁾, in that respect, to situations where structures are not determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the tax authorities should analyse the taxable basis based on a corrected structure that would have been determined by normal commercial conditions. The information submitted by Starbucks, according to which Alki LP was added to the structure for US tax reasons ⁽¹⁷⁴⁾, confirms the Commission's doubts on the economic rationality of the structure.
- (330) Fifth, while the Commission accepts the claim of the Netherlands and Starbucks that certain sales risks of SMBV are mitigated through the arrangements with the Shops, this fact has no bearing on SMBV's relationship with Alki LP. In any event, regarding the limited scope of SMBV in the negotiations with its counterparties of commercial conditions and of prices, the Commission accepts that the forecast system by the Shops seems to reduce business uncertainty for SMBV ⁽¹⁷⁵⁾. Under the contractual arrangements between the Shops and SMBV, the Shops cannot significantly depart from the forecast provided to SMBV and they also are under the obligation to purchase products from SMBV. The off taking of the production of SMBV is ensured through the requirements for the Shops to purchase production from SMBV. However, key risks of a manufacturing business relate not only to inventory risks but mainly to the manufacturing capacity and neither the Netherlands nor Starbucks have

⁽¹⁶⁶⁾ Paragraph 9.23 and 9.26 of the 2010 OECD TP Guidelines.

⁽¹⁶⁷⁾ Paragraph 9.29 of the 2010 OECD TP Guidelines.

⁽¹⁶⁸⁾ Paragraph 9.23 of the 2010 OECD TP Guidelines.

⁽¹⁶⁹⁾ See recital 106.

⁽¹⁷⁰⁾ *Ibid.*

⁽¹⁷¹⁾ *Ibid.*

⁽¹⁷²⁾ See recital 146.

⁽¹⁷³⁾ Similar text can be found in paragraphs 1.36 to 1.41 of the 1995 OECD TP Guidelines.

⁽¹⁷⁴⁾ See recital 107.

⁽¹⁷⁵⁾ See recital 144.

established that the underlying risks of demand variations on the manufacturing capacity utilisation have been completely annulled through those contractual arrangements. Specifically, the contracts with third party manufacturers, [unaffiliated manufacturing company 1] in particular, are not fully aligned with any possible demand variation.

(331) Sixth, the contractual arrangement invoked by the Netherlands by which the SCTC guarantees the quality of the green coffee beans supplied equally has no bearing on the relationship between SMBV and Alki LP. In any event, it is a standard business arrangement that does not reduce the risk of SMBV compared to normal market conditions.

(332) In conclusion, the Commission rejects the claims that any effective risk transfer takes place from SMBV to Alki LP through contractual arrangements. Therefore, any component of the royalty meant to compensate for an entrepreneurial risk transfer cannot be justified.

(d) The level of the royalty payment is not justified by the amounts Alki LP pays for technology to Starbucks US under the Cost Sharing Agreement

(333) Starbucks further seems to invoke that the royalty paid by SMBV to Alki LP is justified because Alki LP pays amounts of the same magnitude to Starbucks US for the coffee roasting technology.

(334) The Commission notes, at the outset, that the SMBV APA is not concerned with the relationship between Alki LP and Starbucks US, but with the relationship between SMBV and Alki LP. Accordingly, all that matters for an assessment of whether the transfer pricing analysis of the transactions between those two entities has been determined in accordance with a methodology that gives a reliable approximation of a market-based outcome in line with the arm's-length principle is the value of those transactions as determined by Starbucks' tax advisor, and not the value of any payments outside that relationship.

(335) In any event, the Commission does not contest that important sums, designated as a 'permanent royalty', are paid by Alki LP to Starbucks US ⁽¹⁷⁶⁾. However, the designation of this payment under the CSA as remunerating the roasting technology cannot be confirmed based on the way in which those payments are structured under the CSA.

(336) First, the payments by Alki LP to Starbucks US are financed to a larger extent by the royalty income it receives from the brand royalty paid to it by Starbucks Coffee BV than from the royalty received from SMBV ⁽¹⁷⁷⁾.

(337) Second, the payments from Alki LP to Starbucks US under the CSA do not appear to be set at arm's length. In particular, regarding the acquisition of the IP relating to business format and brand, Alki LP (including its predecessor [CV 1]) paid in aggregate EUR [30-40] million for the acquisition of this IP, as of 2005, while that IP was sold by Alki LP for EUR [1-1,5] billion in 2014. That difference in value seems to indicate that that arrangement did not reflect an arm's-length remuneration for the IP; the payments under the permanent royalty could therefore be seen as compensating for the sale of the brand in the same transaction for a value that was too low.

(338) In sum, Starbucks' argument that the payments under the CSA justify the royalty payments between SMBV and Alki LP as being arm's length must be rejected.

(e) Conclusion on the arm's-length nature of the royalty payment

(339) In light of the above, the Commission considers that a comparison to comparable uncontrolled transactions, in particular the royalty arrangements in several roasting and manufacturing and distribution agreements Starbucks has concluded with third parties, demonstrates that the arm's-length value of the royalty paid by SMBV to Alki LP for roasting IP should be zero, thus, that no royalty should be due for that IP in that specific relationship, since SMBV does not derive any benefit from the use of the roasting IP licensed from Alki LP.

⁽¹⁷⁶⁾ See recital 112.

⁽¹⁷⁷⁾ Starbucks Coffee BV payments to Alki LP are attributed to the same pool as payments by SMBV, the latter of which present a smaller part of revenues of Alki LP; see recital 110.

- (340) Given that conclusion, this royalty does not need to be estimated. Rather, SMBV's accounting profits, with no deduction of the royalty payment from SMBV to Alki LP from those profits for the licensing of the roasting IP, should be the starting point from which SMBV's tax liability in the Netherlands is determined to ensure that SMBV taxable profits correspond to a level obtained by non-integrated companies whose tax liability is determined by the profits they generate under market conditions. In other words, the un-taxed profits paid as a royalty by SMBV to Alki LP for the roasting IP should have been fully taxable in the Netherlands.
- (341) Consequently, the methodology accepted by the SMBV APA for determining the level of that payment, according to which all profits generated by SMBV in excess of [9-12] % of operating expense is transferred to Alki LP ⁽¹⁷⁸⁾, departs from a methodology that leads to a reliable approximation of a market-based outcome in line with the arm's-length principle. Since the application of that methodology leads to a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profits is determined by the market, the SMBV APA, by accepting that methodology, should be considered to confer a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.
- (f) The arm's-length nature of the prices SCTC charged to SMBV for green coffee beans
- (342) As explained in recital 272, the identification and analysis of SMBV's controlled and uncontrolled transactions is a necessary first step in assessing the arm's-length nature of commercial conditions applicable between related parties for transfer pricing purposes.
- (343) In recital 116 of the Opening Decision, the Commission explained that if the royalty payment was estimated using a direct transfer pricing method, such as the CUP method, the prices charged for the green coffee beans would be the outstanding related controlled transaction that needed to be assessed for transfer pricing purposes and the price charged for the green coffee beans by SCTC to SMBV would have to be assessed to establish whether the level of that price, reflected in SMBV's profit and loss account, was not exaggerated, leading to a reduction of SMBV's taxable profits.
- (344) The transfer pricing report lists the green coffee bean sourcing agreement between SMBV and SCTC among the most important transactions and inter-company flows, but fails to examine or analyse whether the price charged for the green coffee beans by SCTC to SMBV is at arm's length.
- (345) The pricing of green coffee beans by SCTC is described in recitals 114 to 119. Table 6 presents the breakdown by Starbucks of the mark-up of green coffee beans purchased by SCTC charged to SMBV. Based on SCTC's financial data provided in Table 4, Table 11 presents the actual mark-up recorded by SCTC and the actual gross margin charged to its customers each year.

Table 11

Mark-up on green coffee bean sourcing recorded and gross margin applied by SCTC

(%)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
mark-up on COGS	[1,5-4,5]	[1,5-4,5]	[1,5-4,5]	[1,5-4,5]	[4,5-7,5]	[1,5-4,5]	[16,5-19,5]	[13,5-16,5]	[19,5-22,5]	[16,5-19,5]
gross margin on COGS	[4,5-7,5]	[4,5-7,5]	[4,5-7,5]	[4,5-7,5]	[4,5-7,5]	[4,5-7,5]	[16,5-19,5]	[16,5-19,5]	[19,5-22,5]	[16,5-19,5]

- (346) The average mark-up on the costs of green coffee beans supplied by SCTC for the period 2005 to 2010 is [around 3 %], compared to an average mark-up of [around 18 %] over the period 2011 to 2014. The corresponding gross margin on COGS for the period 2005 to 2010 is [around 6 %], compared to an average gross margin on COGS of [around 18 %] over the period 2011 to 2014.

⁽¹⁷⁸⁾ See recital 102.

- (347) According to Starbucks, the mark-up of [around 3 %] applicable on average for the period 2005 to 2010, corresponds to an arm's-length mark-up. When deducted from the mark-ups applied since 2011, that mark-up seems to result in a remuneration recorded by SMBV on the roasting activities in line with the estimated range presented by Company X of 13 to 17 % on COGS for roasting activities ⁽¹⁷⁹⁾. The [around 3 %] mark-up is also within the range for supply function remuneration put forward by Starbucks in the comparable analysis provided on 29 June 2015 ⁽¹⁸⁰⁾. The Commission can therefore accept that the [around 3 %] mark-up on the costs of green coffee beans during the period 2005 to 2010 was at arm's length.
- (348) However, since Starbucks did not provide any valid justification for the increase in the average mark-up to [around 18 %] from 2011 onwards, the Commission considers, as explained in recitals 349 to 357, that no corresponding deduction to SMBV's accounting profits as a result of that increase should be accepted from that period onwards. In fact, had the transfer pricing report properly analysed the price charged by SCTC to SMBV for green coffee beans as a controlled transaction, that price would have been within the scope of the SMBV APA, which is to determine SMBV's tax base in the Netherlands ⁽¹⁸¹⁾. Indeed, since the price paid for the green coffee beans is deducted from SMBV's accounting profits, the SMBV APA should have prescribed an arm's-length price in 2008 from which no deviation would have been possible in 2011, including an increase in the mark-up, unless that APA were replaced or amended.
- (349) Starbucks claims that the increase of that mark-up in 2011 was due to the growing importance of SCTC's operations, particularly the increased expertise in coffee procurement and, more important, its ownership and operation of the evolving C.A.F.E. Practices Programme. That justification does not, however, seem to correspond to the information provided during the investigation. In particular, the C.A.F.E. Practices Programme has been in place since 2004. Furthermore, as SCTC's remuneration is proportionate to the green coffee beans sold, any increase in capacity should have been remunerated accordingly. Indeed, so long as the remuneration constitutes a stable percentage of COGS, the increase of turnover resulted in a proportionate increase of profits.
- (350) Starbucks further claims that the mark-up 'throughout the period' 2005 to 2014 was arm's length in nature ⁽¹⁸²⁾. In its submission of 29 June 2015, Starbucks clarified that the breakdown of Table 5, provided in its submission of 13 April 2015, was constructed based on a comparables analysis. The Commission does not accept that claim for the following reasons.
- (351) First, as regards the pricing of the C.A.F.E. Practices Programme in the comparables analysis provided by Starbucks on 29 June 2015 ⁽¹⁸³⁾, the Commission observes that the figures submitted by Starbucks present consistency issues. Information presented on 13 April 2015 and reproduced in Table 6 contradicts the information provided on 29 June 2015 presented in Table 7. More specifically, in relation to the C.A.F.E. Practices Programme, what was initially presented as the upper quartile, was later presented by Starbucks as the highest observed value. Inconsistencies also concern the use of a transformation factor to express a royalty agreed as a percentage of sales, where Starbucks performs an uncommon adjustment to arrive at a royalty expressed as a percentage of costs ⁽¹⁸⁴⁾.
- (352) In addition, the identified agreements ⁽¹⁸⁵⁾ relate to licensing of technology. It could be compared to a situation where Starbucks through Alki LP licences technology to SMBV, although agreements where coffee technology is licenced out do not seem to be existing standalone from a licence agreement on coffee brands. SCTC does not licence any technology to SMBV for which SMBV should receive a remuneration through a higher mark-up on green coffee beans purchased.
- (353) Second, the Commission observes that the costs of both the C.A.F.E. Practices Programme and the Farmers Support Centres was on average not more than [0,5-1] % of the value of green coffee beans purchased by SCTC ⁽¹⁸⁶⁾. Those costs are of a comparable magnitude to the cost of the [certification programme] designation

⁽¹⁷⁹⁾ See recital 201.

⁽¹⁸⁰⁾ This interquartile range estimated using Starbucks observations is 4 % to 8,5 %, see recital 134.

⁽¹⁸¹⁾ See paragraph 3.42 of the 1995 OECD TP Guidelines, according to which 'when profit margins of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise.'

⁽¹⁸²⁾ As the gross margin from which it results would have been arm's length, see recital 128.

⁽¹⁸³⁾ See recital 130.

⁽¹⁸⁴⁾ See recital 131.

⁽¹⁸⁵⁾ See recital 131, the 11 identified agreements are technology licensing agreements in relation to food and beverage products.

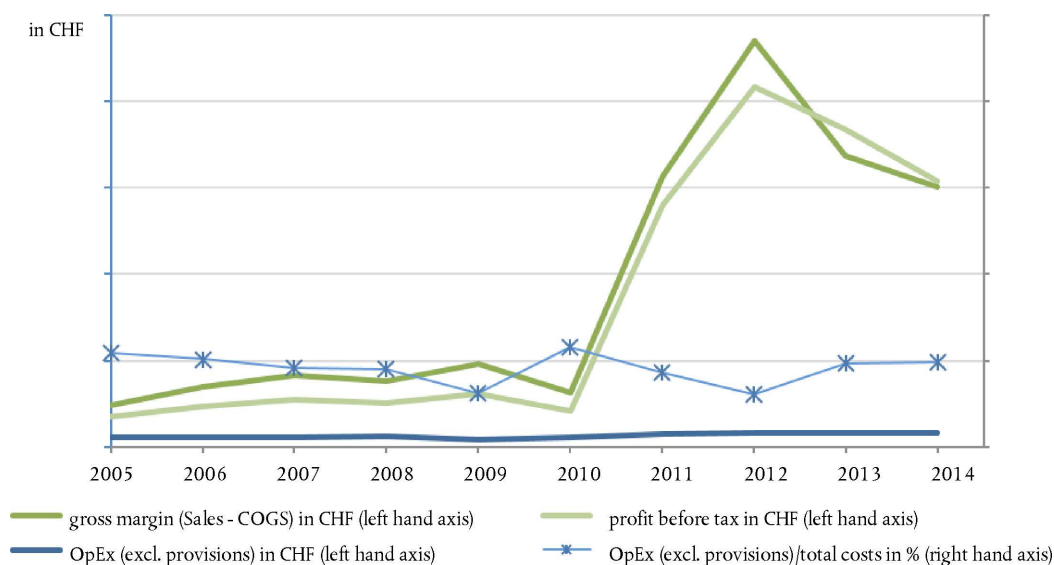
⁽¹⁸⁶⁾ See recital 121.

of [1,5-2] % in proportion of the green coffee beans price used for the '[certification programme coffee product e]', which would be SMBV's most-sold product ⁽¹⁸⁷⁾. In fact, the C.A.F.E. Practices Programme seems to consist of a certification programme more comparable to the [certification programme] designation than to an intellectual property or technology licence as presented by Starbucks.

- (354) Furthermore, the prices of coffee products sold by SMBV to the Shops is determined on a cost basis as explained in recital 96. Therefore, the Commission considers that the direct and indirect costs of C.A.F.E. Practices Programme is, contrary to what Starbucks claims, a more appropriate way to approach the arm's-length pricing of the programme on the price of green coffee beans charged to SMBV.
- (355) Regarding the financing mark-up presented in Table 6, the Commission notes that the method adopted does not calculate the working capital cost because client payables, which contribute in a normal business to finance account receivable and inventories, are not deducted from the estimated amount to finance ⁽¹⁸⁸⁾. Starbucks possibly considers that financing costs are to be added because the agreements regarding the estimated supply costs are based on buying agents, who might not take title to the goods sold. This is not, however, assessed or evidenced in the analysis provided by Starbucks. Therefore, a financing mark-up comparable to the one put forward by Starbucks does not seem justified.
- (356) Third, Figure 4 shows the impact on SCTC's profit in Swiss Francs (CHF) from the increase of the mark-up in 2011. Figure 4 also presents the operating expense of SCTC, which did not demonstrate any such increase that could have been expected from an increased importance of SCTC as claimed by Starbucks. The operating expense in percentage of total costs remained stable and the operating costs would therefore have been covered through a remuneration linked to COGS. The increase in the mark-up from [around 3 %] to [around 18 %] on average for 2005 to 2010 and from 2011 to 2014, respectively ⁽¹⁸⁹⁾, resulted in a quadrupling of SCTC profits, as illustrated in Figure 4.

Figure 4

Profitability of SCTC



- (357) For the sake of completeness, the Commission observes that SMBV's losses on its roasting activities since 2010 can be placed in relation to the increased mark-up on the costs paid to SCTC for the green coffee beans ⁽¹⁹⁰⁾, as shown in Figure 5.

⁽¹⁸⁷⁾ See recital 96.

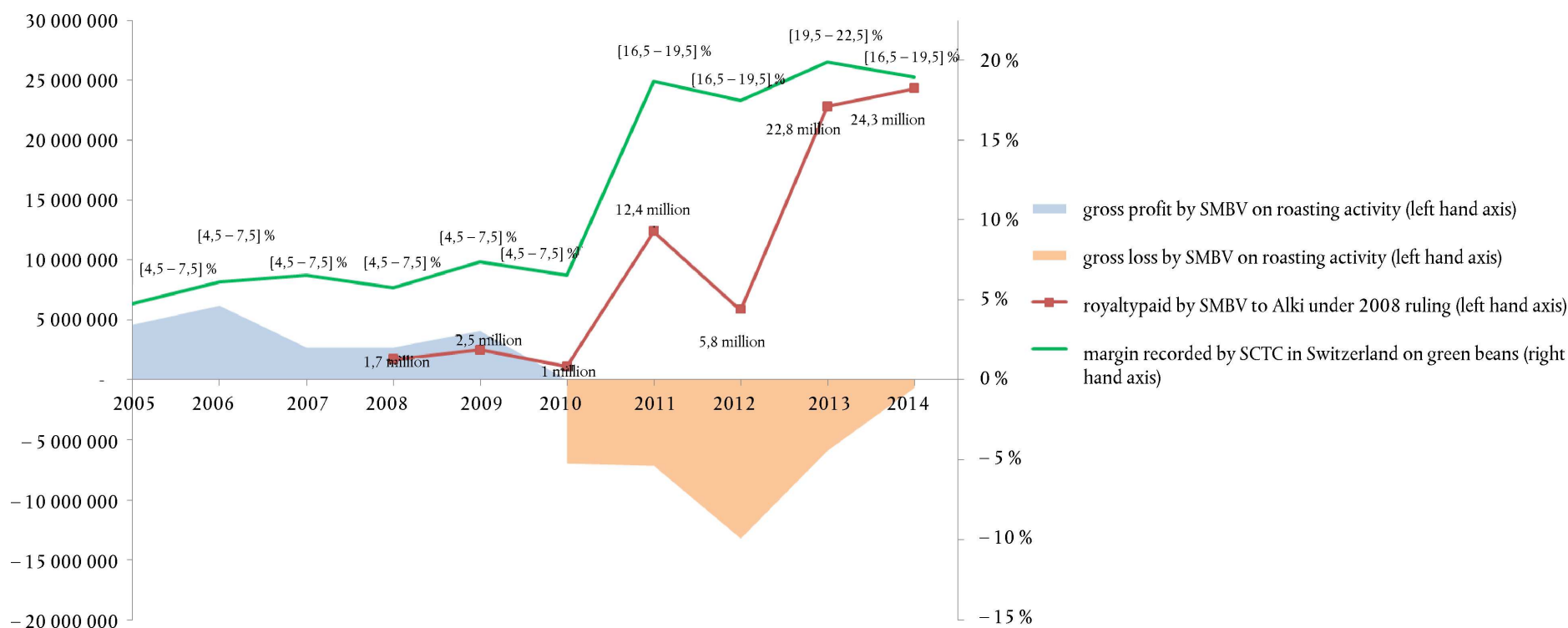
⁽¹⁸⁸⁾ Additionally, SCTC seems to hold considerable amounts of excess cash based on figures in Table 4.

⁽¹⁸⁹⁾ See recital 346.

⁽¹⁹⁰⁾ See recital 315.

Figure 5

Profitability of the roasting activity of SMBV



(358) In light of those observations, the Commission considers that to arrive at a reliable approximation of an arm's-length mark-up for the period from 2011 onwards, the [around 3 %] average mark-up for the period 2005 to 2010 should be increased by the costs of C.A.F.E. Practices Programme and up to the amount of costs of the [certification programme] designation. The cost of the [certification programme] designation represented [1-1,5] % of the costs of green coffee beans purchased by SCTC at the end of 2014 and translated into [0,5-1] % of the price charged to SMBV ⁽¹⁹¹⁾. An arm's-length mark-up recorded by SCTC for the period 2011 onwards would therefore be up to [around 6 %] of the costs of green coffee beans purchased by SCTC, corresponding to a gross margin of up to [around 9 %] on SCTC COGS, charged by SCTC to SMBV. Consequently, the [around 18 %] average mark-up on the costs of green coffee beans supplied by SCTC to SMBV effectively applied from 2011 to 2014 does not reflect a reliable approximation of a market-based outcome in line with the arm's-length principle.

(359) In sum, since the transfer pricing report fails to examine or analyse whether the price charged for the green coffee beans by SCTC to SMBV is at arm's length, the methodology proposed in that report to determine SMBV's taxable profits departs from a methodology that leads to a reliable approximation of a market-based outcome in line with the arm's-length principle. Since the application of that methodology leads to a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profits is determined by the market, the SMBV APA, by accepting that methodology, should be considered to confer a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.

⁽¹⁹¹⁾ See recital 96.

(g) Conclusion on the selective advantage granted by the SMBV APA

- (360) As concluded in recitals 339 to 341, the Commission considers that a comparison to comparable uncontrolled transactions, in particular the roasting IP licensing arrangements in several roasting and manufacturing and distribution agreements Starbucks concluded with third parties, demonstrates that the arm's-length value of the royalty paid by SMBV to Alki LP for the roasting IP should be zero. Consequently, the SMBV APA, by accepting a methodology for determining the level of the royalty according to which all profits generated by SMBV in excess of [9-12] % of operating expense is transferred to Alki LP ⁽¹⁹²⁾, confers a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.
- (361) In addition, the transfer pricing report's failure to examine or analyse whether the price charged for the green coffee beans by SCTC to SMBV is at arm's length means that the methodology proposed in that report, accepted by the SMBV APA, for determining SMBV's taxable profits in the Netherlands, confers a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.

9.2.3.4. SMBV was incorrectly qualified as the less complex function in the transfer pricing report

- (362) As explained in recital 282, it is only if it is impossible to compare a particular intra-group transaction for which an APA is being sought, taking into account the functions performed, to similar uncontrolled transactions, that resorting to a comparison of functions performed is justified. As explained in Section 9.2.3.3, the Commission considers that the royalty arrangements in several roasting and manufacturing and distribution agreements Starbucks concluded with third parties constitute comparable uncontrolled transactions to SMBV's royalty arrangement with Alki LP as follows from the SMBV APA.
- (363) Without prejudice to this conclusion that no functional comparison was warranted in the present case, the Commission further submits that the transfer pricing report's analysis of the functions performed in the application of the TNMM does not result in a reliable approximation of a market-based outcome in line with the arm's-length principle.
- (364) To appropriately estimate the arm's-length remuneration of functions, the transfer pricing report should have engaged in a comparison of the functions performed by each party to the related transactions.
- (365) In one-sided transfer pricing methods such as the TNMM, only the remuneration of the 'tested party' is analysed for transfer pricing purposes, regardless of the resulting remuneration of the other parties to the transaction. On the assumption that SMBV is the 'least complex function' in the relationship between SMBV and Alki LP, Starbucks' tax advisor took SMBV as the 'tested party' and did not consider whether the residual profit allocated to Alki LP is in proportion to Alki LP's functions, risks and assets. Starbucks justifies that choice on the grounds that SMBV does not own valuable IP and does not incur meaningful business risks in performing routine activities; SMBV would therefore be the least complex entity in that relationship ⁽¹⁹³⁾.
- (366) However, Starbucks' line of reasoning demonstrates a confusion between the complexity of functions and risks assumed. Paragraph 3.18 of the 2010 OECD TP Guidelines ⁽¹⁹⁴⁾ explains that the choice of the 'tested party' in the application of the TNMM should be consistent with the functional analysis of the transaction ⁽¹⁹⁵⁾. As a general rule, the 'tested party' is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.
- (367) Complexity and risk are distinct, although considerations of risk flow into the functional analysis. Complexity is to be assessed in relative terms, that is, by comparison to the other parties involved in the transactions. Paragraph 3.18 of the 2010 OECD TP Guidelines refers for the choice of the tested party in this regard to a 'less' complex function, rather than in absolute terms to a function which would not be complex ⁽¹⁹⁶⁾. The

⁽¹⁹²⁾ See recital 102.⁽¹⁹³⁾ See recital 190.⁽¹⁹⁴⁾ The choice of the tested party is only necessary when using the cost plus, resale price or TNMM, see paragraph 3.18 of the 2010 OECD TP Guidelines.⁽¹⁹⁵⁾ This requirement is also to be found in paragraph 3.43 of the 1995 OECD TP Guidelines.⁽¹⁹⁶⁾ This is also the case of paragraph 2.59 and 9.79 of the 2010 OECD TP Guidelines.

requirement to assess the complexity of functions in comparison to the other parties to the transactions is also found in paragraphs 1.21, 1.22 and 1.23 of the 1995 OECD TP Guidelines. Accordingly, where the TNMM is relied upon for transfer pricing purposes, the functions of the other party to the transaction, in this case Alki LP, also have to be analysed. Information on the functions of Alki LP was certainly available to the Dutch tax administration at the time of the SMBV APA request.

- (368) However, if direct observables can be identified in respect of the related transactions, such observables should serve to determine the remuneration of the company engaging in comparable transactions ⁽¹⁹⁷⁾. The existence of direct comparables to determine the arm's-length remuneration is what the Commission effectively argues in Section 9.2.3.3.
- (369) Nevertheless, in the following section, the Commission analyses the relative complexity of the group entities engaging in transactions with SMBV.
- (370) First of all, SMBV performs a number of functions besides its roasting function. This fact, as such, presents a difficulty in finding appropriate comparables for transfer pricing purposes ⁽¹⁹⁸⁾. In addition, the roasting function performed by SMBV is critical for coffee producers. SMBV also undertakes or buys market research, holds IP and engages in contracts with toll manufacturers. Finally, the price setting responsibilities are not clearly defined and SMBV seems to have a degree of control over prices received for goods sold.
- (371) The routine nature of the roasting function performed by SMBV claimed by Starbucks' tax advisor in the transfer pricing report is contradicted by the submissions of competitors, as three of the four competitors having received a MIT request by the Commission do not subcontract roasting. In fact, two of those competitors indicated that they consider the roasting function to be critical and therefore, in principle, they do not consider that it could be subcontracted ⁽¹⁹⁹⁾. However, that the roasting function is an important function does not necessarily mean that it is also very complex.
- (372) Yet, in the specific case of SMBV, an analysis of its operating expense shows a significant expense for market research ⁽²⁰⁰⁾. Moreover, one of SMBV's most important operating expenses is the amortisation of intangible assets. SMBV conducts market research, holds significant IP, and acquired additional IP in 2012 for a value of EUR 4 million. A routine manufacturer does not engage in such activities.
- (373) The Netherlands claims that those expenses, which relate to software and an IT system licence payment for standard IT systems, does not as such evidence that SMBV would be using valuable IP. For example, in the case of Company Y a company designated as toll manufacturer pays IT system licences ⁽²⁰¹⁾. However, in the case of SMBV, the IP amortisation payments do not relate to such a software fee, considering software fees are recorded under a distinct item in accounts of SMBV ⁽²⁰²⁾.
- (373) Such considerations are not sufficient to conclude on their own that SMBV is not the less complex function. The complexity of the functions ensured by Alki LP must also be assessed for this purpose.
- (375) The activities of Alki LP are assessed in recitals 324 to 329. It follows from that assessment that Alki LP's operating capacity is extremely limited to non-existent, given that it has no employees and none of its partners have any employees.
- (376) The Commission therefore concludes that Starbucks' tax advisor was unjustified in designating SMBV as the less complex function compared to Alki LP for the transfer pricing analysis.

⁽¹⁹⁷⁾ See paragraph 2.3 of the 2010 OECD TP Guidelines and paragraph 3.49 of the 1995 OECD TP Guidelines.

⁽¹⁹⁸⁾ According to paragraph 3.42 of the 1995 OECD TP Guidelines 'it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise.'

⁽¹⁹⁹⁾ See recitals 204 to 212.

⁽²⁰⁰⁾ See recital 98.

⁽²⁰¹⁾ See recital 212.

⁽²⁰²⁾ See recital 98.

- (377) Consequently, since the methodology for determining SMBV's tax base in the transfer pricing report was premised on the flawed assumption that SMBV should be the 'tested party' for the application of the TNMM, that methodology does not result in a reliable approximation of a market-based outcome in line with the arm's-length principle. Since the SMBV APA's endorsement of that methodology leads to a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profit under that system is determined by the market, that APA should be considered to confer a selective advantage to SMBV for the purposes of Article 107(1) of the Treaty.

9.2.3.5. The transfer pricing report misapplies the TNMM

- (378) In the preceding sections the Commission demonstrated that the transfer pricing report fails to examine whether the royalty payment made by SMBV to Alki LP for the licensing of the roasting IP, which is the intra-group transaction for which the SMBV APA was effectively requested and granted ⁽²⁰³⁾, is at arm's length. It subsequently demonstrated that the transfer pricing report incorrectly analyses the complexity of all group companies for the application of the TNMM. It is without prejudice to these conclusions, which in and of themselves allow the Commission to further conclude that the SMBV APA confers a selective advantage on SMBV in the form of the lowering of its tax liability in the Netherlands, that the Commission also submits, for the sake of completeness, that Starbucks' tax advisor improperly applied the TNMM in the transfer pricing report.

(a) Starbucks tax advisor inappropriately identified SMBV's main functions in the transfer pricing report

- (379) For transfer pricing purposes, the choice of transfer pricing method and the selection of comparables are determined on the basis of the functional analysis of the company for which an APA is being requested. According to the functional analysis prepared by Starbucks' tax advisor, SMBV's primary functional contribution to the Starbucks group relates to roasting/manufacturing activities ⁽²⁰⁴⁾. On the basis of that assumption, the tax advisor considers SMBV as a low-risk coffee manufacturer performing routine functions and therefore the 'least complex entity' for the purposes of applying the TNMM.
- (380) In the Opening Decision, the Commission expressed the doubt that the Netherlands incorrectly accepted SMBV's classification as a low-risk toll manufacturer in the transfer pricing report ⁽²⁰⁵⁾.
- (381) Based on the information submitted by the Netherlands and Starbucks during the investigation, the Commission considers that the tax advisor incorrectly designated SMBV as a low-risk manufacturer. More specifically, information provided on SMBV's revenues demonstrates that roasting is not the main source of income of SMBV. As illustrated in Table 2, income from the sales of roasted coffee as recorded under the item 'REV PACKAGED COFFEE' ⁽²⁰⁶⁾ represents only [15-20] % of the revenues of SMBV in 2013 and 2014. In 2007, that is, at the time that the SMBV APA was concluded, that proportion was substantively at the same level at [15-20] %.
- (382) Instead, SMBV derives most of its profits recorded in the Netherlands from an activity different from roasting. Indeed, SMBV's reselling function, referred to as providing logistic and administrative services by the Netherlands and Starbucks ⁽²⁰⁷⁾, appears more important than its roasting activity and accounted for [80-85] % of SMBV's revenues in 2013 and 2014. In 2007, based on data which was available at the time the SMBV APA was requested, that proportion was [75-80] %. Moreover, at that moment, [10-30] out of [40-60] SMBV's employees were active in that activity. SMBV was also managing three contractual relationships related to distribution and logistics.

⁽²⁰³⁾ Section 9.2.3.2.

⁽²⁰⁴⁾ See recital 49.

⁽²⁰⁵⁾ See recitals 79 to 96 of the Opening Decision.

⁽²⁰⁶⁾ Starbucks indicated that the revenues under the description 'REV PACKAGED COFFEE' relate to SMBV's roasting and packaging function. Revenues from other items which could cover products processed partially on the basis of coffee roasted by SMBV represents according to Starbucks a small portion of the total roasting output of SMBV, see recital 94.

⁽²⁰⁷⁾ See recitals 166 and 190.

- (383) Contrary to the claim by the Netherlands that the costs of non-coffee products are pass-through costs for SMBV ⁽²⁰⁸⁾, SMBV in fact records a margin on the resale of non-coffee products. Moreover, SMBV's reselling function not only represents the main source of SMBV's income, but also represents the only source of SMBV's profit since 2010, considering SMBV's roasting activity has been loss making since that year ⁽²⁰⁹⁾, without prejudice to the question whether those losses on the roasting activities were caused by incorrect pricing of the green coffee beans ⁽²¹⁰⁾.
- (384) The Netherlands further argues that it did not need to request more information from Starbucks than was provided to its tax administration at the moment of the APA request, because it was familiar with SMBV's business, as the APA was the renewal of a previous ruling ⁽²¹¹⁾. However, the fact that the Netherlands ignored that most of the SMBV's income derives from the resale of non-coffee products clearly contradicts its claim that its tax administration was familiar with SMBV's business ⁽²¹²⁾.
- (385) Although the transfer pricing report does acknowledge that SMBV resells production bought from third parties to the Shops, it ignores this function when choosing comparables and a profit level indicator for the application of the TNMM. Accordingly, Starbucks' tax advisor failed to perform a critical assessment to identify SMBV's principal functions for the transfer pricing analysis ⁽²¹³⁾.
- (386) SMBV's principal function was thus insufficiently identified in the transfer pricing report by Starbucks' tax advisor and wrongly accepted by the Dutch tax administration as the basis for calculating the remuneration accepted in the SMBV APA.
- (b) Starbucks' tax advisor inappropriately used operating expenses as profit level indicator in the application of the TNMM
- (387) Paragraph 2.87 of the 2010 OECD TP Guidelines indicates that typically and subject to the facts of the case, sales or distribution operating expenses might be an appropriate base for distribution activities when using the TNMM ⁽²¹⁴⁾.
- (388) According to the Netherlands, even if the activities of SMBV were not correctly determined in the transfer pricing report, operating expenses are an appropriate indicator for profitability in the application of the TNMM. However, since SMBV's profits are generated and recorded through a margin on products distributed, the Commission considers sales as a more adequate indicator of SMBV's profit generating reselling function. Moreover, between 2008 and 2014 ⁽²¹⁵⁾, SMBV's total sales have increased almost three-fold, while the gross margin has more than doubled over that same period ⁽²¹⁶⁾. By contrast, SMBV's operating expenses increased by only 6 %, so that operating expenses cannot be considered an adequate indicator of SMBV's profit generating resale activity.
- (389) Indeed, SMBV's profits arising from its reselling activities are recorded in the Netherlands and are not attributed to any other member of the group in a position to generate such profits. In fact, the payment of royalties as a residual profit effectively shifts profits SMBV derives from the resale of non-coffee products to Alki LP. However, none of the alleged components of the royalty payment has any relation to profits from SMBV's reselling function, since Alki LP is not in a position to generate active profits from the resale of non-coffee products, as it has no operating capacity either directly or through its partners ⁽²¹⁷⁾. Therefore, attributing those profits to Alki LP through the payment of royalty based on residual profits is not in line with the arm's-length principle.

⁽²⁰⁸⁾ See recital 97.

⁽²⁰⁹⁾ See recital 315.

⁽²¹⁰⁾ See recitals 342 et seq.

⁽²¹¹⁾ See recital 179.

⁽²¹²⁾ See also paragraph 1.43 of the 2010 OECD TP Guidelines and paragraph 1.21 of the 1995 OECD TP Guidelines.

⁽²¹³⁾ *Ibid.*

⁽²¹⁴⁾ This is also in line with the example presented regarding distribution function in paragraph 3.48 of the 1995 OECD TP Guidelines.

⁽²¹⁵⁾ From EUR 128 million in 2008 to EUR 350 million in 2014.

⁽²¹⁶⁾ From EUR 20 million in 2008 to EUR 44 million in 2014.

⁽²¹⁷⁾ See recital 325.

- (390) Moreover, recorded profits have to be attributed, because they are an economic reality, which cannot be superseded by the use of an economic or transfer pricing model that has as its objective approximating economic reality in absence of (direct) observables. In the case of SMBV, profits from the resale of non-coffee products are not attributed through a remuneration in any form to any other group entity nor to any third party that would be in a position to generate active profits from the resale of non-coffee products and, therefore, they should be attributed to SMBV.
- (391) The tax advisor thus inappropriately used operating expenses instead of sales as profit level indicator in the application of the TNMM.
- (c) A functional analysis based on SMBV's reselling function and a remuneration based on margin of sales would have led to a higher level of remuneration
- (392) To illustrate the impact of Starbucks' tax advisor's incorrect identification of SMBV's main functions and its inappropriate selection of operating expenses as profit level indicator, the Commission replicated the tax advisor's analysis with a corrected peer group of companies based on SMBV's reselling function and calculated a mark-up on sales for that corrected peer group.
- (393) Given that SMBV's main business activity was incorrectly identified in the transfer pricing report, the peer group of comparables used by the tax advisor to determine a remuneration for the functions performed by SMBV — NACE code 'Processing of tea and coffee' ⁽²¹⁸⁾ — was equally inappropriate in the application of the TNMM. To correct for the peer group, the Commission conducted a similar analysis, based on the Amadeus database as used in the transfer pricing report, using the NACE code 'Wholesale of coffee, tea, cocoa and spices'. The other selection criteria employed by the Commission to select the peer group were identical to those used by Starbucks' tax advisor in the transfer pricing report ⁽²¹⁹⁾.
- (394) For comparison purposes, the Commission then removed companies from the corrected peer group that mainly distribute products other than coffee and tea (such as spices, sugar or companies selling equipment only), while the retaining companies engaged in roasting, resulting in twelve comparable companies.
- (395) Since half of those twelve companies did not report data on operating expenses ⁽²²⁰⁾, and since that data is sensitive to accounting differences between tax jurisdictions, the Commission calculated a mark-up on sales for the companies in the corrected peer group. The result of those calculations is represented in Table 12.

⁽²¹⁸⁾ See recital 57.

⁽²¹⁹⁾ Active companies or companies with unknown status were retained, in EU-15 countries, Iceland, Norway and Switzerland, which were not owned for 25 % or more by another company to ensure the independence criterion; these choices are identical to the tax advisor. However, a more recent period of observation was retained, as the tax advisor used data for 2001-2005 and the APA was concluded in 2008, three years after the last data period.

⁽²²⁰⁾ In the transfer pricing report the operating expense is arrived at by calculating the difference between total costs and what Bureau van Dijk operating Amadeus designated as 'material costs' which are meant to reflect COGS. 'Material costs' data was not available for many companies of the comparison.

Table 12

Comparables analysis based on wholesale distribution

			2007					2006					2005					2005-2007
	company name	country	turn-over	operating profit	total costs	material costs	Mark-up on Sales	turn-over	operating profit	total costs	material costs	Mark-up on Sales	turn-over	operating profit	total costs	material costs	Mark-up on Sales	average Mark-up on sales
1	ETABLISSEMENTEN SAS KOFFIE	Belgium	30 872	1 683	29 189	20 311	5,45 %	28 128	1 155	26 973	19 167	4,11 %	21 204	646	20 558	13 125	3,05 %	4,20 %
2	TOSTADORES REUNIDOS SA	Spain	14 899	231	14 668	14 403	1,55 %	13 080	244	12 835	n.a.	1,87 %	11 618	206	11 412	n.a.	1,77 %	1,73 %
3	MAGAZZINI DEL CAFFE' S.P.A. O, IN FORMA ABBREVIATA: MDC SPA O MDC SPA	Italy	2 301	− 347	2 648	1 165	− 15,07 %	1 224	− 558	1 782	803	− 45,55 %	639	− 359	998	420	− 56,15 %	− 38,92 %
4	LA CITTADELLA S.P.A.	Italy	2 949	601	2 349	787	20,37 %	2 865	786	2 079	668	27,43 %	2 820	675	2 145	635	23,94 %	23,91 %
5	CAFFE' UNIVERSALE BUONO AROMATICO - C.U.B.A. CAFE'	Italy	1 397	181	1 217	511	12,92 %	1 210	67	1 143	480	5,54 %	1 005	50	955	439	4,95 %	7,80 %
6	CAFES TC-3 SAL	Spain	2 015	118	1 897	n.a.	5,87 %	1 881	73	1 808	n.a.	3,88 %	1 721	46	1 675	n.a.	2,65 %	4,13 %
7	ΚΟΥΙΑΗΣ, Α.&Π.&Λ., Α.Ε.Β.Ε.	Greece	12 880	832	12 048	n.a.	6,46 %	10 092	310	9 782	n.a.	3,07 %	10 126	212	9 914	n.a.	2,09 %	3,87 %
8	CAFFE' SELE S.R.L.	Italy	1 039	91	948	560	8,77 %	968	82	886	536	8,47 %	874	38	836	474	4,30 %	7,18 %
9	RICO CAFÉ' S.R.L.	Italy	306	1	305	181	0,40 %	263	3	260	143	1,32 %	211	2	209	139	1,11 %	0,94 %
10	CAFÉ GRAEXPRES SL	Spain	781	15	766	n.a.	1,92 %	710	7	703	n.a.	1,05 %	666	2	664	n.a.	0,31 %	1,09 %
11	CERDANYA CAFES SL	Spain	310	8	302	n.a.	2,63 %	320	6	314	n.a.	1,77 %	306	3	303	n.a.	1,11 %	1,84 %
12	IMPORCAFÉ - COMÉRCIO E TORREFACÇÃO DE CAFÉ, LDA	Portugal	321	14	307	146	4,28 %	23	6	317	139	1,75 %	n.a.	n.a.	n.a.	n.a.		3,01 %
number of companies							12					12					11	12
lower quartile							1,7 %					1,5 %					1,1 %	1,5 %
median							4,9 %					2,5 %					2,1 %	3,1 %
upper quartile							7,6 %					4,8 %					4,0 %	5,5 %

(396) A peer group analysis of companies active principally in wholesale distribution of coffee results in a median return on sales of 3,1 %, with an interquartile range of 1,5 % to 5,5 %. Although the interquartile range is only presented in one point of the 2010 OECD TP Guidelines among other possible ranges to address comparability concerns ⁽²²¹⁾, it is frequently used by tax advisors. However, to avoid granting an advantage to companies resorting to transfer pricing, the point in the range closest to the most likely market outcome should be used for the purposes of pricing controlled transactions.

(397) In the present case, SMBV tax base as determined by the SMBV APA is outside the interquartile range calculated on the basis of the corrected peer group with a remuneration based on a mark-up on sales. As presented in Table 13, in each year since 2008 SMBV's taxable profit calculated on the basis of the SMBV APA was lower than its taxable profit in the lower point of that range, i.e. 1,5 % of sales:

Table 13

(EUR)

	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Sales SMBV	128 784 681	135 677 607	142 627 243	184 159 097	286 217 379	327 632 453	350 538 852
taxable income SMBV based on Contested Ruling	1 499 118	1 703 001	1 653 318	1 430 620	1 581 461	1 535 460	1 667 869
taxable income lower range (1,5 %)	1 931 770	2 035 164	2 139 409	2 762 386	4 293 261	4 914 487	5 258 083
taxable income median of the range (3,1 %)	3 992 325	4 206 006	4 421 445	5 708 932	8 872 739	10 156 606	10 866 704
taxable income upper range (5,5 %)	7 083 157	7 462 268	7 844 498	10 128 750	15 741 956	18 019 785	19 279 637
taxable income of SMBV as % of sales	1,2 %	1,3 %	1,2 %	0,8 %	0,6 %	0,5 %	0,5 %

(398) The interquartile range of 1,5 % to 5,5 % is based on financial data from the period 2005 to 2007, which is the most recent period pre-dating the SMBV APA. The finding that the tax base agreed to in that APA falls outside of the range is equally valid for different observation periods ⁽²²²⁾.

(399) That Starbucks' tax advisor was incorrect to consider SMBV as a manufacturing company with a remuneration based on operating expenses for the purposes of estimating an arm's-length remuneration for SMBV is further confirmed by an internal data comparison with SMC. SMC is the only other company of the Starbucks group ensuring roasting activities internally ⁽²²³⁾. Since that company is consolidated for tax purposes with Starbucks US, there are no incentives for Starbucks to shift the profits of that company by means of a royalty paid to Starbucks Corporation. Therefore, although SMC's accounts are not audited, they are established for genuine business purposes in the absence of tax considerations. Based on those accounts, SMC is more than [40-50] times more profitable than the remuneration agreed for SMBV in the SMBV APA when considering a return

⁽²²¹⁾ See paragraph 3.57 of the 2010 OECD TP Guidelines.

⁽²²²⁾ If a five year period of 2003 to 2007 is chosen instead the resulting interquartile range would be identical of 1,5 % to 5,8 % with a median of 2,9 %. If the same five year period of 2001 to 2005, as in the transfer pricing report of Starbucks is chosen, the resulting interquartile range would be 1,8 % to 5,7 % with a median of 2,7 %. Finally, if a five year period is chosen ending 2006 instead of 2007, that is a period of 2002-2006, the interquartile range would be 1,7 % to 5,2 % with a median of 2,6 %.

⁽²²³⁾ See recital 139.

on operating expenses. As explained in recital 140 and shown in Table 9, while the SMBV APA agrees on a [9-12] % mark-up of profits over operating expense, that ratio stood at around 500 % for SMC over the past four accounting periods.

- (400) The purpose of the exercise undertaken by the Commission in recitals 392 to 398 is not to calculate an arm's-length remuneration for the functions performed by SMBV within the Starbucks group. The Commission acknowledges that the range presented above is not backed by a sufficient comparability analysis and that the exercise is simply meant to replicate and duplicate the tax advisors analysis if the functions would have been correctly identified. Rather, the purpose of the exercise undertaken by the Commission is to show that even if the conclusions reached by the Commission in Sections 9.2.3.3 and 9.2.3.4 were incorrect, the tax advisor's misidentification of SMBV's main functions and its inappropriate selection of operating expenses as profit level indicator in the application of the TNMM confirm that the methodology proposed by it in the transfer pricing report and accepted by the SMBV APA for determining SMBV's tax base in the Netherlands does not result in a reliable approximation of a market-based outcome in line with the arm's-length principle. Since that methodology results in a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profit under that system is determined by the market, the SMBV APA, by accepting that methodology, should be considered to confer a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.

(d) The inappropriateness of the working capital adjustment

- (401) In the transfer pricing report, Starbucks' tax advisor proposes a 'Conversion Mark-up Adjustment', which is presented by the Netherlands as a working capital adjustment, but the methodology used does not factor in the level of the working capital of either the comparables or of SMBV. Working capital is the sum of the inventories and trade receivable to be financed net of trade payables. There is no constant relation between the COGS used in the adjustment and working capital needs. In particular, a company with a high amount of raw material cost might have low working capital needs if it processes its stock efficiently. Working capital adjustments are aimed at capturing possible differences in the stock and trade receivable and payables processing, which is not captured by the amount of raw material used by the company.
- (402) The Commission therefore considers the tax advisor's 'working capital adjustment' ill-fitted for the declared purpose and adjusting for differences in working capital use. There is no justification for that adjustment in the set of facts presented in the transfer pricing report. The Netherlands' argument that the method presented in the Annex to Chapter III of the 2010 OECD Guidelines, although available at the time, was not part of the 1995 OECD Guidelines, which were applicable at the moment the APA was entered into ⁽²²⁴⁾, is therefore irrelevant
- (403) In response to the doubts expressed by the Commission on the working capital adjustment in the Opening Decision ⁽²²⁵⁾, the Netherlands provided a simulation of a mark-up calculated using the methodology of the adjustment for different time periods, using a different interest rate and finally using the same interest rate as a reference, but deducting rather than adding 50 basis points. Those simulations do not, however, address those doubts. The Commission did not express doubts on the time period used by Starbucks' tax advisor in the transfer pricing report. Rather, in recital 101 of the Opening Decision, the Commission notes that the hypothetical raw material remuneration was estimated by reference to the EURIBOR to which a spread of 50 basis points was added, the level of which is not explained. The Netherlands does not explain that level by presenting simulations with different interest rates and a different spread of minus 50 basis points, which remains unexplained.
- (404) Regarding the simulation provided by the Netherlands, where SMBV's pre-tax profits divided by full costs, including COGS, are compared to the ratio of pre-tax profit to total costs of competitors ⁽²²⁶⁾, the Commission notes that the Netherlands take a range that is based on information dating from after the SMBV APA. If an inter-quartile range of pre-tax profit over total costs is established on the basis of the financial data of peers for the period 2001-2005, as used in the transfer pricing report, this range would be 4,9 % to 13,1 % and the profits of SMBV over that period would be outside that range ⁽²²⁷⁾. For example, in 2008 SMBV's pre-tax profits over total costs were at 1,2 % and decreased to 0,5 % in 2014.

⁽²²⁴⁾ See recital 177.

⁽²²⁵⁾ See recitals 101 to 113 of the Opening Decision.

⁽²²⁶⁾ See recital 178.

⁽²²⁷⁾ This range results from the figures in Table 5 of the Opening Decision.

- (405) The Netherlands further refers to an article of the 2012 International Transfer Pricing Journal that would argue that for both fully-fledged and toll or contract manufacturers the total costs, including COGS, are the most suitable profit level indicator. The article would also present a comparison between margins on total costs of fully-fledged manufacturers and toll or contract manufacturers. This analysis would show, on the basis of the sample chosen, that toll and contract manufactures would have higher margins on total costs than fully-fledged manufacturers. However, notwithstanding the general validity of the outcome of the empirical study presented in the article, the findings of the article contradict rather than support the Netherlands' argument that the profitability of low-risk manufacturers should be adjusted downwards compared to fully fledged manufacturers. This is because the Netherlands accepted a reduction of the margin on costs to factor in the fact that SMBV would not be a fully-fledged manufacturer, whereas the empirical findings of the article seem to indicate that a higher margin would have been appropriate.
- (406) Finally, the transfer pricing report also accepts a considerable reduction in the cost base used to calculate the tax base in 2008 compared to the previous arrangement by excluding the costs of [unaffiliated manufacturing company 1], although the activities of SMBV did not change and the commercial relationship with [unaffiliated manufacturing company 1] also did not change. Combined with the misclassification of the actual activities of SMBV, that adjustment does not seem sufficiently reasoned.
- (407) In sum, even if the comparables analysis had not been based on an incorrect classification of SMBV's activities as coffee roasting and Starbucks' tax advisor had not improperly used operating expense instead of sales as profit level indicator in the application of the TNMM, the use of the working capital adjustment and the exclusion of [unaffiliated manufacturing company 1]'s costs from SMBV's tax base mean that the methodology proposed by the transfer pricing report and accepted by the SMBV APA does not result in a reliable approximation of a market-based outcome in line with the arm's-length principle.
- (408) By accepting that methodology, which leads to a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profit under that system is determined by the market, the SMBV APA confers a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.

9.2.4. *Subsidiary line of reasoning: Selective advantage due to a derogation from the Decree*

- (409) The Netherlands and Starbucks argued that the Decree constitutes the appropriate reference system against which the existence of a selective advantage resulting from SMBV APA must be determined.
- (410) As noted at recitals 245 to 251, the Commission does not agree with the arguments of the Netherlands and Starbucks concerning the applicable reference system. However, in a subsidiary line of reasoning, the Commission concludes that the SMBV APA also grants SMBV a selective advantage in the context of the more limited reference system composed of group companies applying transfer pricing to which Article 8b(1) CIT and the Decree apply.
- (411) Article 8b(1) CIT and the Decree are considered to establish the 'arm's-length principle' under Dutch tax law, according to which transactions between intra-group companies should be remunerated as if they were agreed to by independent companies negotiating under comparable circumstances at arm's length. The preamble to the Decree, in particular, explains that the arm's-length principle as set out in the OECD TP Guidelines has been transposed into domestic law and that those guidelines apply directly to the Netherlands ⁽²²⁸⁾.
- (412) Considering that the Commission has already demonstrated in Section 9.2.3.1 that the SMBV APA endorses certain methodological choices made by Starbucks' tax advisor for transfer pricing purposes that cannot be considered to result in a reliable approximation of a market-based outcome resulting in a reduction of SMBV's tax liability in the Netherlands, the Commission can similarly conclude that that APA also gives rise to a selective advantage under the more limited reference framework of Article 8b(1) CIT and the Decree.

⁽²²⁸⁾ See recital 87.

9.2.5. *Justification*

- (413) Neither the Netherlands nor Starbucks have advanced any possible justification for the selective treatment of SMBV as a result of the SMBV APA. The Commission recalls, in this respect, that the burden of establishing such a justification lies with the Member State.
- (414) In any event, the Commission has not been able to identify any possible ground for justifying the preferential treatment from which SMBV benefits as a result of the SMBV APA that could be said to derive directly from the intrinsic, basic or guiding principles of the reference system or that is the result of inherent mechanisms necessary for the functioning and effectiveness of the system ⁽²²⁹⁾, whether that reference system is the general Dutch corporate income tax system, as established by the Commission, or the Decree, as advocated by the Netherlands and Starbucks.

9.2.6. *Conclusion on the existence of a selective advantage*

- (415) The Commission concludes that the SMBV APA, by endorsing a method for arriving at a profit allocation to SMBV within the Starbucks group that cannot be considered to result in a reliable approximation of a market-based outcome in line with the arm's-length principle and that results in a lowering of SMBV's tax liability under the general Dutch corporate income tax system as compared to non-integrated companies whose taxable profit under that system is determined by the market, confers a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.
- (416) By a subsidiary line of reasoning, the Commission concludes that the SMBV APA, by endorsing under the Decree, based on Article 8b(1) CIT, a method for arriving at a profit allocation to SMBV that cannot be considered to result in a reliable approximation of a market-based outcome in line with the arm's-length principle and that results in a lowering of SMBV's tax liability as compared to other group companies taxable in the Netherlands, confers a selective advantage on SMBV for the purposes of Article 107(1) of the Treaty.

9.3. **Beneficiary of the contested measure**

- (417) The Commission considers the SMBV APA to grant a selective advantage to SMBV within the meaning of Article 107(1) of the Treaty, since it leads to a lowering of that entity's taxable profit in the Netherlands as compared to non-integrated companies whose taxable profits are determined by transactions concluded on market terms. However, the Commission notes that SMBV forms part of a multi-national corporate group, i.e. the Starbucks group, the remuneration of SMBV's role within that group being the subject-matter of the SMBV APA.
- (418) Separate legal entities may be considered to form one economic unit for the purpose of the application of State aid rules. That economic unit is then considered to be the relevant undertaking benefitting from the aid measure. As the Court of Justice has previously held, '[i]n competition law, the term "undertaking" must be understood as designating an economic unit [...] even if in law that economic unit consists of several persons, natural or legal' ⁽²³⁰⁾. To determine whether several entities form an economic unit, the Court of Justice looks at the existence of a controlling share or functional, economic or organic links ⁽²³¹⁾. In the present case, SMBV is fully controlled by Alki LP, which in turn is controlled by companies of the Starbucks group ⁽²³²⁾.
- (419) Moreover, it is the Starbucks group which took the decision to establish SMBV in the Netherlands and thus the Starbucks group which benefits from the SMBV APA as that APA, as indicated in recital 45, establishes the profit that should be allocated to SMBV within that corporate group for the functions it provides to the companies of that group. The SMBV APA is, after all, a ruling that accepts a transfer pricing methodology for transactions within the Starbucks group, so that any favourable tax treatment afforded to SMBV by the Dutch tax administration, benefits the Starbucks group as a whole by providing additional resources not only to SMBV, but to the entire the group. In other words, as discussed in recital 257, where transfer pricing is required to set prices for

⁽²²⁹⁾ Joined Cases C-78/08 to C-80/08 *Paint Graphos and others* ECLI:EU:C:2009:417, paragraph 69.

⁽²³⁰⁾ Case C-170/83 *Hydrotherm* ECLI:EU:C:1984:271, paragraph 11. See also Case T-137/02 *Pollmeier Malchow v Commission* ECLI:EU:T:2004:304, paragraph 50.

⁽²³¹⁾ Case C-480/09 *P Acea Electrabel Produzione SpA v Commission* ECLI:EU:C:2010:787 paragraphs 47 to 55; Case C-222/04 *Cassa di Risparmio di Firenze SpA and Others* ECLI:EU:C:2006:8, paragraph 112.

⁽²³²⁾ The corporate structure of the Starbucks group is explained in more detail in recital 27 and Figure 1 of the Opening Decision.

products and services within various legal entities of one and the same group, the effects of setting a transfer price affects by its very nature more than one group company (a price increase in one company reduces the profit of the other).

- (420) Accordingly, notwithstanding the fact that the group is organised in different legal personalities, in the context of a transfer pricing arrangement those companies must be considered as a single group benefitting from the contested aid measure ⁽²³³⁾.
- (421) Finally, in the present case the determination of SMBV's tax base in the Netherlands influences the royalty payments to Alki LP as the royalty corresponds to any profit recorded by SMBV above [9-12] % of operating expense as agreed by the SMBV APA ⁽²³⁴⁾. The reduction of SMBV's tax liability in the Netherlands therefore not only benefits SMBV, but also Alki LP and therefore the Starbucks group.

9.4. Conclusion on the existence of aid

- (422) In light of the foregoing, the Commission concludes that the SMBV APA concluded by the Dutch tax administration grants SMBV and the Starbucks group a selective advantage which is imputable to the Netherlands, financed through State resources and which distorts or threatens to distort competition and is liable to affect intra-EU trade. The SMBV APA therefore constitutes State aid within the meaning of Article 107(1) of the Treaty.
- (423) Since the SMBV APA gives rise to a reduction of charges that should normally be borne by SMBV in the course of its business operations, that APA should be considered as granting operating aid to SMBV and the Starbucks group.

9.5. Evidence relied upon by the Commission for a finding of aid

- (424) One of the arguments advanced by the Netherlands during the administrative procedure is that some of the information relied upon by the Commission in its Opening Decision, as well as data relied upon during the formal investigation procedure was not available to the Dutch tax administration on the date on which it entered into the SMBV. Thus, the Netherlands accuses the Commission of enjoying 'the benefit of hindsight' when examining the SMBV.
- (425) For instance, while the assessment of SMBV's classification as a toll manufacturer refers to the functions performed by SMBV at the time of the APA, it also relates to other activities, such as market research or the amortisation of intangible assets, which only occurred later and therefore could not have been taken into account by the Dutch tax administration when it entered into the SMBV APA in 2008. Equally, the fact that the costs for green coffee beans increased significantly after 2010, which implies that the royalty payments were financed through other activities than the roasting activity in contravention of the arm's-length principle, only became evident after the APA was concluded.
- (426) The Commission notes, in this regard, that a considerable number of arguments supporting the Commission's conclusion that the SMBV APA does not comply with the arm's-length principle rely on information and data available to the Dutch tax administration at the time that APA was concluded. This relates, in particular, to several of the roasting and manufacturing agreements between Starbucks and third parties listed in recitals 148 to 150, information on the complexity of the functions performed by SMBV and Alki LP, information questioning the classification of SMBV as a low-risk toll manufacturer and the appropriateness of using operating expenses as profit level indicator instead of sales and the increase by 50 basis points of the raw material mark-up ⁽²³⁵⁾.

⁽²³³⁾ See, by analogy, Case 323/82 *Intermills* ECLI:EU:C:1984:345: paragraph 11 'It is clear from the information supplied by the applicants themselves that following the restructuring both SA Intermills and the three manufacturing companies are controlled by the Walloon regional executive and that, following the transfer of the plant to the three newly constituted companies, SA Intermills continues to have an interest in those companies. It must therefore be accepted that, in spite of the fact that the three manufacturing companies each has a legal personality separate from the former SA Intermills, all those undertakings together form a single group, at least as far as the aid granted by the Belgian authorities is concerned [...]'.

⁽²³⁴⁾ See recital 102.

⁽²³⁵⁾ Moreover, the SMBV APA's non-compliance with the arm's length principle has been further confirmed and exacerbated in the years following its conclusion. For instance, whereas in 2007, income from roasted beans presented only [15-20] % of the total revenues of SMBV, this further decreased in later years to [...] % in 2013 and 2014. This is aligned with the fact that SMBV engaged in other activities, such as market research, implying significant expenses and other IP related activities, given the inclusion of intangible amortisation expenses as one of the largest operating expense items in 2014.

- (427) As regards information on the costs for green coffee beans, the Commission observes that the transfer pricing report lists the green coffee bean sourcing agreement between SMBV and SCTC among the most important transactions and inter-company flows, but fails to examine or analyse whether the price charged for the green coffee beans by SCTC to SMBV is at arm's length, since the tax advisor instead relied on the TNMM to calculate a remuneration based on the roasting function of SMBV.
- (428) Had the transfer pricing report properly analysed that agreement, an arm's-length remuneration for the green coffee beans would have had to have been estimated for the purposes of the SMBV APA request ⁽²³⁶⁾. Had the SMBV APA consequently covered the green coffee beans transaction, an arm's-length remuneration agreed to in 2008 would have left no room for the unjustified increases in the price of green coffee beans from 2011 and onwards.
- (429) In any event, as explained in recital 348 et seq., Starbucks did not provide any valid justification for the increase in the price of green coffee beans after 2010, so the argument is irrelevant.
- (430) Moreover, information on the mark-up applied to that transaction was available to the Dutch tax administration at the time that the SMBV APA was requested and, had that administration requested that information, it would have resulted in an arm's-length mark-up of [around 3 %] of COGS for SCTC ⁽²³⁷⁾, which is in any event lower than the [around 6 %] mark-up and the corresponding gross margin of [around 9 %] on GOCS which the Commission considers at arm's length in recital 358. If that mark-up had subsequently been accepted in an APA, SCTC would have been prevented from increasing that mark-up to an average of [around 18 %] during the period 2011 onwards, absent a request to modify the APA. In this regard, the Commission recalls that the SMBV APA declares itself to be valid for 10 years provided the critical assumptions presented by SMBV are correct and, in case they are not correct, the APA should be regarded as terminated.

9.6. Compatibility of the aid

- (431) State aid shall be deemed compatible with the internal market if it falls within any of the categories listed in Article 107(2) of the Treaty ⁽²³⁸⁾ and it may be deemed compatible with the international market if it found by the Commission to fall within any of the categories listed in Article 107(3) of the Treaty. However, it is the Member State granting the aid which bears the burden of proving that State aid granted by it is compatible with the internal market pursuant to Articles 107(2) or 107(3) of the Treaty.
- (432) The Netherlands has not invoked any of the grounds for a finding of compatibility in either of those provisions for the State aid it has granted by concluding the SMBV APA.
- (433) Moreover, as explained in recital 423, the SMBV APA should be considered as granting operating aid to SMBV and the Starbucks group. As a general rule, such aid can normally not be considered compatible with the internal market under Article 107(3)(c) of the Treaty in that it does not facilitate the development of certain activities or of certain economic areas, nor are the tax incentives in question limited in time, digressive or proportionate to what is necessary to remedy to a specific economic handicap of the areas concerned.
- (434) Consequently, the State aid granted to SMBV and the Starbucks group by the Netherlands by concluding the SMBV APA is incompatible with the internal market.

9.7. Unlawfulness of the aid

- (435) According to Article 108(3) of the Treaty, Member States are obliged to inform the Commission of any plan to grant aid (notification obligation) and they may not put into effect any proposed aid measures until the Commission has taken a final position decision on the aid in question (standstill obligation).

⁽²³⁶⁾ See paragraph 3.42 of the 1995 OECD TP Guidelines, according to which 'when profit margins of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise.'

⁽²³⁷⁾ See Table 11.

⁽²³⁸⁾ The exceptions provided for in Article 107(2) of the Treaty concern aid of a social character granted to individual consumers, aid to make good the damage caused by natural disasters or exceptional occurrences and aid granted to certain areas of the Federal Republic of Germany, none of which apply in the present case.

- (436) The Commission notes that the Netherlands did not notify the Commission of any plan to grant the contested aid measure, nor did it respect the standstill obligation laid down in Article 108(3) of the Treaty. Therefore, in accordance with Article 1(f) of Regulation (EU) 2015/1589 ⁽²³⁹⁾, the SMBV APA constitutes unlawful aid, put into effect in contravention of Article 108(3) of the Treaty.

10. RECOVERY

- (437) Article 16(1) of Regulation (EU) 2015/1589 establishes an obligation on the Commission to order recovery of unlawful and incompatible aid. That provision also provides that the Member State concerned shall take all necessary measures to recover unlawful aid that is found to be incompatible. Article 16(2) of Regulation (EU) 2015/1589 establishes that the aid is to be recovered, including interest from the date on which the unlawful aid was at the disposal of the beneficiary until the date of its effective recovery. Commission Regulation (EC) No 794/2004 ⁽²⁴⁰⁾ elaborates the methods to be used for the calculation of recovery interest. Finally, Article 16(3) of Regulation (EU) 2015/1589 states, that 'recovery shall be effected without delay and in accordance with the procedures under the national law of the Member State concerned, provided that they allow for the immediate and effective execution of the Commission decision'.

10.1. Legitimate expectations

- (438) Article 16(1) of Regulation (EU) 2015/1589 provides that the Commission shall not require recovery of the aid if this would be contrary to a general principle of law.
- (439) NOB is the only interested party that raises the issue of legitimate expectations. From the outset, it should be noted that the principle of legitimate expectations can only be invoked by those liable to repay the aid ⁽²⁴¹⁾, namely Starbucks, and that Starbucks did not submit any argument to that effect.
- (440) In any event, for a claim of legitimate expectations to succeed, the expectation must arise from prior Commission action in the form of precise assurances ⁽²⁴²⁾. This means that the legitimate expectation must arise from a previous behaviour of the Commission that, for instance, had already approved the same or a similar aid scheme. NOB did not refer to any such acts of the Commission.
- (441) The argument of legitimate expectations by NOB is therefore without merit for the purposes of recovery of the aid unlawfully granted by the Netherlands to Starbucks by way of the contested tax ruling in favour of SMBV.

10.2. Methodology for recovery

- (442) In accordance with the Treaty and the Court of Justice's established case-law, the Commission is competent to decide that the Member State concerned must abolish or alter aid when it has found that it is incompatible with the internal market. The Court has also consistently held that the obligation on a State to abolish aid regarded by the Commission as being incompatible with the internal market is designed to re-establish the previously existing situation. In that context, the Court has stated that that objective is attained once the recipient has repaid the amounts granted by way of unlawful aid, thus forfeiting the advantage which it had enjoyed over its competitors on the market, and the situation prior to the payment of the aid is restored.
- (443) No provision of Union law requires the Commission, when ordering the recovery of aid declared incompatible with the internal market, to quantify the exact amount of the aid to be recovered. Rather, it is sufficient for the Commission's decision to include information enabling the addressee of the decision to work out that amount itself without overmuch difficulty ⁽²⁴³⁾.

⁽²³⁹⁾ Reference is made to Regulation (EU) 2015/1589 with respect to the unlawfulness of the aid and the recovery obligation.

⁽²⁴⁰⁾ Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EU) 2015/1589 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (OJ L 140, 30.4.2004, p. 1).

⁽²⁴¹⁾ Joined Cases T-116/01 and T-118/01 *P&O European Ferries (Vizcaya) SA and Diputación Foral de Vizcaya v Commission* ECLI:EU:T:2003:217, paragraph 115.

⁽²⁴²⁾ Case T-290/97 *Mehibas Dordtselaan v Commission* ECLI:EU:T:2000:8, paragraph 59 and judgement in cases C-182/03 and C-217/03 *Belgium and Forum 187 ASBL v Commission* ECLI:EU:C:2006:416, paragraph 147.

⁽²⁴³⁾ See Case C-441/06 *Commission v France* ECLI:EU:C:2007:616, paragraph 29 and the case-law cited.

- (444) In relation to unlawful State aid in the form of tax measures, the Notice on business taxation provides in point 35 thereof that the amount to be recovered should be calculated on the basis of a comparison between the tax actually paid and the amount which should have been paid if the generally applicable rule had been applied.
- (445) As concluded in recitals 339 to 341, the Commission considers that a comparison to comparable uncontrolled transactions using the CUP method, in particular the roasting IP licensing arrangements in several roasting and manufacturing and distribution agreements Starbucks concluded with third parties, demonstrates that the arm's-length value of the royalty paid by SMBV to Alki LP for the roasting IP should be zero. In other words, no royalty should be due for that IP in that specific relationship, since SMBV does not seem to derive any benefit from the use of the roasting IP licensed from Alki LP.
- (446) Given that conclusion, the Netherlands should take SMBV's accounting profits, with no deduction of the royalty payment from SMBV to Alki LP from those profits for the licensing of the roasting IP, as the starting point from which SMBV's tax liability in the Netherlands is determined to properly ensure that the aid granted by the SMBV APA is eliminated through recovery.
- (447) In addition, given the Commission's conclusion in recital 358 that an average mark-up of up to [around 6 %] of the costs of green coffee beans sold by SCTC to SMBV for the period from fiscal years 2011 onwards and the prices of green coffee beans sold to SMBV corresponding to a gross margin of [around 9 %] for SCTC constitutes a reliable approximation of an arm's-length price, SMBV's accounting profits for 2011 fiscal years and onwards should be increased by the difference in the gross margin on green coffee beans effectively applied during that period and a gross margin on COGS of SCTC of [around 9 %].
- (448) It is the difference between the corresponding amount of accounting profits arrived at following the two steps detailed in recitals 446 and 447 fully taxed under the rules of the general Dutch corporate income tax system and the corporate income taxes effectively paid by SMBV to the Netherlands since 1 October 2007 that constitutes the amount of aid that must be recovered from SMBV and the Starbucks group to eliminate the advantage SMBV and the Starbucks group received from the Netherlands as a result of the SMBV APA.

10.3. Entity from which the aid is to be recovered

- (449) In light of the observations in recitals 417 to 421, the Commission considers that the Netherlands should, in the first place, recover the unlawful and incompatible aid granted by the SMBV APA from SMBV. Should SMBV not be in a position to repay the full amount of the aid received as a result of the SMBV APA, the Netherlands should recover the remaining amount of that aid from Starbucks Corporation, since it is the entity which controls the Starbucks group, so as to ensure that the advantage granted is eliminated and the previously existing situation on the market is restored through recovery.

11. CONCLUSION

- (450) In conclusion, the Commission finds that the Netherlands has unlawfully granted State aid to SMBV and the Starbucks group by concluding the SMBV APA, in breach of Article 108(3) of the Treaty, which the Netherlands is required to recovery by virtue of Article 16 of Regulation (EU) 2015/1589 from SMBV and, if the latter fails to repay the full amount of the aid, from Starbucks Corporation for the amount of aid outstanding,

HAS ADOPTED THIS DECISION:

Article 1

The advanced pricing arrangement entered into by the Netherlands on 28 April 2008 with Starbucks Manufacturing EMEA B.V., which enables the latter to determine its corporate income tax liability in the Netherlands on a yearly basis for a period of 10 years, constitutes aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union that is incompatible with the internal market and that was unlawfully put into effect by the Netherlands in breach of Article 108(3) of the Treaty.

Article 2

- (1) The Netherlands shall recover the incompatible and unlawful aid referred to in Article 1 from Starbucks Manufacturing EMEA B.V.
- (2) Any sums that remain unrecoverable from Starbucks Manufacturing EMEA B.V., following the recovery described in the preceding paragraph, shall be recovered from Starbucks Corporation.
- (3) The sums to be recovered shall bear interest from the date on which they were put at the disposal of the beneficiaries until their actual recovery.
- (4) The interest shall be calculated on a compound basis in accordance with Chapter V of Regulation (EC) No 794/2004.

Article 3

- (1) Recovery of the aid granted referred to in Article 1 shall be immediate and effective.
- (2) The Netherlands shall ensure that this Decision is implemented within four months following the date of notification of this Decision.

Article 4

- (1) Within two months following notification of this decision, the Netherlands shall submit information regarding the methodology used to calculate the exact amount of aid.
- (2) The Netherlands shall keep the Commission informed of the progress of the national measures taken to implement this Decision until recovery of the aid granted referred to in Article 1 has been completed. It shall immediately submit, on simple request by the Commission, information on the measures already taken and planned to comply with this Decision.

Article 5

This Decision is addressed to The Netherlands.

Done at Brussels, 21 October 2015.

For the Commission
Margrethe VESTAGER
Member of the Commission

COMMISSION DECISION (EU) 2017/503
of 8 November 2016
on State aid scheme SA.39621 2015/C (ex 2015/NN)
(notified under document C(2016) 7086)
(Only the French text is authentic)
(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to those articles ⁽¹⁾, and having regard to their comments,

Whereas:

1. PROCEDURE

- (1) By letter dated 13 November 2015 (the ‘Opening Decision’), the Commission informed the French authorities that it had decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union (TFEU) in respect of the measure.
- (2) The French authorities submitted their comments on that letter in their letter dated 17 December 2015.
- (3) The Commission decision to initiate the procedure was published in the *Official Journal of the European Union* on 2 February 2016 ⁽²⁾. The Commission invited interested parties to submit their comments on the measure in question.
- (4) The Commission forwarded the comments received from interested parties to the French authorities and gave them the opportunity to respond. The French authorities’ observations were sent by letter dated 24 May 2016.
- (5) On 2 May 2016 the Commission sent a list of questions to the French authorities, which replied by letters dated 21 June and 15 July 2016. On 27 July the Commission sent a new list of questions to the French authorities, which replied on 9 September 2016.

2. DETAILED DESCRIPTION OF THE MEASURE

- (6) The mechanism is described in detail in the Opening Decision and summarised in the sections below.

2.1. General operation of the mechanism

- (7) Law No 2010-1488 of 7 December 2010 on the new organisation of the electricity market (‘the NOME Act’) made it obligatory for electricity suppliers, network operators (for losses), and consumers (for consumption outside a supply contract) — ‘the suppliers’ — to contribute to the security of electricity supply in France in line with their own and their customers’ power and energy consumption. In order to fulfil this obligation, every year each of them must prove that they have a certain volume of capacity guarantees in relation to their own and their customers’ peak-period consumption.

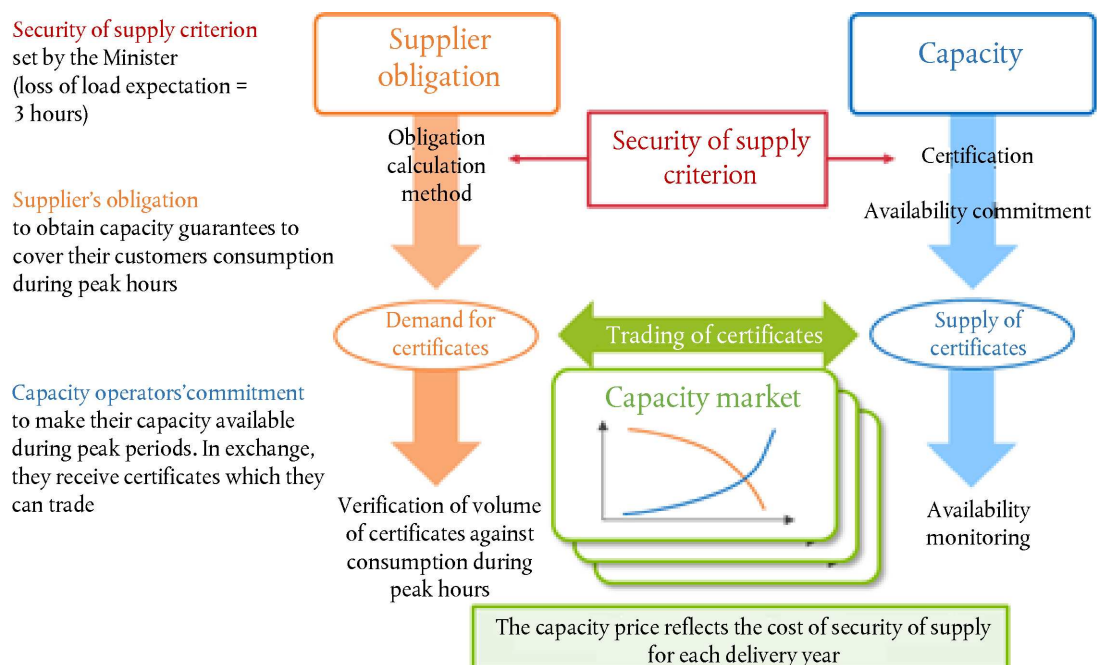
⁽¹⁾ State aid SA.39621 (2015/C) (ex 2015/NN) — Capacity mechanism in France — Invitation to submit comments pursuant to Article 108(2) of the Treaty on the Functioning of the European Union (OJ C 46, 2.2.2016, p. 35).

⁽²⁾ See footnote 1.

- (8) Capacity guarantees are obtained by suppliers either directly for resources they own (generation plants or demand-side response capacities), or must be purchased on a decentralised market from other holders (capacity operators, other suppliers, traders, consumers who are their own suppliers, etc.).
- (9) Operators of generation or demand-side response capacity ('capacity operators' or 'operators'), on the other hand, are obliged to have their capacity certified by the operator of the public electricity transmission grid (RTE). Operators will be allocated capacity guarantees by RTE according to the projected contribution of their plant to reducing the risk of shortfall at times of peak demand.
- (10) Capacity guarantees are tradable and transferable. The purchase by suppliers of capacity guarantees from capacity operators to meet their legal obligation will be organised on the basis of a decentralised market for capacity guarantees. The general operation of the mechanism is illustrated in Figure 1.

Figure 1

General operation of the mechanism



Source: Letter from the French authorities dated 2 February 2015.

2.2. Capacity obligations

2.2.1. Obligations of suppliers

- (11) Calculation of a supplier's reference power, i.e. its capacity obligation, is based on the following principles:
- (1) consideration of peak-period consumption (PP1) during the delivery year (DY; one calendar year);
 - (2) correction for the temperature sensitivity of consumption (thermosensitivity), on the one hand; and
 - (3) correction for the demand-side response power of the certified capacity activated during the PP1 period, on the other.
- (12) The operator of the transmission grid specifies each year the PP1 days that determine the suppliers' capacity obligation in mainland France, on the basis of the national demand forecast for the following day (D-1). The

number of PP1 days must be between 10 and 15 for each delivery year, and the hours used to calculate the capacity obligation are the normal time-slots (7.00-15.00 and 18.00-20.00) of the PP1 days selected. The number of PP1 peak hours is therefore between 100 and 150 hours per year. The PP1 days are notified to suppliers before 10.30 one day in advance (D-1).

- (13) The obligation is not laid down by rules in advance, but is determined on the basis of measured data, so that each consumer's actual contribution to the shortfall risk can be referred back to them. To reflect the contribution of a consumer to the shortfall risk in view of its thermosensitivity, the consumer's observed consumption during the delivery year is adapted in order to simulate a cold spell corresponding in severity to the risk that the system is intended to cover (ten-yearly cold spell), thus respecting the security of supply criterion set by the French authorities. The security of supply criterion was laid down by Decree No 2006-1170 of 20 September 2006, and corresponds to an average expected shortfall of three hours per year.
- (14) The parameters used to determine the actual need for capacity guarantees in the delivery year will be published four years before the delivery year and will remain stabilised throughout the financial year, to enable trading within a fixed regulatory framework and ensure that the value of the product will not be altered by intervention external to the market. Each supplier's exact obligation will then be calculated after the delivery year by applying these parameters.
- (15) Demand-side response can be taken into account using two different methods: either by reducing a supplier's capacity obligation by reducing consumption ('implicit demand-side response') or by certifying demand-side response capacity ('explicit demand-side response'). The obligations for the two types of demand-side response capacity are different: 'implicit demand-side response' must actually be activated during PP1 hours, whereas 'explicit demand-side response' must be available during PP2 hours.
- (16) The French authorities have laid down that the capacity guarantees should be linked to the ARENH ⁽³⁾ product for alternative suppliers, which should, in their opinion, contribute to reducing the market concentration of capacity guarantees.

2.2.2. Obligations of capacity operators and certification principles

- (17) A request for certification must be made to RTE by the operator of every generation plant (technologically neutral mechanism) connected to the public transmission grid or to the public distribution network. A request for certification may be made to RTE for every demand-side response facility, whichever network it is connected to. It is therefore the capacity operator who makes an initial estimate of the capacity volume that it could have available during peak consumption periods (PP2) in a given delivery year.
- (18) There are between 10 and 25 PP2 days in a delivery year. In addition, PP1 days are necessarily PP2 days. PP2 days that are not PP1 days are selected one day in advance by RTE on the basis of stress on the electricity system. The time-slots concerned are the same as those for PP1 days. There are therefore between 100 and 250 PP2 peak hours per year.
- (19) The certified level is then calculated by RTE on the basis of the data submitted using the calculation methods laid down in the legal basis for the mechanism. Corrections are applied, for example, to take into account the potential number of successive days of activation of the certified capacities, or the actual contribution to reducing the shortfall risk of a capacity for which the primary energy source is subject to the vagaries of the weather.
- (20) The operator may then change its availability forecasts throughout the duration of the mechanism, including during the delivery year, using a rebalancing mechanism. Rebalancing corresponds to 'recertification' of capacity and enables the operator to adjust its forecasts as and when new information on its capacity becomes available. Rebalancing may be upwards or downwards.

⁽³⁾ Regulated access to incumbent nuclear electricity (*Accès Régulé à l'Électricité Nucléaire Historique* — ARENH) is a right that entitles suppliers to purchase electricity from EDF at a regulated price and in volumes determined by the French energy regulator (*Commission de régulation de l'énergie* — CRE). For more information on ARENH, see: https://clients.rte-france.com/lang/an/clients_producteurs/services_clients/dispositif_arenh.jsp

- (21) This declaration system is supplemented by a capacity control system: the principle is that all certified capacities must be activated at least once per year. Random tests are made for each capacity without notifying the operator in advance. A capacity may not be tested more than three times per delivery period.
- (22) The precise certification arrangements vary according to the type of capacity concerned:
 - (1) certification of existing generation capacities may begin four years before the delivery period, and a request for certification must be made three years before the delivery period begins;
 - (2) certification requests for planned generation capacities may be made after the signing of the first settlement under the signed connection agreement, and up to two months before the delivery period begins; and
 - (3) demand-side response capacities may be certified up to two months before the delivery period begins.
- (23) The certificates portfolio manager (*responsable du périmètre de certification* — RPC) is the legal person with financial liability for the imbalances of capacity operators within that area. Operators may act as their own RPC or enter into a contract with an RPC. RPCs may accumulate the capacities within their portfolio.
- (24) With regard to the financial settlement of imbalances, RTE notifies each RPC of the imbalance within their area at the latest on 1 December of the delivery year +2.

2.3. Trading in capacity guarantees

- (25) The capacity guarantees are all entered in the register of capacity guarantees held by RTE, the network manager. Each supplier and each capacity operator is obliged to open an account with RTE in the register of capacity guarantees. Vertically integrated players are therefore obliged to hold two accounts within this register, one for their production activities and one for their retail activities.
- (26) Ownership of a capacity guarantee results from RTE entering it in the holder's account in the register of capacity guarantees. Each capacity guarantee issued is numbered to enable it to be managed and trades to be traced. A guarantee is valid for one delivery year. A capacity guarantee, the unit of which is 0,1 MW ⁽⁴⁾, exists solely once issued: an operator holding a capacity guarantee does not bear any risk relating to the underlying capacity.
- (27) Transfers of capacity guarantees between operators (issuance and transfer) are carried out by transferring them in the register of capacity guarantees at the request of both parties (the transferor and the recipient). The actual transfer of ownership takes place when a capacity guarantee is entered in the recipient's account.
- (28) Capacity guarantees may be traded directly (over the counter) or on organised markets.
- (29) Trading in capacity guarantees may take place throughout the period between certification and the deadline for transfer of capacity guarantees. As explained in recital 23, RTE notifies each supplier of its capacity obligation at the latest on 1 December in the delivery year +2. The transfer deadline is 15 days after this.
- (30) Suppliers which have a surplus of capacity guarantees in relation to their obligation on the deadline for notifying the obligation are required to make a public offer for sale before the deadline for transferring capacity guarantees.
- (31) Five days after the deadline for transferring capacity guarantees, RTE calculates for each supplier the imbalance between the supplier's capacity obligation and the capacity guarantees in the supplier's account in the register, and the corresponding financial settlement.

⁽⁴⁾ The certified capacity level is rounded to the nearest 0,1 MW. Capacities with power of less than 1 MW may be aggregated in order to participate in the market.

2.4. Financial settlement of imbalances

- (32) The mechanism makes provision for allocating responsibility for the imbalances between forecasts and actual results.
- (33) The general structure of the financial settlements corresponds to imbalance settlements carried out in a manner that is very similar to the one used for energy ('rebalancing') and assumes that suppliers and RPCs pay a financial settlement in the event of a negative imbalance and receive a financial settlement for a positive imbalance. In the event of a negative imbalance all final consumers will benefit from a price reduction via the TURPE system (Public Electricity Grid User Tariff) ⁽⁵⁾.
- (34) The settlement price applied for a given delivery year depends on certain criteria:
- (1) when security of supply is not significantly threatened, the settlement price is wholly based on the market reference price (MRP: the arithmetic mean of the capacity prices set during the auctions held prior to the delivery year). For the settlement of negative imbalances, an incentive coefficient ('k') is added to this price to provide an incentive to use the certificates market rather than wait for the financial settlement (for positive imbalances, it is deducted); and
 - (2) when security of supply is significantly at risk (overall imbalance below a threshold to be set by RTE: 2 GW below the overall obligation for the first two delivery years), the imbalance settlement price refers to an administered price ('Padmin'). The administered price is a ceiling for the capacity price on the market.
- (35) Once the various imbalance settlements have been calculated, the RPCs and suppliers with negative imbalances pay the settlement amount they owe to their respective fund, and the RPCs and suppliers with positive imbalances receive the settlement amount owing to them from their respective fund. However, for a given delivery year, the sum of positive settlements may not exceed the sum of payments made in relation to the negative financial settlements. Any balance remaining in the funds for the settlement of imbalances is redistributed in full to the users of the public electricity transmission grid, i.e. all final customers.
- (36) There is no financial flow between the fund for the settlement of RPC imbalances and the fund for the settlement of supplier imbalances. There is therefore no financial flow between capacity operators and the suppliers affected by the settlement of imbalances.
- (37) RTE handles administrative and financial management and accounting for the imbalance funds ('fund for the settlement of certificates portfolio managers' imbalances' and 'fund for the settlement of suppliers' capacity rebalancing') in line with private accounting rules. It is therefore responsible for invoicing and recovering amounts owed by RPCs and suppliers, and for recording any defaults on payment.
- (38) The Energy Regulatory Commission (CRE), the French regulatory authority in the energy sector, is responsible for monitoring the settlement of suppliers' imbalances (Article 7 of Decree No 2012-1405, codified in Article R. 335-12 of the Energy Code) and may apply administrative sanctions in the event of failure to fulfil the legal obligation to pay for imbalances. The sanction applied must be proportionate and may not exceed EUR 120 000 per MW of capacity for a delivery year (Article L. 335-7 of the Energy Code).

2.5. National legal basis

- (39) The legislative and regulatory texts governing the capacity mechanism are:
- (1) Law No 2010-1488 of 7 December 2010 on the new organisation of the electricity market, codified in particular in Articles L. 335-1 to L. 335-7 and L. 321-16 to L. 321-17 of the Energy Code;
 - (2) Decree No 2012-1405 of 14 December 2012 on the contribution of suppliers to the security of electricity supply and establishing a capacity obligation mechanism in the electricity sector, laid down by Article L. 335-6 and codified in the regulatory part of the Energy Code, R. 335-1 to D. 335-54;

⁽⁵⁾ TURPE (*Tarif d'Utilisation du Réseau Public d'Électricité*), established by Law No 2000-108 of 10 February 2000, is used to pay the operators of the transmission and distribution network. The TURPE calculation methodology and any adjustments are determined by the CRE.

- (3) the Order of 22 January 2015 laying down the rules for the capacity mechanism and adopted pursuant to Article 2 of Decree No 2012-1405 of 14 December 2012 on the contribution of suppliers to the security of electricity supply and establishing a capacity obligation mechanism in the electricity sector; and
- (4) the Annex to the Order of 22 January 2015: Rules of the capacity mechanism.
- (40) In view of the remedies proposed by France following the Commission's objections in the Opening Decision, these texts will be amended or supplemented to reflect all the remedies described in Section 3 of this Decision.

2.6. Beneficiaries

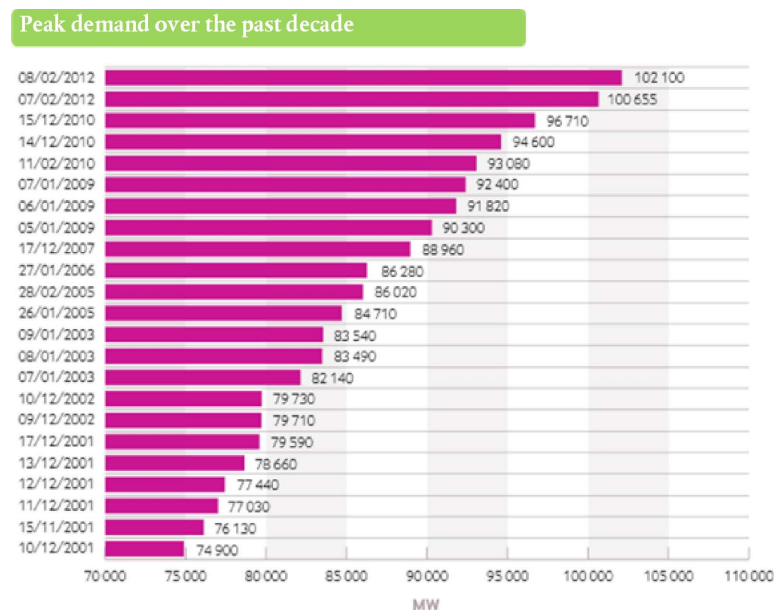
- (41) The beneficiaries of the mechanism are the capacity holders, who receive capacity guarantees (certificates) from the State (via RTE) and may resell them.

2.7. Objective of the mechanism: security of supply

- (42) The indicator used by France to assess the risk of a disruption to the balance between electricity supply and demand is the expected duration of a shortfall caused by a supply-demand imbalance (loss of load expectation, 'LOLE'). The French authorities have chosen to use an average duration of three hours per year as the expected loss of load for France.
- (43) The French authorities explained that, for many years, France has experienced a spike in electricity consumption during winter. The French electricity system is characterised by significant consumption thermosensitivity, leading to a peak in electricity consumption during winter cold spells. As illustrated in Figure 2, this thermosensitivity has continued to grow in recent years, owing in particular to the increase in consumption linked to electric heating, but also to new uses of electricity which often coincide with peak demand in the evening.
- (44) Peak demand has increased more rapidly than the general level of electricity consumption. In addition, French peak demand is very volatile and the consumption imbalances can therefore be particularly substantial (up to 20 GW between two years). Controlling peak electricity consumption is therefore a major concern, particularly in the context of the transfer of energy use to electricity.

Figure 2

Historical peak demand in France



Source: RTE — Generation Adequacy Report on the supply-demand balance in France, 2014 (p. 33).

- (45) According to RTE, in terms of supply Europe is characterised by stagnating demand and significant overcapacity in electricity generation, caused by several factors. Since 2008, the economic crisis has reduced electricity demand. At the same time, there has been rapid development of subsidised 'non-market' renewable energy, which benefits from priority access on the electricity grid. In addition, European coal-fired power stations have enjoyed a strong upturn in activity, linked to the fall in the price of coal resulting from the boom in American shale gas that prompted the United States to export a huge amount of its newly surplus coal production to Europe. Finally, gas-fired power stations — which have become less competitive than coal-fired plants — have seen a sharp reduction in their profitability and therefore in their activity.
- (46) In this context, unpredictable weather conditions result in uncertainty over payment for the peak capacities necessary to cover this peak demand. Spikes in consumption occur rarely, for only a few hours per year, or not at all in some years when temperatures are mild.
- (47) The French capacity mechanism was devised as one way of responding to this problem, to ensure compliance with the security of supply criterion laid down by the public authorities. Its objective is both to provide a means of changing consumption behaviour during peak hours (the demand approach) and to encourage adequate investment in production plants and demand-side response capacities (the supply approach).

2.8. Budget

- (48) The value of capacity guarantees is not set by the authorities, but rather determined by the market. Trades are freely agreed by the participants in the mechanism on the basis of their forecasts, their coverage strategy, and the information at their disposal.
- (49) In spite of the decentralised nature of the mechanism, which makes it difficult to estimate the budget, an estimate has been made assuming an overall capacity obligation for French demand of between 80 000 and 95 000 MW and a security coefficient maintained at 0,93. Demand will depend on the trend in consumption in mainland France, including measures to control demand put in place by electricity suppliers, leading to a reduction in their individual obligation. On this basis the gross income received by operators on the capacity market could range from EUR 0/kW to EUR 30/kW between 2017 and 2026, with the highest amounts in years in which new production facilities had to be constructed.

2.9. Duration

- (50) The first delivery year begins on 1 January 2017. By way of derogation from the general rule that certification is carried out four years before the delivery year, certification for the first delivery year (2017) began on 1 April 2015. For the moment, so long as no end date for the mechanism has been set by the French authorities, an annual assessment will be carried out by RTE and the regulator as laid down by French legislation. Where applicable, the assessment may give rise to either a revision of the mechanism (for example, to bring it into line with the latest changes to European legislation) or the end of the mechanism if it is no longer required ⁽⁶⁾.

2.10. Cumulation

- (51) With regard to plants under a purchase obligation contract (electricity from renewable sources) or eligible for the top-up payment, Articles L. 121-24 and L. 335-5 of the Energy Code provide that profits from the sale of capacity guarantees will be deducted from their total public service costs, including other State aid awarded that finances the support mechanism via the obligation to purchase. Similarly, producers will not be subject to imbalance settlement if actual capacity is lower than the certified capacity owing to uncertain availability of the primary resource ⁽⁷⁾.

⁽⁶⁾ Article 20 of the Decree on the capacity mechanism provides for an annual report by the CRE on the basis of RTE work on the mechanism ('One year after publication of the rules on the capacity mechanism, and every subsequent year, the Energy Regulatory Commission must send the Minister responsible for energy a report on the integration of the capacity mechanism in the European market, drawn up on the basis of work carried out by the operator of the transmission grid. This report must include information on developments, in neighbouring countries, in regulations on the contribution of operators to security of electricity supply. It must analyse the interaction of the French capacity mechanism with the arrangements put in place in these countries and, where applicable, propose improvements to the operation of the capacity mechanism'). In addition, the Order adopting the operating rules of the mechanism contains two articles on the assessment reports to be produced by RTE (in addition to the report required by the Decree): Articles 5 and 8 (on the cross-border aspect and the dynamic impact of the mechanism).

⁽⁷⁾ For example, if a producer of wind power has a problem with maintenance or with the facility and does not rebalance, it will be subject to imbalance settlement. However, if there is no wind, the producer will not be subject to imbalance settlement.

3. GROUNDS FOR INITIATING THE PROCEDURE

3.1. State aid within the meaning of Article 107(1) TFEU

- (52) In recital 143 of the Opening Decision, the Commission had already concluded that the measure constituted State aid within the meaning of Article 107(1) TFEU, for the reasons set out below.

3.1.1. Imputability and financing through State resources

- (53) In the Opening Decision, the Commission considered that a transfer of State resources could be deemed to exist not only if there was a transfer of money directly from the State budget or from a public body, but also if the funds to support the mechanism came from the undertakings' equity capital, provided that (i) the State does not collect the State resources to be collected and/or (ii) the financial resources used under the mechanism remain under public control, whilst not necessarily being public property on a permanent basis.
- (54) With regard to the first point, France foregoes public resources because it allocates capacity certificates to capacity operators free of charge, rather than selling them (as in the NOx ⁽⁸⁾ and Romanian green certificates ⁽⁹⁾ cases).
- (55) With regard to the second point, the financial resources to support the mechanism remain under State control (similarly to *Vent de Colère* ⁽¹⁰⁾ and *Essent* ⁽¹¹⁾), since: (i) the funds are financed by the mandatory contributions imposed by the State and therefore imputable to it; (ii) the State sets the parameters (security of supply criterion and methodology for setting the reference market price determining the imbalance settlement price) that influence the capacity price and the overall number of certificates, even if they are not fixed as such by the State; (iii) the Energy Regulatory Commission (CRE) is authorised to impose sanctions on suppliers that do not fulfil their obligations in terms of imbalance settlement; (iv) the operator of the transmission grid — RTE — has been appointed by the State to manage the imbalance settlement fund.

3.1.2. Selective advantage

- (56) According to the Commission, the *Altmark* ⁽¹²⁾ judgment does not apply in this particular case because the public service obligation is not clearly defined. There are numerous obligations under the mechanism and they differ according to the various stakeholders (power-station operators, demand-side response operators, suppliers). In terms of the obligation on capacity operators, the certification obligation is not strictly regulated, in that: (i) it is optional for demand-side response capacities; and (ii) the operators of existing production plants have a choice as to the level of capacity that they certify.
- (57) The allocation of capacity guarantees therefore constitutes an advantage, not compensation for a public service obligation. This advantage is selective since the mechanism provides for aid to capacity operators and not to other sectors of the economy.

3.1.3. Effect on competition and trade between Member States

- (58) According to the Commission, the capacity mechanism could affect competition with capacity operators located abroad (thus also affecting trade between Member States) in that the capacity operators located in France obtain an advantage that the capacity operators abroad could not obtain as they cannot be certified.

⁽⁸⁾ Case C-279/08 P *Commission v Netherlands* [2011] ECLI:EU:C:2011:551.

⁽⁹⁾ SA.37177 Romania — Amendments to the green certificates support system for promoting electricity from renewable sources.

⁽¹⁰⁾ Case C-262/12 *Association Vent de Colère! Fédération nationale and Others v Ministre de l'Ecologie, du Développement durable, des Transports et du Logement et Ministre de l'Economie, des Finances et de l'Industrie* [2013] ECLI:EU:C:2013:851.

⁽¹¹⁾ Joined Cases C-204/12 to C-208/12 *Essent Belgium NV v Vlaamse Reguleringsinstantie voor de Elektriciteits- en Gasmarkt* [2014] ECLI:EU:C:2014:2192.

⁽¹²⁾ Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECLI:EU:C:2003:415.

3.2. Objective of common interest and necessity

- (59) France's concern with regard to adequacy of generation capacity is strictly linked to a peak demand problem which arises during relatively short periods of intense cold weather, owing to France's particular reliance on electric heating.
- (60) The Opening Decision raised doubts as to the necessity of the measure because:
- (1) the 2015 Scenario Outlook and Adequacy Forecast of the European Network of Transmission System Operators for Electricity (ENTSO-E) ⁽¹³⁾ identifies a security of supply problem only as of 2025;
 - (2) France did not seem to have explored alternatives to the capacity mechanism, such as tariffs that would encourage reduced consumption in peak hours; and
 - (3) in spite of the implementation of a favourable regulatory framework for demand-side response, which had allowed independent demand-side response to take over the demand-side response historically offered by the incumbent supplier, RTE does not anticipate a substantial net increase in demand-side response capacity from 2014 to 2019.

3.3. Appropriateness of the aid

- (61) In the Opening Decision, the Commission considered that the mechanism risked discriminating between different demand-side response capacities. In particular, two types of demand-side response can participate in the mechanism: implicit demand-side response, which consists of suppliers reducing their capacity obligation by effectively switching off certain customers during peak hours on 10 to 15 days per year, thereby releasing capacity; and explicit demand-side response, which requires (larger) consumers or aggregators to get their demand reduction potential certified, and keep that capacity available (but not necessarily curtailed) during peak hours on 10-25 days per year.
- (62) In addition, in the Opening Decision the Commission criticised the fact that the mechanism was not open to all technologies that could contribute to security of supply, including interconnectors and/or foreign capacities.
- (63) The Commission had also highlighted the risk of new generation capacity being excluded from participation in the mechanism, mainly because of the absence of reliable price signals for capacity guarantees. More specifically, the Commission was concerned that:
- (1) the relatively short validity period of capacity guarantees could not give a reliable price signal;
 - (2) suppliers, and especially new entrants, could have difficulty forecasting the development of their client portfolios far in advance;
 - (3) the incentives for operators to be in balance before the delivery year were not sufficient; and
 - (4) the ceiling on the price of imbalance settlements did not reflect the cost of new entry (CONE).

3.4. Proportionality

- (64) In the Opening Decision the Commission had identified a risk that the mechanism could lead to overcompensation of some capacity operators, primarily for the following reasons:
- (1) the risk of suppliers overestimating demand — this is a potential risk if the suppliers' individual capacity obligations are not sufficiently clear;
 - (2) the potential lack of transparency regarding capacity pricing, in particular owing to a potentially high volume of OTC trades and intra-group transactions, which could distort the price signal and lead to overcompensation;

⁽¹³⁾ The Commission referred to the 2015 edition, available here: https://www.entsoe.eu/Documents/SDC%20documents/SOAF/150630_SOAF_2015_publication_wcover.pdf

- (3) the limited participation in the mechanism (exclusion of cross-border capacity and discrimination between different demand-side response operators);
- (4) EDF's market power — the possibility of EDF artificially increasing the value of capacity guarantees as a seller, whilst applying lower prices to its retail branch. Underlying this, the Commission identified three more specific risks: the risk of capacity withholding, the risk of capacity guarantee withholding, and the risk of a price squeeze.

3.5. Avoidance of negative effects on competition and trade

- (65) In the Opening Decision, the Commission identified a number of problems regarding potential distortions of competition at both generation and supply level.
- (66) The Commission expressed concerns regarding the existence of significant information asymmetries. Large vertically integrated suppliers, especially those already present on the French market, are likely to have an advantage because of their more comprehensive knowledge of the market, especially in terms of capacity availability, supply needs and prices. They are consequently able to produce more reliable forecasts and be more efficient in fulfilling the obligations imposed by the mechanism.
- (67) Another effect of information asymmetries is that it is likely to be more difficult for new entrants to estimate their future portfolio of clients, which is a key aspect of calculating the need for capacity guarantees.
- (68) The Commission also expressed concerns regarding the possibility of a dominant incumbent operator being able to withhold capacity.
- (69) The Commission also raised the risk of a dominant incumbent operator being able to withhold capacity guarantees.
- (70) Furthermore, the Commission referred to a risk of price-based exclusionary practices (margin/price squeeze, predatory prices) by the dominant incumbent operator.
- (71) The Commission stressed that the lack of long-term price signals for capacity might create or reinforce barriers to entry for new producers. Long-term investments by new entrants may require some degree of price predictability over a certain number of years, which one-year certificates are unlikely to provide.
- (72) The Commission also reiterated its position regarding reduced competition in the mechanism owing to the exclusion of certain types of capacity operators (cross-border capacities, discrimination between demand-side response capacity operators).

4. COMMENTS BY INTERESTED PARTIES AND OBSERVATIONS BY FRANCE

- (73) The Commission received 18 responses from interested parties other than France, RTE and the CRE during the consultation period on the Opening Decision. One party replied after the deadline.
- (74) The various comments are grouped by topic below. They are addressed as part of the assessment of the measure, but not referred to explicitly.

4.1. State aid within the meaning of Article 107(1) TFEU

- (75) The respondents were divided concerning the classification of the mechanism as aid. Half of the respondents considered that the measure constituted State aid, either explicitly, or implicitly by not reacting to the Commission's arguments on this point; and half considered that the mechanism did not constitute State aid, for the reasons set out below.

- (76) Two respondents explicitly referred to Decision No 369417 of 9 October 2015 by the French Council of State (action brought by the National Association of Energy Retailers — ANODE ⁽¹⁴⁾), in which the Council of State considered that the proposed capacity mechanism did not have the characteristics of State aid. The French authorities also referred to the conclusions of the Council of State in this case ⁽¹⁵⁾.
- (77) The French authorities' arguments regarding classification of the measure as State aid should be read in conjunction with those already set out in the Opening Decision.
- (78) The French authorities chose not to return to these aspects during the in-depth investigation with the Commission, and focused on the proposal for measures to ensure that the capacity mechanism was compatible with the internal market, irrespective of the question of classification as State aid. For the sake of completeness, France's arguments concerning classification as State aid are nevertheless included below.

4.1.1. *Imputability and financing through State resources*

4.1.1.1. Comments by interested parties

- (79) Two demand-side response aggregators, two vertically integrated electricity companies, and the French Electricity Union considered that the measure is not financed using State resources. More specifically, these respondents considered that the funds in question are channelled directly and exclusively between private operators; RTE neither holds nor uses imbalance settlement funds.
- (80) Furthermore, according to these respondents, the rules applicable to the management of these resources can be compared to those governing management of 'imbalance adjustment' under the balance manager system in the energy market.
- (81) EDF added that the role of the French State in relation to the mechanism is restricted to setting out a specific regulatory framework in which only private operators are active. According to EDF, by establishing a capacity mechanism, the French State is in effect exercising its prerogatives as a public authority and acting as a market regulator.
- (82) EDF considered that the capacity mechanism is sufficiently distinct from the system at issue in *Commission v Netherlands* (the NOx case) ⁽¹⁶⁾, in which the Dutch State granted real 'pollution rights' that made it possible to avoid paying fines and had a market value from the moment they were granted by the State. Certificates consequently have no value in the relationship between the French State and capacity operators.

4.1.1.2. Observations by France

- (83) According to the French authorities, the price of capacity guarantees, and therefore the revenue that capacity operators could gain from selling their certificates, is not set by the State. The State does not intervene concerning the quantity of products offered on the market either. In a decentralised mechanism, it is the market that determines the price and quantity of certificates. Financial flows relating to the capacity mechanism take place between stakeholders governed by private law, and not at all under State control.
- (84) In addition, the French authorities consider that the financial flows relating to the payment of imbalance settlements should make up a very small part of the mechanism (taking into account the incentives to rebalance on the market in advance) and cannot be considered to be State resources or under State control. The imbalance settlement laid down for the capacity mechanism follows a template identical to the model currently in force in Europe for the settlement of imbalances on the energy market ('electricity balancing settlement mechanisms').

⁽¹⁴⁾ ANODE (Association Nationale des Opérateurs Détaillants en Énergie) is the association of alternative suppliers in France.

⁽¹⁵⁾ Decision of the Council of State, 9th and 10th chambers combined, 9 October 2015.

⁽¹⁶⁾ Case C-279/08; see footnote 8. The Commission referred to this case in recital 108 of the Opening Decision.

- (85) The French authorities further argue that the mechanism is more similar to that dealt with in the *PreussenElektra* ⁽¹⁷⁾ case than to those discussed in the *Vent de Colère* ⁽¹⁸⁾ and *Essent* ⁽¹⁹⁾ cases. As in *PreussenElektra*, and contrary to *Vent de Colère*, the capacity mechanism does not provide for any compensation mechanism for suppliers. Unlike in *Essent*, (i) the financial flows remain the property of private stakeholders at all times (suppliers and capacity operators), and (ii) the financial flows are not the result of a tax. The presence of State resources is all the more debatable since, unlike in the *PreussenElektra* case-law, no minimum purchase price is set for capacity guarantees.
- (86) Furthermore, according to the French authorities, the sale of capacity guarantees should not be considered to be a waiver of public resources; the State does not forego any resources, since the market value of certificates can come (i) from the intrinsic underlying value that they cover, or (ii) from their scarcity when they are issued. These two factors are outside the power of the State and distinguish this case from the NOx and *Romanian green certificates* cases, in which the certificates could be sold at auction or had a minimum value (respectively).
- (87) Finally, in the Romanian case, the law explicitly obliged suppliers to pass on the costs of obtaining green certificates to consumers. The reasoning of the Court of Justice of the European Union (CJEU) in *Vent de Colère* was similar, where suppliers acted only as financial intermediaries (the contribution to the public electricity service ⁽²⁰⁾ made it possible to compensate for their additional costs). On the other hand, in the case of the French mechanism, suppliers are completely free to choose the way in which they pass on costs to their customers. There is no mechanism to compensate suppliers for the additional costs relating to the purchase of capacity guarantees.

4.1.2. Selective advantage

4.1.2.1. Comments by interested parties

- (88) Together with EDF, a company principally active in France in the wholesale market considers that the mechanism constitutes a public service obligation and refers to the Commission Decision in Case N475/2003 on an invitation to tender for new capacity in Ireland ⁽²¹⁾.
- (89) According to EDF, since the certification procedure corresponds to an availability commitment, it constitutes consideration for a service provided by the capacity operators, not an alleged advantage granted free of charge.
- (90) Furthermore, EDF and another vertically integrated electricity company consider that the capacity mechanism does not confer a selective advantage on capacity operators. In their opinion, the various participants in the mechanism are in the same factual and legal situation and are treated entirely equally: they are remunerated in the same way, whatever the technology used. In this way no operator can draw an advantage from the specific nature of its generation facilities.
- (91) EDF takes the view that it is wrong to consider the supposed advantage selective because the capacity 'provides for aid to capacity operators and not to other sectors of the economy'. In so considering, the Commission misunderstands the characteristics of the capacity mechanism (market-wide and technology-neutral), as does CJEU case-law, which assesses the selectivity of a measure in relation to other undertakings in a comparable factual and legal situation.

4.1.2.2. Observations by France

- (92) First, according to the French authorities, the allocation of certificates under the capacity mechanism is indeed consideration for an availability commitment at times of high demand or stress on the electricity system.

⁽¹⁷⁾ Case C-379/98 *PreussenElektra AG v Schleswag AG*, in the presence of *Windpark Reußenköge III GmbH* and *Land Schleswig-Holstein* [2001] ECLI:EU:C:2001:160.

⁽¹⁸⁾ Case C-262/12; see footnote 10.

⁽¹⁹⁾ Joined Cases C-204/12 and C-208/12; see footnote 11.

⁽²⁰⁾ The contribution to the public electricity service (*contribution au service public de l'électricité* — CSPE) is a fiscal levy on electricity consumers in France, intended to compensate operators for the additional costs resulting from the obligations imposed on them by the law on the public electricity service.

⁽²¹⁾ http://ec.europa.eu/competition/state_aid/cases/137628/137628_485545_28_2.pdf

- (93) Second, the French authorities take the view that the public service obligation is clearly defined. With regard to demand-side response, the optional nature of certification facilitates its participation in the capacity mechanism. For generation plants, the declarative part of the certification process does not call into question the precise nature of the public service obligation: the CRE will be able to impose the necessary sanctions in the event of an attempt to manipulate the market, in particular should a participant underestimate its capacities in order to put upward pressure on the price of capacity guarantees.
- (94) As the capacity mechanism is technologically neutral, the authorities consider that it does not confer any selective advantage for any particular production or demand-side response technology.
- (95) According to France, the Commission's point of view, in which it appears to consider that the capacity mechanism is selective in so far as it applies only to capacity operators (not to other sectors of the economy), means that any sectoral measure would be inherently selective.

4.1.3. *Effect on competition and trade between Member States*

4.1.3.1. Comments by interested parties

- (96) No respondents commented on this point.

4.1.3.2. Observations by France

- (97) The French authorities consider that the capacity mechanism will have no impact on the electricity market, both at national level and in interactions with neighbouring countries, which will continue to function in the same manner. More specifically, they take the view that the capacity mechanism will not alter the price of electricity on spot markets.

4.2. **Objective of common interest and necessity**

4.2.1. *Comments by interested parties*

- (98) The respondents in general are of the view that the mechanism is necessary and that it should become an integral part of the market design. Only three respondents question the necessity of the measure, on the grounds that:

- (1) RTE's 2015 Generation Adequacy Report does not foresee any reliability issues;
- (2) there is currently overcapacity in France, as demonstrated by the fact that, for 2017, the volume of certified capacity is higher than that needed to serve peak demand; and
- (3) demand has been decreasing in recent years and peak demand is stable (RTE estimated an increase in peak demand).

4.2.2. *Observations by France*

4.2.2.1. Security of supply

- (99) According to the French authorities, a security of supply indicator was indeed defined and a shortfall risk was identified in RTE's latest studies: RTE's latest Generation Adequacy Report, drawn up before the mechanism came into force (in 2014), shows a margin deficit of 2 GW for winter 2016-2017 in the baseline scenario. This margin was reduced to 200 MW in the 2015 Generation Adequacy Report for winter 2017-18, but this was due to the signal given by the introduction of the mechanism. These analyses are confirmed by those of the Pentalateral Energy Forum.
- (100) However, the adequacy study carried out by ENTSO-E (the Scenario Outlook and Adequacy Forecast) used a deterministic methodology: the peak demand caused by cold spells and thermosensitivity was not modelled in the assessment. These different methodologies produce different results. The application of the target methodology

that ENTSO-E is striving to implement will help reduce the discrepancies between these various forecast exercises. In this regard, the Mid-Term Adequacy Forecast published in 2016 by ENTSO-E ⁽²²⁾, which is the first version to use a probabilistic methodology, is consistent with the results of the study by PLEF and RTE.

- (101) Contrary to what the Commission appears to suggest, the French capacity mechanism was not designed to address any 'missing money' problems, but to guarantee the security of supply of the French electricity system (especially at times of peak demand), by remunerating the availability of facilities that cannot be remunerated in a satisfactory manner on the energy market alone.
- (102) France is implementing various measures in addition to the capacity mechanism: interconnection projects; reviews of regulated tariffs and tariffs for using public electricity transmission and distribution networks, so that they better reflect scarcity; the development of demand-side response capacities (e.g. through the development of the regulatory framework for electricity markets to enable demand-side response to be included in all mechanisms, the removal of technical and competitive barriers to the aggregation of capacities, the deployment of smart meters); the deployment of renewables, etc.
- (103) In the meanwhile, RTE has published its 2016 Generation Adequacy Report. According to the French authorities, RTE's latest Generation Adequacy Report does not change their analysis. On the contrary: it supports it by illustrating once again that France's security of supply depends on the future of certain thermal power plants (such as CCGTs) and demand-side response, i.e. precisely those energy sources that are most sensitive to the implementation of the capacity mechanism.

Figure 3

Shortfall indicators in 'high thermal' and 'low thermal' scenarios

		2016-17	2017-18	2018-19	2019-20	2020-21
'High thermal' scenario	Expected energy not served	2,0 GWh	1,4 GWh	2,5 GWh	2,7 GWh	0,8 GWh
	Loss of load expectation	0 h 45	0 h 30	1 h 00	0 h 45	0 h 15
	Capacity margin or deficit	4 700 MW	5 400 MW	3 600 MW	3 700 MW	6 600 MW
'Low thermal' scenario	Expected energy not served	8,6 GWh	13,4 GWh	26,5 GWh	26,2 GWh	7,6 GWh
	Loss of load expectation	2 h 30	3 h 45	6 h 45	6 h 15	2 h 15
	Capacity margin or deficit	600 MW	– 700 MW	– 2 500 MW	– 2 400 MW	900 MW

Source: RTE 2016 Generation Adequacy Report.

- (104) According to RTE, among the thermal scenarios presented in the 2016 Generation Adequacy Report (see Figure 3), the 'low thermal' scenario should be applied in the absence of a capacity mechanism. The 'low thermal' scenario includes the closure of certain facilities, e.g. those for which operators have currently postponed closure pending the introduction of the capacity mechanism. The 'high thermal' scenario, however, corresponds to all current plants being maintained, independently of any economic considerations: according to the French authorities, there is therefore little chance of it becoming reality.

⁽²²⁾ Available here: <https://www.entsoe.eu/outlooks/maf/Pages/default.aspx>

- (105) Thus, in the 'low thermal' scenario, security of supply is threatened from winter 2017-2018, if an average winter is used as the baseline. Moreover, again assuming the 'low thermal' scenario, RTE calculated the expected shortfall by simulating an extreme winter, with cold spells, for the next five winters. The results of this calculation are shown in Figure 4.

Figure 4

Expected shortfall in extreme winter (in hours)

	2016-17	2017-18	2018-19	2019-20	2020-21
Expected shortfall	5-15	8-21	16-36	14-34	5-13

Source: RTE.

- (106) The calculation shows that, every time, the expected shortfall would exceed the shortfall criterion used by France, i.e. an expected shortfall of an average duration of three hours per year. It should be noted that the French capacity mechanism is designed precisely to protect against extreme winters.

4.2.2.2. Other objections raised by the Commission in the Opening Decision

- (107) In recital 164 of the Opening Decision, the Commission pointed out that the Competition Authority had suggested the introduction of an hourly and seasonally adjusted TURPE, with a distinction between peak and off-peak periods, in order to provide an incentive for industrial consumers to reduce their demand during peak periods. France confirmed that the TURPE is already hourly and seasonally adjusted, with prices differentiated according to the season, day of the week and/or the time of day.
- (108) Lastly, in recital 153 of the Opening Decision, the Commission considered that the de-rating factors (in the optional legal certification scheme) were not clear enough. France explained that, in this optional legal certification scheme, the certified capacity level corresponds to the average power delivered by the facility during PP2 hours over all historical years, multiplied by the energy source contribution coefficient (or de-rating factor). These contribution coefficients (85 % for run-of-river hydroelectricity, 70 % for wind and 25 % for solar) reflect the fact that, for facilities processing 'unavoidable' energy sources, the average availability during PP2 periods does not perfectly reflect the contribution of these facilities to reducing the shortfall risk owing to: (i) the correlation between the availability of the facility and periods of system stress (which is not the case for controllable capacity); and (ii) a profile of non-constant availability during PP2 hours (controllable capacities have an even availability profile), which has an impact since the shortfall probability function during PP2 hours is not uniform. The contribution coefficients for delivery years 2017, 2018 and 2019 were calculated using the scenarios in RTE's Generation Adequacy Report, based on a large number of statistical series.

4.3. Appropriateness of the aid

4.3.1. Discrimination between demand-side response capacities

4.3.1.1. Comments by interested parties

- (109) Most respondents refer to the presumed discrimination between explicit and implicit demand-side response providers. Most of them (five) consider that the mechanism is more favourable to explicit demand-side response owing to the activation obligation on implicit demand-side response, which is considered rather burdensome. Two respondents pointed out that under the security of supply criterion, an explicit demand-side response capacity should be activated only once every 10 years (since the mechanism is designed for a ten-year winter

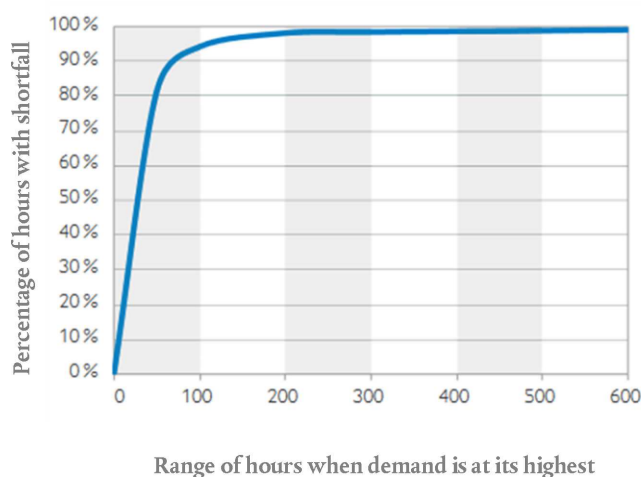
peak). They therefore felt that the number of PP2 hours (availability of explicit demand-side response) should be 10 times higher than the number of PP1 hours (actual reduction of implicit demand-side response). Two respondents disagreed, pointing out that, in their view, implicit demand-side response has more advantageous conditions, since explicit demand-side response operators must bear the costs of certification. Two respondents believed that the French authorities had struck a fair balance between the obligations on both types of demand-side response operators.

4.3.1.2. Observations by France

- (110) France defended itself by pointing out the different obligations on both types of demand-side response operators. To participate in the mechanism, it claims that different conditions are required precisely to enable both types of capacity. In particular, since more is required from an implicit demand-side response operator (activation versus availability), it is logical that the number of days to which it relates (PP1) is lower than the number of days during which an explicit demand-side response operator must be available.
- (111) Some interested parties were now concerned that the duration of the PP2 period, although longer than the PP1 period, could potentially be insufficient. According to France, determining the length of the PP1 and PP2 periods is a complex issue, the solution to which necessarily constitutes a compromise. RTE has carried out studies to reach a satisfactory compromise, the results of which were presented in the *Rapport d'accompagnement de la proposition de règles du mécanisme de capacité* (Report accompanying the draft rules on the capacity mechanism) (2014).
- (112) In summary, in order to identify the times of higher demand (see Figure 5 below) while being able to identify the participation of consumers under the demand-side response mechanism in reducing the shortfall risk, the French authorities chose to apply a volume of 100 to 150 hours for the PP1 period.

Figure 5

Links between shortfall and hours when demand is at its highest



Source: RTE, Report accompanying the draft rules on the capacity mechanism (2014), p. 139.

- (113) According to France, PP2 should be longer than PP1 (since the concept of activation is more onerous than that of availability), but PP2 should not be too long, in order to avoid unduly disadvantaging certain energy sources, and especially demand-side response. The same RTE study showed that 99 % of shortfall hours are included in the 300 hours when demand is highest and that, consequently, a targeted PP2 period, containing between 100 and 300 hours when demand is highest, was a consistent choice to appropriately estimate the contribution of explicit demand-side response capacities to reducing the shortfall risk.

- (114) Within this 100-300 hour range, the French authorities chose the figure of 250 hours. This figure makes it possible to (i) cover around 99 % of shortfall hours (see Figure 5) and does not therefore lead to a deterioration in covering the shortfall risk in relation to the maximum option of 300 hours; (ii) increase the availability of explicit demand-side response in relation to other energy sources ⁽²³⁾. Thus, to ensure the same level of security of supply, the French authorities chose to apply a maximum of 250 hours for the PP2 period in order to maximise the contribution of explicit demand-side response for the same level of shortfall risk coverage.
- (115) A PP2 period 10 times as long as the PP1 period would mean measuring the availability of power generation and demand-side response facilities over 1 000 to 1 500 hours. Given the availability constraints of demand-side capacity over prolonged periods, widening the availability obligation would have the effect for these capacities of reducing their potential value on the capacity mechanism. 100 MW of industrial demand-side response capable of being made available for around 100 hours, but not 1 000 hours, would have the same value as 20 MW of thermal generation, whereas the studies show that their contribution to reducing the shortfall risk is comparable to 90 MW of thermal generation. Therefore, and in order to guarantee fair competition between demand-side operators and generators, the French authorities chose not to apply a PP2 period 10 times longer than the PP1 period and to use a targeted PP2 period.
- (116) Moreover, the French authorities stress that the capacity mechanism includes control of capacity availability (in the absence of voluntary activation), which makes it possible to ensure that there is no deadweight effect between an availability commitment and an activation commitment.
- (117) The French authorities are, however, open to setting values other than those used in the current rules, but believe that the framework presently in force strikes a fair balance between independent demand-side response operators and suppliers. They therefore feel that the PP1/PP2 ratio should be maintained as is for the first delivery years. Its value can be reviewed if the signals sent are not appropriate enough and such an evaluation can be integrated into the assessment of the functioning of the capacity market.

4.3.2. *Exclusion of cross-border capacities*

4.3.2.1. *Comments by interested parties*

- (118) The comments received in response to the Opening Decision show a broad consensus among market operators that the French mechanism should be opened to cross-border capacities gradually (i.e. without endangering the launch of the mechanism in January 2017).

4.3.2.2. *Observations and remedies proposed by France*

- (119) In response, France proposed to explicitly take into account foreign capacities with a hybrid model, which remunerates both interconnections and foreign production and demand-side response capacities. In this proposal, the largest remuneration would be for interconnections or foreign capacities, depending on scarcity.
- (120) In the proposal, the foreign production and demand-side response capacities should acquire interconnection tickets to be able to become certified and subsequently offer their capacity certificates on the French capacity market.
- (121) Tickets will be distributed per border on the basis of that interconnector's contribution to security of supply in France. They will then be auctioned 'border by border'. All production and demand-side response capacities of the country connected to France by a given interconnection will be able to take part in the auction of tickets corresponding to that interconnection. The auctions will take place during delivery year-1 ('DY-1'). The system

⁽²³⁾ In the report accompanying the rules, RTE highlighted that most energy sources were unaffected by the choice of a PP2 duration of 200, 250 or 300 hours, but that demand-side response was affected, and that its contribution to the shortfall risk was affected by a wider range of availability.

does not prevent capacities contracted under the French mechanism from taking part simultaneously in other capacity mechanisms in the EU. In this context, it will be necessary to define, in partnership with the relevant countries, a procedure for checking and evaluating the service provided.

- (122) Once foreign production and demand-side response capacities have obtained interconnection tickets, they can be certified and obtain capacity certificates. They can then sell these capacity certificates on the French capacity market.
- (123) The French authorities undertake to implement the above 'pragmatic hybrid' solution unilaterally, i.e. to integrate into their regulatory framework the possibility for facilities located in neighbouring Member States to participate explicitly in the French capacity mechanism, provided there is sufficient transit capacity for the interconnections. This regulatory framework will nonetheless provide for the agreement of the transmission system operators ⁽²⁴⁾ (TSOs) in the Member States concerned, in the form of a cooperation agreement making it possible to introduce a certification process and controls needed for the mechanism to be implemented.
- (124) Should certain TSOs in the Member States concerned fail to sign such an agreement, the French authorities undertake to implement a safeguard procedure allowing explicit participation of foreign capacities in the capacity mechanism and to thus move away definitively from the model based on implicit participation. This safeguard procedure will consist of explicit participation of interconnections (a solution that can be implemented without the support of other Member States and that reflects the value added by interconnection capacities to France's security of supply).
- (125) The implementation of these commitments requires a review of the 2012 Decree, adopted by the Council of State after consultation with the Higher Energy Council, the French Energy Commission and the Competition Authority. The French authorities do not consider it feasible that the Decree will be adopted before late 2017, followed by a review of the rules drawn up for its application. They believe that this stage could take around six months. The schedule put forward by the French authorities is therefore based on adaptation to the regulatory framework in 2018, followed by actual implementation for delivery year 2019.

4.3.3. *Lack of signals for new investments*

4.3.3.1. *Comments by interested parties*

- (126) The Commission received many replies on this point, with a marked divergence of opinion.
- (127) The majority of respondents (seven) agreed that the mechanism is unable, in its original form, to encourage new investments in power plants. The most often-cited reasons include the lack of a representative price signal sufficiently in advance of the delivery year, the EUR 40 000/MW capacity price ceiling (resulting from the cap applicable to the imbalance settlement mechanism) and the absence of long-term contracts.
- (128) Most respondents confirmed that, in their view, either the mechanism is too complex or that at least the suppliers, and especially new entrants, will find it difficult to estimate their future portfolios. One respondent pointed out that a centralised capacity mechanism could avoid this kind of problem.
- (129) Two (incumbent) producers disagreed, arguing that the mechanism will in fact be able to attract new investment, in particular in view of the four-year lead time before the delivery year, the possibility for the market to develop forward products and the price signal, which they deemed reliable. They also believe that the mechanism provides sufficient safeguards to ensure the transparency of capacity obligations, in particular in view of the regular publication by RTE of forecasts on the overall level of capacity certificates required for each delivery year.

⁽²⁴⁾ Under Article 2 of Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (OJ L 211, 14.8.2009, p. 55), transmission system operator means 'a natural or legal person responsible for operating, ensuring the maintenance of and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity'.

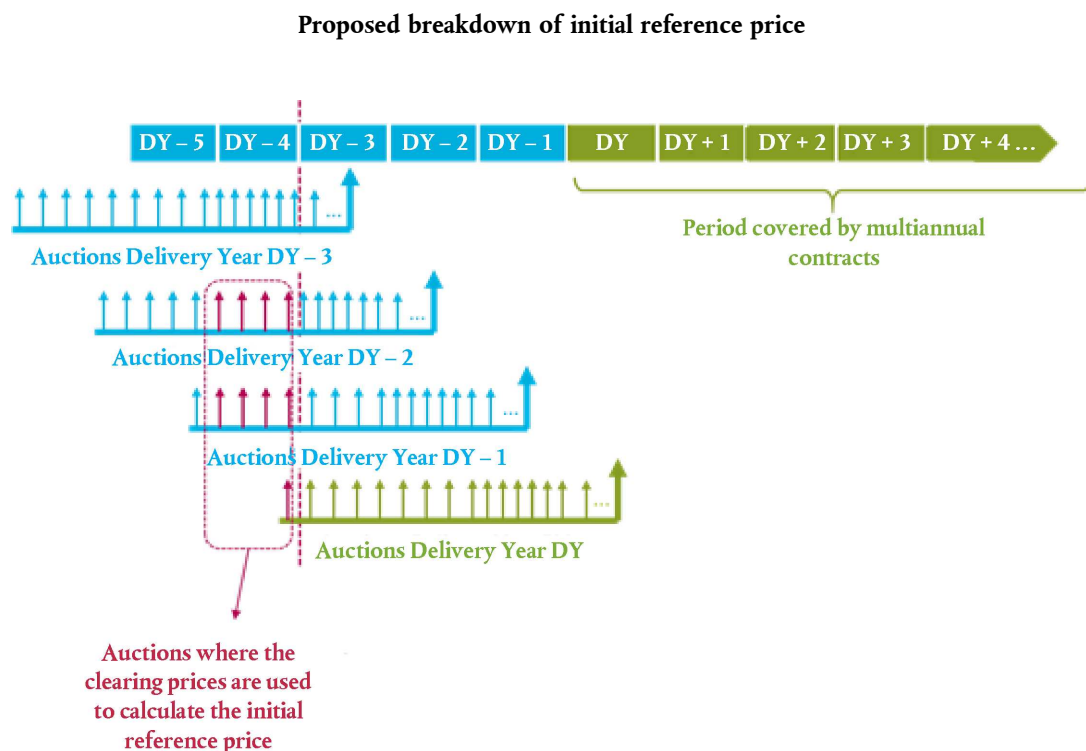
- (130) Two other respondents (alternative producers) argued that the main aim of the mechanism is to maintain in operation existing capacity rather than to stimulate new investments.

4.3.3.2. Observations and remedies proposed by France

Lack of long-term contracts

- (131) Following feedback from third parties, the French authorities undertook to implement a multiannual contract scheme aimed at fostering investment in new capacities. All new capacities ⁽²⁵⁾ will be eligible for the scheme if they do not already have a support mechanism.
- (132) To allow new projects sufficient start-up time, an initial auction of capacity certificates will be held on the EPEX platform in DY-4. Potential new capacities should submit their bids to RTE in the last quarter of DY-4. Offers must primarily propose a price and a volume.
- (133) The competitiveness of the price is then measured against an 'initial reference price', which sets the maximum limit for offers to be accepted. The initial reference price will be a weighted price ⁽²⁶⁾ of the capacity resulting not only from the auction held in DY-4 for the delivery year DY, but also from the auctions held during the same year for delivery years DY-2 and DY-1, as indicated in Figure 6.

Figure 6



Source: Letter from the French authorities dated 9 September 2016.

⁽²⁵⁾ The criteria applied to distinguish investments in new capacities from investments in maintenance or to extend the lifetime of existing facilities will be aligned with the definitions that already exist in French law, thereby distinguishing 'new capacities' from maintenance or lifetime extension investments. Thus, Article L. 311-1 of the French Energy Code, in its version arising from Law No 2015-992 on energy transition for green growth, states: 'Subject to Article L 311-6, the operation of any new electricity generation facility requires prior administrative authorisation. Under this Article, new electricity generation facilities are also generally those whose installed power is at least 20 % higher and those whose primary energy source is modified'.

⁽²⁶⁾ The precise weighting is yet to be determined by the French authorities after market consultation.

- (134) The initial reference price will therefore not be known to market operators beforehand and the market outcomes will be used to determine it.
- (135) Regarding the volumes to be contracted, France will apply a demand curve to limit these volumes to those bids that are genuinely competitive in the long term. The demand curve will be drawn up annually by RTE and approved by the CRE, and must reflect the value of the new capacity for society. This means ensuring that the multiannual contract scheme will actually have a positive impact for consumers.
- (136) The successful bids will be awarded a 7-year contract for difference, comparable in operation to a feed-in premium, which means that any difference between the offer price and the market reference price (MRP) gives rise to a refund of the difference (if the MRP is higher than the offer price) or a subsidy (if the MRP is lower than the offer price). However, in order to encourage market participants to maximise their income, any income generated by the sale of the certificates at a price higher than the offer price does not give rise to a reimbursement of the difference (selling price-offer price) by the investor.
- (137) Moreover, the French authorities plan to introduce environmental criteria that will lead to preference being given to low-carbon generators, in the form of (i) environmental precedence, with identical technical and economic characteristics; and (ii) a cap on the emissions that can be generated by an asset that would benefit from the specific framework for new capacities. The environmental criteria, such as greenhouse gas emission levels, will be defined in the rules and the most environmentally friendly tender may be selected if necessary. Moreover, existing facilities will continue to be subject to current EU and French environmental laws, which may require investment in these facilities to make them compliant.
- (138) The French authorities undertake to implement the scheme for a selection of capacities in 2019, combined with a first actual participation by selected capacities for delivery year 2023. Moreover, they undertake to implement, from 2019, a transitional system of multiannual contracts, covering the period between 2020 and 2023. For example, this would mean that in 2019, a 'permanent' scheme for delivery year 2023 would be launched, but also a transitional scheme for delivery years 2020, 2021 and 2022.

Difficulty for suppliers to predict far in advance how their customer portfolios will evolve

- (139) The French authorities believe that the regular RTE forecasts should provide enough assistance to suppliers to better predict their eventual capacity obligations. They add that suppliers are allowed, at least during the first years of the mechanism, to rebalance their capacity positions free of charge until the end of the delivery year.
- (140) Notwithstanding the above, in addition to these safeguards, the French authorities propose to include in the mechanism's rules provisions on supporting alternative suppliers with regard to the calculation of their capacity obligation. Currently, the rules require RTE to provide each supplier with a provisional estimate of their obligation one year after the delivery year and with a final level of their obligation two years after the delivery year. In addition, RTE has developed support tools to inform the suppliers of their obligations even before those deadlines. France proposes to formalise the obligation for RTE to assist suppliers in calculating their obligation, in particular through the provision of tools enabling alternative suppliers to better anticipate their capacity obligation and the scheduling of regular windows during which suppliers will use these tools to obtain a forecast of their obligation. Suppliers will also have the option of using these tools on request, outside of the windows laid down in the rules.

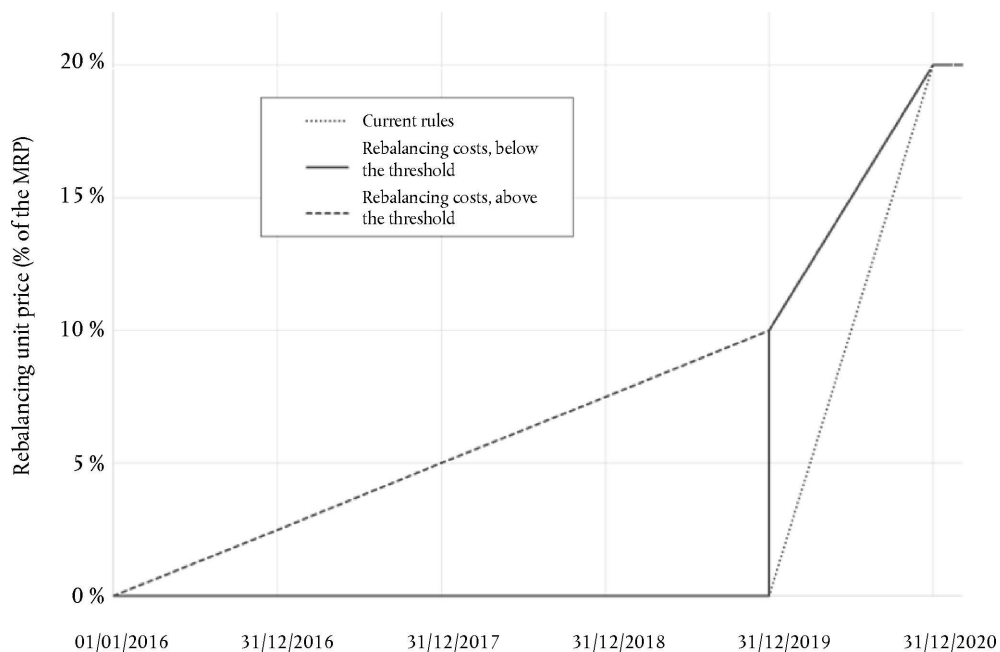
Potential lack of incentives to encourage operators to be in balance before the delivery year

- (141) Moreover, the French authorities have undertaken to revise the rebalancing arrangements, so as to encourage capacity operators to obtain the most precise certification possible. More precisely, the rebalancing costs applied to operators are calculated on the basis of each operator's rebalancing volume:
- (1) where the sum total of rebalancing is less than 1 GW (sum total of absolute values), rebalancing remains free before the delivery year;

- (2) where the sum total of rebalancing is more than 1 GW (sum total of absolute values), rebalancing before the delivery year must be paid for;
- (142) The gradual increase in rebalancing costs, depending on the case, is illustrated in Figure 7 below (delivery year: 2020), with a unit price that rises as the delivery year approaches.

Figure 7

Illustration of the new proposed framework for rebalancing for 2020, where $k = 0,2$



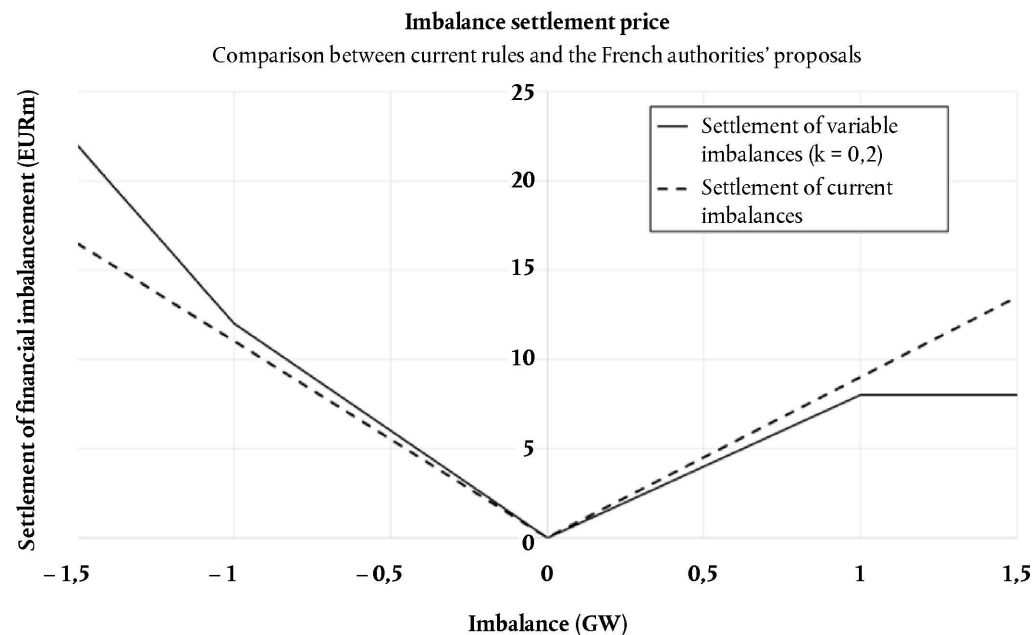
Source: Letter from the French authorities dated 9 September 2016.

- (143) Capacity operators must now rebalance within a short time frame, set out in the rules, when significant events occur (i.e. involving unavailability of facilities compared with their forecast availability, such as mothballing, decommissioning, damage leading to reduced availability for a long period, etc.) ⁽²⁷⁾.
- (144) The French authorities also propose that the imbalance settlement mechanism be revised in order to further discourage market operators from having a negative or positive imbalance at any point in time. In particular, the 'k' incentive coefficient, applied to imbalances, will be doubled (it was set at 0,1 in the Order of 22 January 2015 but will thus be increased to 0,2), will be further increased for negative imbalances exceeding a maximum threshold of 1 GW, and will be even less rewarding for positive imbalances also exceeding a maximum threshold of 1 GW (the precise level of the thresholds is yet to be set by the authorities on the basis of market feedback but in any event will not exceed 1 GW). These changes are illustrated in Figure 8.

⁽²⁷⁾ Previously, capacity operators were merely required to notify events involving a deviation of more than 100 MW from their forecast availability. The main difference is that the declaration was not necessarily combined with rebalancing (the operator could delay rebalancing, or not rebalance at all and have an imbalance). The only case where there was a rebalancing obligation concerned decommissioning. Furthermore, this provision was not set out by law but by the certification contract; it will now be enshrined in law (higher-level legislation).

Figure 8

Illustration of the proposed imbalance settlement with the threshold effect of 1 GW and where $k = 0,2$



Source: Letter from the French authorities dated 9 September 2016.

The price cap on the settlement of imbalances does not reflect the CONE

- (145) In addition, the French authorities have undertaken to gradually increase the administered price (which is a cap on the price of imbalances and, therefore, indirectly on the price of capacity certificates), according to the following schedule:
- (1) in 2017, an administered price of EUR 20 000/MW, to allow operators to master how the market works with limited risk, given the late actual implementation of the mechanism;
 - (2) in 2018 and 2019, an administered price of EUR 40 000/MW;
 - (3) from 2020, an administered price of EUR 60 000/MW, to allow the capacity mechanism, where necessary, to send price signals corresponding to new capacity needs, in a market which should by then have become mature enough.
- (146) Furthermore, the French authorities undertake, for delivery years 2021 and after, to update the administered price annually so as to bring it in line with the cost of new entry (CONE), specifically the costs of a combined-cycle or open-cycle gas-fired power plant, as calculated by the operator of the public electricity transmission grid and approved by the regulator. This update is not necessarily carried out by means of a full revision of the capacity mechanism rules.
- (147) This schedule makes it possible to (i) match any increase in the administered price with the entry into force of the multiannual contract scheme for new capacities; and (ii) question market operators jointly on the increase in the administered price and on the introduction of the multiannual contract scheme for new capacities ⁽²⁸⁾.

⁽²⁸⁾ As part of the full investigation into the capacity mechanism, the European Commission and the French authorities carried out preliminary analyses on the financing needs associated with new investment projects in gasification combined cycle projects (on the basis of the financial data of the Landvisiau project and various elements in economic literature). These analyses highlight the fact that capacity revenue of EUR 60 000/MW/year is consistent, in order of magnitude, with new investments in GCC but that, in order to ensure the profitability of projects, an administered price increase may be envisaged. Based on existing financial data, the profitability of projects is ensured only for capacity revenues very close to EUR 60 000/MW/year. These analyses must be continued in order to reach a more precise conclusion on the advisability of increasing the administered price and thus ensuring that the administered price level can constitute a safeguard for consumers while not acting as a barrier to entry on the electricity market.

- (148) In addition to the above and what was stated in the Opening Decision, the Commission explained in the discussions with the French authorities that it was concerned that the spread between the ARENH and the market price for electricity might be an implicit cap on capacity prices, given that the ARENH product includes capacity certificates.
- (149) The French authorities replied that:
- (1) the volume of capacity certificates linked to the ARENH product is low enough in comparison with the entire capacity market and is consequently unable to influence the price of other capacity certificates; and
 - (2) the current spread is more or less equal to EUR 10/MWh, which corresponds to a capacity price of EUR 87 600/MW. Since the administered capacity price is set at EUR 20 000/MW/year, EUR 40 000/MW/year and EUR 60 000/MW/year for 2017, 2018-2019 and 2020 respectively, ARENH is not currently a competitive product ⁽²⁹⁾.
- (150) Nonetheless, the French authorities undertake, as part of a future evaluation of the functioning of the market, to study the advisability of 'unbundling' (*'financiariser'*) the capacity portion of the ARENH product ⁽³⁰⁾, to avoid the product disrupting the free formation of prices on the capacity market.

4.3.4. Other objections from the Commission

- (151) In recital 182 of the Opening Decision, the Commission stated that France should clarify why some proposals to improve the mechanism set out by the Competition Authority in Notice No 12-A-09 of 12 April 2012 had not been implemented.
- (152) The French authorities explained that, taking into account the proposed amendments (i.e. to oblige generators to declare the forecast availability of their generation facilities based on their historical availability and implement a mechanism for the explicit participation of cross-border capacities), there remained only two Competition Authority proposals that had not been implemented:
- (1) not allocating certificates to facilities subject to purchase obligations (renewables), because the feed-in premiums for the electricity generated by those facilities already cover the full costs of the facilities; and
 - (2) not making alternative suppliers bear the cost of financing the transitional call for proposals.
- (153) In relation to the first rejected proposal, the authorities explained that they had retained certification for facilities subject to purchase obligations in order to fulfil the capacity mechanism's market-wide criterion. However, to avoid accumulation of remuneration for facilities subject to purchase obligations, it was decided that agreed buyers would be responsible for certifying these facilities and the holders of the associated capacity certificates, with the revenue arising from the sale of capacities being deducted from the compensation given to agreed buyers.
- (154) As regards the second rejected proposal, the authorities explained that the decision had been taken not to launch the transitional call for proposals; alternative suppliers therefore have no costs to bear. They will, however, bear the costs for this mechanism in the future, since the current fall-back tender will be cancelled and replaced by the multiannual contract mechanism once the Decree is amended.

4.4. Proportionality

4.4.1. Demand overestimation

4.4.1.1. Comments by interested parties

- (155) The comments by third parties on this point are included in Section 4.3.3.1 above.

⁽²⁹⁾ An ARENH-market price spread of around EUR 7/MWh would result in a capacity price of around EUR 60 000/MW/year, i.e. the administered price. With an ARENH price of EUR 42/MWh, the energy price would have to be at least EUR 35/MWh for the ARENH-market price spread to be able to constitute an implicit cap on the capacity price. However, according to the French authorities, the forward prices up to 2019 are not of this order of magnitude.

⁽³⁰⁾ The 'unbundling' of the capacity ARENH implies that the price of the capacity would be deducted from the price of the energy ARENH.

Observations by France

- (156) The observations made by France on this point are included in recital 139 above.
- (157) The observations notwithstanding, the authorities propose to oblige RTE to support alternative suppliers in calculating their capacity obligation, as explained in recital 140.

*4.4.2. Lack of transparency on capacity pricing**4.4.2.1. Comments by interested parties*

- (158) A large majority of respondents (thirteen) complained about the lack of visibility on over-the-counter (OTC) transactions, especially intra-group transactions, although several respondents take the view that most of the transactions should be in this form. One respondent again pointed out that a centralised capacity mechanism could avoid this kind of problem.
- (159) The incumbent considers that the mechanism in its current form provides sufficient safeguards to ensure transparency of trades (including intra-group trades), in particular:
- (1) the obligation to keep separate accounts in the transactions register (one account for capacity operators and one account for suppliers); and
 - (2) the transparency obligations towards CRE and the latter's monitoring of internal transactions.

4.4.2.2. Observations by France

- (160) The French authorities also point to the guarantees identified by the incumbent (set out in recital 160). They also indicate that, taking into account suppliers' need to adapt to evolving customer bases, it seems appropriate to maintain the possibility of over-the-counter trades between market participants, in addition to the periodic auctions. A continuous trading mechanism would ensure this flexibility as well as transaction and price visibility, while reducing asymmetry of information between market participants. However, participation in such a mechanism would be costly, especially for relatively small suppliers. The French authorities therefore propose to maintain over-the-counter trades in association with an organised market, where the price of each transaction would be made public.
- (161) However, they also propose to include additional safeguards to improve the transparency and representativeness of the capacity trades.
- (162) The mechanism already provides for auction prices on the platform to be set up by EPEX Spot to be public. In order to ensure a level of transparency equivalent to that of a trading platform for OTC transactions, the French authorities propose to give all participants access to the register of (anonymised) OTC transactions, thereby providing visibility on volumes and prices, while ensuring the anonymity of the operators. Stakeholders will then be able to take that information into account in their purchasing and supply strategy in the auctions.
- (163) In addition, the auctions will be strengthened. The French authorities have undertaken to increase liquidity in the auctions held, by increasing the number of auctions throughout the four years preceding the first delivery year to 15, i.e. 1 in DY-4, 4 in DY-3, 4 in DY-2 and 6 in DY-1 (in the initial version of the scheme the French authorities had planned only 10 auctions, spread over the three years preceding the delivery year).
- (164) Moreover, the French authorities undertake to oblige, within the regulatory framework, certain capacity operators to offer their certificates on the market on the basis of the following formula:
- (1) DY-4: 25 % of the certified capacity level;
 - (2) DY-3: the greater of 25 % of the certified capacity level and 25 % of the volume of unsold capacity certificates;

- (3) DY-2: the greater of 25 % of the certified capacity level and 50 % of the volume of unsold capacity certificates;
 - (4) DY-1: the greater of 25 % of the certified capacity level and 100 % of the volume of unsold capacity certificates.
- (165) This constraint will apply to certificates portfolio managers holding a capacity volume exceeding a threshold of 3 GW.

4.4.3. Exclusion of certain types of capacity operator from the mechanism

- (166) The comments by third parties and the observations by the French authorities regarding the potential discrimination between the various types of demand-side response capacity are discussed in Section 4.3.1.
- (167) The comments by interested parties and the proposals of the French authorities to remedy the exclusion of cross-border capacities and new investments are described in Section 4.3.3.

4.4.4. EDF's market power

4.4.4.1. Risk of capacity withholding

Comments by interested parties

- (168) Three quarters of the parties who responded to the Opening Decision referred specifically to the risk of capacity withholding in the French mechanism.
- (169) A French industrial consumer association is concerned that EDF will have an incentive to influence the market reference price (MRP) upwards and sell the surplus capacity after the delivery year, given that:
- (1) in such a scenario, the imbalance settlement penalty that EDF would pay would be largely offset by revenues from a relatively high MRP; and
 - (2) the MRP will be used to invoice the capacity cost to the vast majority of consumers, and will therefore be passed on to them.
- (170) An alternative supplier pointed out that, in addition to the fact that the auctions will probably not be very representative of the trades conducted under the mechanism (suppliers should be inclined to choose bilateral transactions to avoid advance payments in cash), the fact that the MRP will not take into account the transactions carried out during and after the delivery year may have the effect of further weakening the disincentive effect of the imbalance settlement mechanism and thereby encouraging withholding strategies by capacity operators.
- (171) In order to further encourage capacity operators not to withhold capacity, the alternative supplier proposes three remedies:
- (1) review the reference base for the MRP;
 - (2) strengthen the disincentive effect of the imbalance settlement mechanism; and
 - (3) remove the option of a fall-back tender, since that can encourage operators to withhold capacity.
- (172) The AFIEG (Association of Alternative Suppliers and Producers) criticises the option of rebalancing capacities at no cost prior to the delivery year, since in its opinion, it creates the possibility of gaming on the availability of the nuclear fleet and thereby artificially creating scarcity or overcapacity.

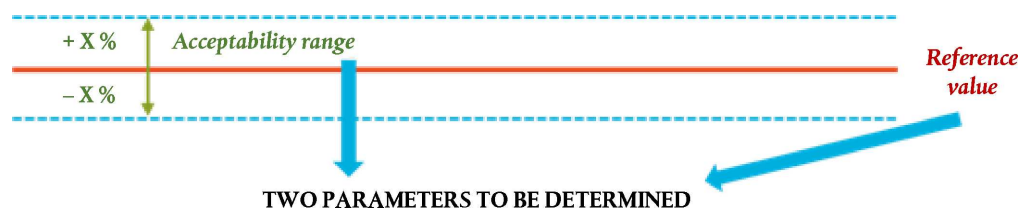
Observations by France

- (173) In view of these reactions to the Opening Decision by market operators, the French authorities expressed their willingness to improve the mechanism to minimise any risk of abuse of market power.

- (174) In particular, they undertake to impose on capacity operators the obligation to accurately certify in advance all of their available capacity and have limited their certification possibilities to a range around historical reference values (see Figure 9). Any divergence from this range must be justified with RTE and the regulator.

Figure 9

Illustration of the certification range



Source: Letter from the French authorities dated 9 September 2016.

- (175) Moreover, the French authorities have undertaken to revise the rebalancing arrangements, so as to encourage capacity operators to obtain the most precise certification possible. They propose that any significant cumulative rebalancing (exceeding a maximum threshold of 1 GW; the precise level of the threshold is yet to be set by the authorities on the basis of market feedback but in any event will not exceed 1 GW) occurring before the delivery year would trigger a penalty. The penalty, aimed at discouraging capacity operators from under-certifying or over-certifying their capacities, increases gradually until the imbalances are settled. Capacity operators must also rebalance as soon as they become aware of an event involving unavailability of facilities (mothballing, decommissioning, damage causing reduced availability for a long period, etc.) compared with their forecast availability.
- (176) The authorities also propose that the imbalance settlement mechanism be revised in order to further discourage market operators from having negative or positive imbalances at any point in time. In particular, the 'k' incentive coefficient, applied to imbalances, will be doubled, will be further increased for negative imbalances exceeding a maximum threshold of 1 GW, and will be even less rewarding for positive imbalances also exceeding a maximum threshold of 1 GW (the precise level of the thresholds is yet to be set by the authorities on the basis of market feedback but in any event will not exceed 1 GW).
- (177) In response to the complaint from one alternative supplier that the fall-back tender could encourage operators to adopt a withholding strategy, the French authorities confirmed that this fall-back tender would indeed be cancelled and replaced by the multiannual contract scheme (described in recitals 131 to 138).
- (178) Finally, as explained in recitals 146 and 147, the French authorities propose to increase the maximum amount of compensation for price deviations applied in the event of a serious threat to security of supply (i.e. an overall negative imbalance greater than 2 GW). It is proposed that this ceiling (the administered price) be gradually increased from EUR 20 000/MW in 2017 to EUR 40 000/MW in 2018 and 2019, reaching EUR 60 000/MW in 2020. From delivery year 2021, the authorities will update this administered price annually so as to bring it in line with the cost of new entry (CONE), specifically the costs of a combined-cycle or open-cycle gas-fired power plant, as calculated by the operator of the public electricity transmission grid and approved by the regulator.

4.4.5. Risk of the withholding of guarantees

4.4.5.1. Comments by interested parties

- (179) Four respondents are especially worried about the risk of guarantee withholding or, in any case, a lack of liquidity for certificates in the market.
- (180) The AFIEG pointed out that the mechanism requiring market participants with a surplus of guarantees after the delivery year (but before the imbalance settlement) to sell these by auction will not be sufficient to prevent withholding of the guarantees *before* the delivery year (relevant period for determining the MRP).

(181) In addition to suggestions to improve the incentives to be in balance before the delivery year (review of the reference base for the MRP and strengthening of the disincentive effect of the imbalance settlement mechanism), respondents suggest two ways of improving access to the certificates:

- (1) require EDF to resell its certificates in one way or another (e.g. through a 'certificate release scheme', imposing a 'market-maker' obligation on it); or
- (2) improve the ARENH product, by (a) introducing a capacity ARENH. To this end, the ARENH would be split into two products: a capacity product and an energy product. Each supplier would be free to buy either product or the two simultaneously; and/or (b) revising upwards the amount of capacity linked to the ARENH energy product (1,15 guarantees per MW of ARENH). In this respect, the French authorities stressed that suppliers have the obligation to make a public offer for sale for all guarantees owned on top of their internal needs. In their view, this should ensure that potential withholding of capacity is prevented. Moreover, part of the certificates owned by the incumbent operator would be automatically transferred to the alternative suppliers through ARENH, and the regulator would still supervise any potential abuse of market power.

4.4.5.2. Observations by France

(182) In view of these concerns, the French authorities undertook to revise the mechanism so as to oblige capacity operators to offer certain minimum volumes of certificates in each of the auctions organised before the delivery year, as explained in recitals 165 and 166. Additional auctions will also be held, as explained in recital 164.

4.4.6. Risk of a price squeeze by the dominant incumbent operator

4.4.6.1. Comments by interested parties

(183) With reference to a Competition Authority report of 2012, two respondents fear cross-subsidisation by the incumbent between its production and retail activity (i.e. selling certificates to competitors at a higher price than the transfer price between its production and retail segments, leading to a foreclosure of the retail market). This cross-subsidisation could, they believe, lead to a price squeeze for an alternative supplier without generation assets, since it will have to meet its capacity obligations by purchasing certificates on the market.

4.4.6.2. Observations by France

(184) Regarding the possibility of price-based exclusionary practices (margin squeeze, price squeeze, predatory pricing), the French authorities noted that such anti-competitive practices are already scrutinised and sanctioned by the Competition Authority.

(185) Nonetheless, to facilitate the detection of such practices, the authorities will strengthen the rules by obliging vertically integrated operators to inform the Energy Regulatory Commission of the method which they used to take into account capacity guarantee prices in their offers.

(186) They will also specify more clearly in the rules that vertically integrated operators are required to declare a price for all internal transactions relating to capacity certificates. A loophole in the legislation allowing free transfers of certificates will also be corrected.

(187) Finally, the French authorities have undertaken to provide full access for market operators to the register of capacity guarantees, where the OTC transactions are registered, while ensuring the anonymity of operators involved in each transaction.

4.5. Avoidance of negative effects on competition and trade

4.5.1. Barriers to the entry of new generation capacities

(188) The comments from third parties and the French authorities' observations and remedies regarding the participation of new generation capacities in the French capacity mechanism are discussed in Section 4.3.3.

- (189) In their response to the Opening Decision dated 17 December 2015, the French authorities indicated that the proposed mechanism is not necessarily designed to generate new large-scale investment increasing overall generation capacity, but rather to ensure the availability of the necessary capacity, for example to cope with a cold spell in winter.
- (190) Nevertheless, the French authorities have recognised that the mechanism must enable new generation capacities to compete with existing generation capacity and acknowledged the need for a more stable framework for new entrants that would facilitate this competition. Two new features have been proposed to address this issue:
- (1) as described in recitals 146 to 148, a gradual increase in the administered price over time, which would initially rise from EUR 20 000/MW for delivery year 2017 to EUR 40 000/MW for delivery years 2018 and 2019, reaching EUR 60 000/MW for delivery year 2020. From delivery year (DY) 2021, the authorities will review this administered price annually so as to bring it in line with the cost of new entry (CONE), specifically the costs of a combined-cycle or open-cycle gas-fired power plant, as calculated by the operator of the public electricity transmission grid and approved by the regulator; and
 - (2) the establishment of a multiannual scheme for contracts for differences (CFD) specifically for new generation capacities, as described in recitals 131 to 138.

4.5.2. Discrimination between explicit and implicit demand-side response

- (191) The comments from third parties and the French authorities' observations regarding this point have been dealt with in Section 4.3.1.

4.5.3. Explicit participation by foreign capacities

- (192) The comments from third parties and the French authorities' observations and remedies regarding the explicit participation of foreign capacities are discussed in Section 4.3.2.
- (193) As described in recitals 119 to 125, in response to the concerns of the Commission and third parties, the French authorities have proposed a hybrid model involving the allocation of interconnection tickets that would, in time, allow the participation by generation and demand-side response capacities located in Member States bordering France. In their view, this approach complies with the basic principles set out in Annex 2 to the Commission Staff Working Document accompanying the European Commission's Sector Inquiry on Capacity Mechanisms.

4.5.4. Information asymmetry between the dominant incumbent operator and its current and potential competitors

4.5.4.1. Difficulty for suppliers to predict far in advance how their customer portfolios will evolve.

Comments from interested parties

- (194) The comments from third parties on this point are included in Section 4.3.3.1 above.

Observations by France

- (195) The observations by France on this point are included in recital 139 above.
- (196) As explained in recital 140 above, the latest proposal from the French authorities is to help suppliers better estimate their future customer portfolios and clearly set out this support in the rules.

4.5.4.2. Lack of transparency on capacity pricing

Comments from interested parties

- (197) The comments from third parties on this point are included in recitals 159 and 160 above.

Observations by France

- (198) As explained in Section 4.4.2 above, the latest proposal from the French authorities on this point is to offer suppliers flexibility by allowing over-the-counter trading while guaranteeing liquidity on the organised trading platform and ensuring the transparency of over-the-counter trading.

5. ASSESSMENT OF THE MEASURE**5.1. State aid within the meaning of Article 107(1) TFEU**

- (199) In recital 143 of the Opening Decision, the Commission had already concluded that the mechanism constituted State aid within the meaning of Article 107(1) TFEU.

5.1.1. Imputability and financing through State resources

- (200) As regards the existence of State resources in the French capacity mechanism, the French authorities allocate capacity guarantees to capacity operators free of charge. At the same time, they create a market for these guarantees by imposing a quota obligation on electricity suppliers, linking these quotas with their customers' demand peaks. They therefore create a demand for the certificates and a corresponding value. Moreover, instead of selling the certificates to capacity operators or auctioning them, the State allocates them free of charge and, as a result, foregoes public resources.
- (201) No arguments have been put forward by the French authorities or third parties that call this assessment into question.
- (202) However, in the intervening period, the Commission adopted another decision confirming that a system of certificate-based subsidies for power plants using renewable energy constitutes State aid ⁽³¹⁾. In that case, no minimum price was guaranteed for the green certificates.
- (203) Furthermore, it is incorrect to claim that the present case differs from the case of Romania's green certificates by arguing that, in the French mechanism, suppliers can choose whether or not to pass on the purchase price of the capacity guarantees to customers. In fact, the price of the capacity guarantees must be included in at least the regulated sales tariffs, as laid down in Article R 337-19 of Decree No 2015-1823 of 30 December 2015 on the codification of the regulatory part of the Energy Code. Furthermore, the French authorities have argued that the market price (the MRP, used for the settlement of imbalances) must be the average of the prices resulting from the different auctions held (and therefore cannot take over-the-counter trading prices into account), precisely so as to ensure that the MRP can be replicated. This replicability is the ability to replicate the PRM in sales contracts between suppliers and their customers, as is desired by many market participants, according to the French authorities. This confirms that a great many, if not all, suppliers will pass on the costs arising from the purchase of the capacity guarantees to their customers.
- (204) Furthermore, the capacity mechanism as initially envisaged by the French authorities included a fall-back option for the public authorities, namely an alternative tender procedure to be used in the event that new capacity was required and the capacity market was not generating incentives for the development of new capacity. This possibility of direct market intervention by the State further confirms the classification of the capacity mechanism as State aid.
- (205) In addition, some of the changes that France has made to the capacity mechanism as a result of interested parties' comments on the doubts expressed by the Commission in the Opening Decision must be considered State aid in themselves. This includes the multiannual contracts by which the State guarantees the beneficiaries a certain capacity revenue for seven years. The State plays a crucial role in this mechanism, as it obliges RTE to enter into contracts with new capacities provided that they are competitive and, as a result of these contracts, these new capacities will be certain of receiving a fixed price for their capacity for seven years.

⁽³¹⁾ SA.37345 (2015/NN) — Polish certificates of origin system to support renewables and reduction of burdens arising from the renewables certificate obligation for energy intensive users.

5.1.2. *Selective advantage*

- (206) As regards the argument put forward by EDF and by an undertaking active in France mainly on the wholesale market, taking the view that the mechanism is a public service obligation because capacity remuneration is consideration for a service provided by the capacity operators, the Commission is of the opinion that this argument has already been addressed in the Opening Decision. The Commission considered that the service could not be provided or assigned a value by the market. Indeed, the French authorities had to create a market by imposing obligations relating to the availability and the withholding of capacity guarantees on the different operators in the electricity market so as to give value to this availability. In fact, as a result of establishing this capacity market, capacity operators will receive funds that they would not otherwise have received, and will therefore obtain an advantage that they would not have obtained if the market created by the authorities did not exist.
- (207) Furthermore, the argument put forward by EDF and another vertically integrated electricity undertaking that the capacity mechanism does not confer any selective advantage on capacity operators since all the mechanism's participants are in the same factual and legal situation and are treated entirely equally has already been addressed in the same Opening Decision. The Commission takes the view that the advantage is selective, since the mechanism provides for aid to capacity operators and not to other sectors of the economy.
- (208) As France has not put forward any new arguments, the Commission stands by its assessment and conclusions set out in the Opening Decision (to which this Decision refers), namely that the mechanism confers a selective advantage on capacity operators.

5.1.3. *Effect on competition and trade between Member States*

- (209) The French authorities repeated their argument, which was taken into account by the Commission in its Opening Decision, that the capacity mechanism will not have an impact on the electricity market. The Commission had reached the conclusion that the mechanism had the potential to affect trade between Member States and distort competition because French capacity operators would gain an advantage that their foreign competitors could not, as they are not permitted to participate in the French capacity market.
- (210) It should be noted that one of the remedies proposed by France is precisely to have explicit participation of cross-border capacities in the French mechanism. However, this participation is restricted to France's usable interconnection capacity (i.e. once de-rating factors have been applied) with its neighbouring countries. Furthermore, there is no guarantee that cross-border capacities will receive the same remuneration as French capacities for the service provided, given the additional cost of participating in the French mechanism linked to the obtaining and purchasing of interconnection tickets.
- (211) This therefore confirms the Commission's assessment and conclusion in the Opening Decision (to which this Decision refers), namely that the advantage relating to capacity remuneration, conferred upon French capacity operators, has the potential to affect trade between Member States and distort competition.

5.1.4. *Conclusion on the existence of State aid*

- (212) For the reasons referred to above, the Commission maintains that the French capacity mechanism constitutes State aid within the meaning of Article 107(1) TFEU.

5.2. **Lawfulness of the aid**

- (213) When the French authorities first issued certificates to capacity suppliers on 1 April 2015, they began allocating the intangible assets to the beneficiaries. The Commission therefore considers that the French authorities have begun to implement the aid measure in question within the meaning of Article 108(3) TFEU.
- (214) Furthermore, the French authorities have not suspended any transactions involving capacity guarantees following the publication of the Opening Decision.

- (215) Given that the Commission had not reached a final decision on the measure by the date on which the French authorities began implementing the mechanism, France acted in breach of its obligation under Article 108(3) TFEU.

5.3. Compatibility with the internal market

- (216) To assess whether an aid measure can be considered compatible with the internal market, the Commission generally analyses whether the aid measure is designed so that the positive impact of achieving an objective of common interest exceeds the potential negative effects on trade and competition.
- (217) The main aim of the measure is the security of electricity supply. The Commission has therefore assessed the measure in the light of Section 3.9 of the Guidelines on State aid for environmental protection and energy 2014-2020 (EEAG), which relates to aid for generation adequacy.
- (218) The Commission's assessment in this Decision will be strictly limited to those points about which it expressed concerns in the Opening Decision.

5.3.1. Objective of common interest and necessity

5.3.1.1. Security of supply

- (219) As described in recital 149 of the Opening Decision, France explained that its electricity peak demand had been rising for several years (rising from 79 590 MW in 2001 to 102 100 MW in 2012), while average electricity demand in France had remained stable. This is largely due to France's highly thermosensitive electricity system, as electric heating is widely used in residential and commercial buildings.
- (220) Furthermore, according to the French authorities, peaking power plants (usually gas-fired plants), have become less competitive in recent years for a number of reasons (see recital 45). Despite this, these power plants, particularly the peaking power plants, are needed to cover the extreme energy demand spikes described in Section 5.3.1.1. Nevertheless, as these spikes are rare and unpredictable, market operators refrain from investing in new generation capacity.
- (221) For these reasons, and as shown in RTE's calculations reproduced in recital 105, there is a risk that France could fail to comply with its shortfall indicator of three hours per year on average in the event of a cold spell (once every 10 years in France).
- (222) As regards recital 154 of the Opening Decision, France has demonstrated that RTE's adequacy studies were more recent and detailed than ENTSO-E's old deterministic studies. For example, they take account of the precarious situation of a number of existing power plants and the risk that they will close ('Low thermal' scenario; see Figure 3. There may therefore be differences between the old adequacy studies carried out by RTE and those drawn up by ENTSO-E.
- (223) In this regard, France has also taken into account the conclusions of the Mid-Term Adequacy Forecast published by ENTSO-E in 2016, which is the first version to use a probabilistic methodology (see recital 100). In the baseline scenario for 2020, the expected shortfall in France is slightly below the supply security target set by the public authorities. However, this is not the case in the study carried out using GRARE, based on the largest number of Monte Carlo projections (2 100), which calculates that the expected shortfall in France is between 5 and 20 hours (P95). Moreover, it should be noted that all the studies carried out for 2020 are based on the following hypotheses: (i) mothballed plants are fully available, which is an optimistic hypothesis, according to ENTSO-E, and (ii) France's capacity mechanism is operational from 2017 to 2020. One can therefore conclude that ENTSO-E's most recent studies do not contradict and in fact actually support the French authorities' conclusions regarding the need for the mechanism.

- (224) RTE's studies also take into account the most recent data on peak demand and therefore also take account of the impact of alternative measures implemented to increase demand-side response capacity (as requested by the Commission in recital 163 of the Opening Decision). These studies nevertheless clearly show that there is a risk that France's upper shortfall limit will be exceeded in the coming years, unless the State intervenes.
- (225) The vast majority of interested parties are also in agreement about the need to put in place a capacity mechanism in France as a matter of urgency. Some of them submitted their financial plans in order to illustrate the existence of France's 'missing money' problem, which contradicted the findings of France's Competition Authority in its Opinion published in 2012 (referred to in recital 158 of the Opening Decision).
- (226) RTE's assessment of the capacity adequacy in its 2015 Generation Adequacy Report was more optimistic than in 2014 (the year in which the capacity mechanism began operating). France explained that this improvement was due to the positive signal given by the launch of the mechanism (some power plants had abandoned their planned closures when the mechanism was launched).
- (227) Moreover, while the French authorities do not contest the fact that there is currently overcapacity in France, this does not rule out threats to security of supply in the coming years, particularly if many loss-making power plants were forced to close. RTE's studies confirm that the 'missing money' problem exists and point out that there is a real risk that power plants could close, a hypothesis that is also supported by recitals 43, 44 and 46.

5.3.1.2. The Commission's other objections:

- (228) As regards the proposal to charge different prices for using the network depending on the season, day of the week and/or time of day, France has confirmed that the TURPE is already hourly and seasonally adjusted.
- (229) France also provided a satisfactory explanation regarding the de-rating factors applied to renewables, as requested by the Commission in recital 153 of the Opening Decision. The de-rating factors appear rather optimistic about the contribution of renewables to security of supply, no longer giving rise to concerns regarding under-estimated available capacity. In any case, renewables will be able to choose the general scheme, based on monitored self-certification.

5.3.1.3. Conclusion on the objective of common interest and the necessity of the measure

- (230) For these reasons, the Commission takes the view that the mechanism, which addresses the objective of common interest of ensuring security of electricity supply, is indeed necessary in France. Furthermore, this does not contradict the objective set out in the EEAG to gradually phase out subsidies that are harmful to the environment, for example by facilitating demand management (232), increasing interconnection capacity (194), including the contribution of renewable energy in the mechanism (230) and giving preference to low-carbon generators (137).

5.3.2. Appropriateness of the aid

5.3.2.1. Discrimination between different types of demand-side response capacity

- (231) France does not dispute the difference in treatment between explicit and implicit demand-side response. On the contrary, France takes the view that these different conditions are needed precisely so as to enable both types of demand-side response to participate in the mechanism on equal terms. France had to strike a balance between activation and availability obligations for the two types of capacity, without restricting the possibility to participate in the mechanism.
- (232) The Commission is in agreement with France and takes the view that it is logical for the number of days covered by the implicit demand-side response obligation (PP1 days) to be lower than the number of days during which an explicit demand-side response operator must be available, as more is required of implicit demand-side response (activation as opposed to availability).

- (233) The Commission accepts that the number of PP2 hours should remain strictly defined, so as not to exclude explicit capacities from the mechanism or restrict their participation any more than is necessary.
- (234) As explained in recitals 111 to 115, RTE has carried out a detailed study to set the number of PP1 and PP2 hours, so as to base this calculation on the impact that demand-side response could have in terms of addressing shortfalls. It was found that 94 % of shortfall hours could be caught during the 100 hours per year when demand is highest (for this reason, the PP1 period represents the 100-150 hours when demand is highest) and that 99 % of shortfall hours are included in the 300 hours when demand is highest (which is why PP2 covers between 100 and 300 ⁽³²⁾ peak-demand hours).
- (235) Furthermore, the argument put forward by a number of third parties that explicit demand-side response capacities must be activated only during cold spells (meaning once every 10 years) is, in our view, not justified because all capacities will be activated at least once in each delivery year for the monitoring test.
- (236) For these reasons, the Commission takes the view that France has struck the right balance between the different obligations of demand-side response capacities without restricting their participation in the mechanism. The Commission takes note of France's proposal to evaluate the PP1/PP2 ratio in the future, and to revise it if necessary.
- (237) The measure is therefore sufficiently flexible and provides adequate and appropriate incentives for the different types of demand-side response capacity as required by paragraph 226 of the EEAG.

5.3.2.2. Exclusion of cross-border capacities

- (238) In order to dispel the Commission's doubts on this point, the French authorities have proposed a mechanism that allows explicit participation in the French mechanism by cross-border generation capacities and demand-side response capacities. This proposal is conditional upon cooperation agreements with the transmission system operators in the neighbouring countries where participating capacities are located. So as to avoid resorting to implicit participation of cross-border capacities in the absence of such an agreement, the French authorities have proposed that the relevant interconnections be certified to enable them to participate in the mechanism directly ⁽³³⁾.
- (239) The remedy proposed by France, as described in recitals 119 to 124 of this Decision, therefore complies with paragraph 226 of the EEAG. The Commission emphasises that the timetable for implementing this remedy, as set out in recital 125, must be considered a strict timetable and that France must inform the Commission about the various implementation stages of this remedy.

5.3.2.3. Lack of signals for new investments

Lack of long-term contracts

- (240) Following the doubts expressed on this point by the Commission in the Opening Decision, France proposed a mechanism allowing new capacities to participate in the capacity mechanism, as described in recitals 131 to 138 of this Decision. This mechanism consists of multiannual contracts for new competitive capacities.
- (241) The Commission had already concluded that longer-term contracts could be justified to attract new investment, particularly new entrants, in order to make it easier for them to secure financing ⁽³⁴⁾.
- (242) France explained that the aim of seven-year contracts for new investments was to guarantee around 50 % of new capacities' investment costs. This measure would therefore help lower the rate of return required by property developers and the finance providers for these investment projects and would make it easier to secure external

⁽³²⁾ Within the 100-300 hour interval, the French authorities chose the figure of 250 hours for the reasons given in recital 114.

⁽³³⁾ See footnote 24.

⁽³⁴⁾ Commission Decision C (2014) 5083 final of 23 July 2014, SA.35980 — GB capacity mechanism, recitals 129 and 139.

financing. It is also worth noting that this contract duration is shorter than the 20-year contract in place for the Landivisiau project in Brittany and the 15-year contract in the capacity mechanism in the United Kingdom. Although it is difficult to find a good and reliable benchmark for the length of capacity contracts, it should be noted that shorter contracts have the advantage of being more flexible for the market over the longer term and prevent the lock-in effect in relation to the choice of technology.

- (243) The Commission takes the view that France has struck the right balance between the advantages and disadvantages of the different possible contract durations and that the chosen duration offers satisfactory security for long-term investments, on the one hand, while preventing the risk of technology 'lock in' that could be brought about by longer contracts.

Difficulty for suppliers to predict far in advance how their customer portfolios will evolve

- (244) In the Opening Decision, the Commission expressed doubts as to whether suppliers, and particularly new entrants, would be able to accurately forecast, far in advance, how their customer portfolios would evolve and therefore give a reliable price signal to the market regarding the system's capacity needs.
- (245) These doubts, which were confirmed by a number of third parties, were dispelled on three levels. Firstly, France proposed to oblige RTE to help alternative suppliers better forecast the final level of their capacity obligations. Secondly, the mechanism allows for greater transparency and liquidity of the certificates market. Thirdly, the mechanism allows smaller suppliers to rebalance their certificate portfolios through an adjustment, both during the delivery year and *ex post*.
- (246) This remedy will help alternative suppliers to better predict their specific obligations in terms of capacity guarantees. By helping suppliers better estimate their capacity needs, this remedy will ensure a more accurate capacity price and, if required, will encourage investment in new capacities.

Potential lack of incentives for operators to be in balance before the delivery year (DY)

- (247) After the Commission expressed reservations about the potential shortcomings of the incentives for operators to be in balance before the delivery year (DY), the French authorities proposed that any significant cumulative rebalancing taking place before the delivery year would be subject to a penalty. Moreover, the authorities have proposed to double the 'k' incentive coefficient applied to imbalances, and to further increase the penalties for the settlement of imbalances (relating to an ongoing transaction) for imbalances exceeding the upper limit of 1 GW (see recitals 141 and 143). Furthermore, the previous rule stipulates that, as of the beginning of the DY, any rebalancing is subject to payment.
- (248) The remedies proposed by France have a common objective to encourage participants in the mechanism to be in balance before the DY begins, and in any event before imbalances are settled. This will encourage participants to carry out the vast majority of required transactions prior to the DY and will also make the MRP more representative (the MRP is used for the settlement of imbalances and for re-invoicing customers). As such, the price signal resulting from trading in capacity guarantees will, in our view, be more representative and reliable, and the mechanism will be more credible in terms of encouraging new investment if required.

The price cap on the settlement of imbalances does not reflect the CONE

- (249) In response to the Commission's criticism that the price cap on the settlement of imbalances does not reflect the CONE, the French authorities have undertaken to gradually increase the administered price (see recitals 146 and 147), so that, by DY 2021, it will match the cost of new entry (CONE).
- (250) This remedy corresponds to market needs and the Commission's request to bring the indirect cap on capacity prices (the administered price) into line with the cost of new entry. If required, new investments can therefore be made.

- (251) The authorities have also assured the Commission that the spread between the ARENH and the market price for electricity does not constitute an indirect cap on capacity prices (see recitals 149 to 151). More specifically, they explained that the volume of capacity guarantees linked to the ARENH product is sufficiently low in relation to the overall capacity market, and therefore cannot influence the price of the other capacity guarantees. Furthermore, the current spread is such that the ARENH is not a competitive product at the present time. The Commission noted, however, that the French authorities will examine, during a future assessment of the mechanism, whether it is appropriate to 'unbundle' the capacity part of the ARENH product, to ensure that this product does not distort the free setting of prices on the capacity market, if required.

Conclusion on signals for new investments

- (252) The various remedies proposed to provide better incentives for new investment are in line with paragraph 226 of the EEAG. In particular, France will implement measures to ensure the participation of cross-border capacities and to encourage new investments, which will open up the mechanism to many potential capacity operators.

5.3.2.4. The Commission's other objections

- (253) The French authorities clarified, to the Commission's satisfaction, the reasons for their adopting, where applicable, the various proposed improvements to the mechanism put forward by the Competition Authority.

5.3.2.5. Conclusion on the appropriateness of the measure

- (254) In the light of the above considerations, the measure is an appropriate means of meeting the identified objective of common interest.

5.3.3. Incentive effect

- (255) In recital 184 of the Opening Decision, the Commission had already concluded that the mechanism could have the required incentive effect. It stands by this conclusion.

5.3.4. Proportionality

5.3.4.1. Demand overestimation

- (256) In the Opening Decision, the Commission had identified a risk that suppliers might overestimate demand, particularly if suppliers' individual capacity obligations were not sufficiently clear.
- (257) It is clear from the Commission's observations in recitals 245 to 247 that the French authorities have put in place measures to help suppliers better calculate their capacity obligations.
- (258) This remedy effectively addresses the objections raised by the Commission in its Opening Decision.

5.3.4.2. Lack of transparency on capacity pricing

- (259) In the initial version of the capacity mechanism, the various participants had little overview of the over-the-counter transactions, as they relied on the CRE publishing, at regular intervals, data on the volume of capacity guarantee trading and the average transaction prices. Furthermore, in order to prevent abuses and a lack of transparency, the authorities had required vertically integrated operators to hold separate accounts in the capacity guarantee register (one account for capacity operators and one for suppliers).
- (260) In the light of the Commission's concerns regarding the lack of transparency of commercial agreements in the mechanism, France proposed remedies to improve the visibility of all trades and for all operators. Firstly, the French authorities proposed to grant all operators access to the register of (anonymised) over-the-counter transactions, thereby providing visibility on volumes and prices, while ensuring the anonymity of operators (see recital 163). Secondly, they proposed to bolster the organised auctions by increasing the number of auctions held in the four years preceding the first delivery year to 15 and by obliging certain capacity operators (CPMs > 3 GW) to offer their certificates on the market in accordance with a specific formula (see recitals 164 and 165).

- (261) The approach proposed by the French authorities gives suppliers a certain amount of flexibility by allowing over-the-counter trades and at the same time guaranteeing a certain level of transparency for these trades.
- (262) Free access to the (anonymised) register of transactions guarantees the transparency of the over-the-counter market and ensures that the incumbent operator — who will be the main seller — and its competitors have access to the same information. The proposed approach also enables market operators to take into account the prices achieved on the over-the-counter market when formulating their bids on the spot market and therefore ensures greater consistency between these two markets. In this regard, the proposed approach also reinforces control by the regulator, as any attempt by an operator to manipulate prices would be immediately obvious if the operator's behaviour on the organised market were radically different from its behaviour on the over-the-counter market.
- (263) Furthermore, bolstering the organised auctions should guarantee a sufficient level of liquidity for these auctions and consequently make the market reference price more representative (the capacity price used by the majority of suppliers for their sales and also as a reference value for the imbalance settlement mechanism).
- (264) This remedy therefore prevents the risk of capacity guarantees being withheld by the largest capacity operators for financial reasons, encourages market transparency, improves the liquidity of the organised market and facilitates market surveillance by the regulator.
- (265) The introduction of a 'double restriction' for the years DY-3, DY-2 and DY-1 addresses the risk of market manipulation by integrated market operators, who could artificially reduce their number of unsold certificates by internal transfers. By including a restriction on the level of certified capacity, the French authorities are ensuring that integrated market operators will be obliged to guarantee a certain amount of liquidity on the organised spot market, even if they carry out internal transfers.
- (266) Choosing to set the restriction on certified capacity at 25 % ensures that integrated market operators, and particularly the dominant operator, will offer all or some of their certificates on the organised spot market and will not be able to circumvent this requirement by carrying out internal transfers. This remedy is therefore akin to a market-making solution.
- (267) Applying an upper limit (in GW) to the requirement to offer a certain volume of capacity guarantees in the organised auctions will ensure that the largest market operators, and especially the incumbent operator, will take on the role of 'market maker' in the mechanism, thereby guaranteeing the liquidity of the auctions at all times.
- (268) By guaranteeing market liquidity, the French authorities have addressed the objection raised by the Commission in recital 200 of the Opening Decision.
- (269) More generally, the French authorities' remedies have addressed the Commission's concerns regarding the mechanism's lack of transparency on pricing, as set out in the Opening Decision.

5.3.4.3. Exclusion of certain types of capacity operator from the mechanism

- (270) In the Opening Decision, the Commission took the view that the risk of excluding certain operators from the mechanism, such as certain demand-side response capacities (due to possible discrimination against them), foreign capacities and new generation capacities, could lead to a risk that those operators able to participate in the mechanism would be over-compensated, given the lower level of competitive pressure.
- (271) As explained in Sections 5.3.2.1, 5.3.2.2 and 5.3.2.3 respectively, the French authorities have undertaken to implement appropriate measures so as to ensure that the operators mentioned above can participate in the mechanism. This will ensure competition inside the mechanism and should lead to a capacity price that does not overcompensate.
- (272) In order to comply with the EEAG, the proposed mechanisms relating to the participation of cross-border capacities and the multiannual contracts with new generation capacities must be proportionate.

- (273) The mechanism for including cross-border capacities is described in recitals 119 to 124 of this Decision. Once foreign capacities have obtained interconnector tickets, they will participate directly in the French capacity guarantee market. Since this market is deemed not to lead to overcompensation, the same will be true of the sale of guarantees by foreign capacities. Under the mechanism put in place to allow participation by foreign capacities, some remuneration may also flow to interconnectors from the sale of interconnector tickets. Since the participation in these auctions is likely to be very high (all demand-side response and electricity generation capacity in the interconnected neighbouring Member State can participate), particularly bearing in mind the number of tickets that can be expected to be auctioned, one can take the view that these auctions will not lead to any overcompensation. As a result, the mechanism is proportionate.
- (274) The mechanism proposed by the French authorities to allow new capacities to participate in the French capacity market is described in recitals 131 to 138 of this Decision. As regards the proportionality of the mechanism, the Commission believes that the mechanism excludes the possibility that new capacities will be overcompensated. Specifically, bids made by new capacities will in any case have to be lower than the initial reference price, which is itself an average price resulting from different competitive processes (it is proposed that the price be calculated as the weighted average of the capacity prices resulting from the auction held in DY-4 and from the ongoing DY-2 and DY-1 auctions). The fact that the new capacity providers will not know the initial reference price when making their bids should ensure that these bids are as low as possible in order to be competitive. Given that the participants will not know whether other bids for new capacities have already been submitted when they place their own bids, the volume restrictions on new capacities will therefore encourage bidders to offer the lowest possible price for their investments. For these reasons, the Commission takes the view that there should be no risk of overcompensation in relation to new investments. As a result, the mechanism is proportionate.

5.3.4.4. EDF's market power

- (275) As explained in recital 64, point (4), underlying the Commission's concern that EDF could easily manipulate capacity prices in its favour were three of the mechanism's more specific risks (some of which could apply to all the operators in the market):
- (1) risk of capacity withholding;
 - (2) risk of capacity guarantee withholding; and
 - (3) risk of a price squeeze.

Risk of capacity withholding

- (276) France has proposed three categories of changes to the mechanism to prevent the risk of capacity withholding as far as possible:
- (1) require capacity operators to certify their available capacity within a range delineated by the historic reference values;
 - (2) impose rebalancing obligations within a short time frame, as set out in the rules, when significant events occur (e.g. mothballing, decommissioning or damage leading to reduced availability for a long period) and charge for any cumulative rebalancing exceeding a certain limit (maximum 1 GW) before the delivery year; and
 - (3) modify the imbalance settlement mechanism: the 'k' incentive coefficient will be doubled and will be further increased for negative imbalances exceeding a maximum threshold of 1 GW/will be even less rewarding for positive imbalances also exceeding a maximum threshold of 1 GW. Furthermore, the administered price will be gradually increased, from EUR 20 000/MW in 2017 to EUR 40 000/MW in 2018 and 2019, reaching EUR 60 000/MW in 2020 and will eventually be updated annually to bring it in line with the CONE.
- (277) The first remedy ensures that capacity operators with a large capacity portfolio will not be in a position to manipulate the market within the certification range. Moreover, this remedy makes it easier for the regulatory authorities to identify any suspicious behaviour in relation to the existing framework.

- (278) The second remedy should bolster the incentives for market operators to provide the best estimate of the availability of their facilities within the certification range. As regards the measure requiring payment for significant rebalancing prior to the DY, the French authorities have proposed to make this measure asymmetrical and require payment for the rebalancing of certification levels only from market operators that have carried out a significant amount of rebalancing. The reasoning behind this is that applying this measure to all market operators could hinder competition as it would, in practice, be much more restrictive for operators with a low capacity volume compared with the dominant operator, which would be able to accumulate imbalances. The introduction of a payment threshold (still to be determined, but maximum 1 GW) will therefore make it possible to (i) maintain the flexibility of the current set-up for the majority of market operators; while at the same time (ii) making it impossible for market operators with a large capacity portfolio to manipulate the market by rebalancing lots of 'small' amounts.
- (279) The third remedy will bolster the incentives for all market operators to trade their certificates on the capacity market, contribute to the establishment of a market reference price that actually reflects the value of capacity, and prevent arbitrage between using the market and direct sourcing when settling imbalances.
- (280) The Commission takes the view that this set of remedies reduces the risk of capacity withholding as far as possible, although such a risk cannot be ruled out entirely. Naturally, supervision of the market by the French regulatory authorities complements the incentives built into the mechanism.

Risk of the withholding of guarantees

- (281) To prevent the risk of guarantees being withheld, the French authorities have undertaken to increase the number of auctions held before the delivery year and to require capacity operators to offer a minimum guarantee volume at each of the auctions held.
- (282) These remedies are in addition to the remedies already in place, such as the option for suppliers to obtain capacity guarantees by purchasing the ARENH product. In this regard, the authorities have proposed to examine, when assessing the functioning of the market in the future, whether it is appropriate to 'unbundle' the capacity part of the ARENH product to ensure that this product does not distort the free price formation on the capacity market. This remedy partially addresses the revisions to the ARENH suggested by certain interested parties, set out in recital 182 of this Decision.
- (283) This set of remedies proposed by the French authorities should help keep to a minimum the ability of large capacity operators, and especially the incumbent, to withhold capacity guarantees and the advantage for them of so doing. This would also ensure the liquidity of auctions.
- (284) The Commission therefore takes the view that these commitments constitute a set of remedies that are proportionate to the liquidity concerns raised by the Commission in the Opening Decision.

Risk of a price squeeze by the dominant incumbent operator

- (285) In recital 194 of the Opening Decision, the Commission had pointed out the risk that cross-subsidisation might occur between the incumbent operator's production and retail arms (i.e. the selling of capacity guarantees to competitors at a higher price than the price of internal transfers of the guarantees between its production and retail arms, thereby excluding its competitors from the electricity supply market).
- (286) In order to make it easier to detect and address these practices, the French authorities will remove a loophole in the existing rules that allows guarantees to be transferred free of charge. Following this change in the rules, suppliers will no longer be able to transfer capacity guarantees at zero cost from their production arm to their retail arm. The rules will lay down that internal transfers by an integrated operator must be carried out at a price

that is representative of the prices resulting from the organised market sessions. To that end, if the price resulting from the organised market session(s) is not known on the date of the internal transfer, integrated operators will be able to declare a price indexed to the price of the organised market sessions. For example, an integrated operator will be able to declare that an internal transfer is equal to the market reference price before its exact value has been officially set by the Energy Regulatory Commission.

- (287) Furthermore, market operators will have full access to the register of capacity guarantee transactions. The market will thus be able to monitor over-the-counter trades, as these (anonymous) transfers will be public. As explained in recital 263, this measure therefore guarantees the transparency of the over-the-counter market.
- (288) The French authorities have therefore addressed the Commission's objections regarding the risk of a price squeeze by the incumbent operator.

5.3.4.5. Conclusion on the proportionality of the measure

- (289) Taking into account the different remedies proposed by France, the Commission considers that the revised mechanism is proportionate to its objective.

5.3.5. *Avoidance of negative effects on competition and trade*

5.3.5.1. Barriers to the entry of new generation capacities

- (290) In order to address the difficulty for new generation capacities to participate in the mechanism, as identified by the Commission in its Opening Decision, the French authorities have undertaken to change the mechanism as follows:
- (1) by establishing a multiannual scheme for contracts for differences (CFD) specifically for new generation capacities, as described in recitals 131 to 138;
 - (2) as described in recitals 146 to 148, by gradually increasing the administered price over time, eventually bringing it into line with the CONE.
- (291) These remedies are sufficient to remove the barriers to entry for new capacities.

5.3.5.2. Discrimination between explicit and implicit demand-side response

- (292) As explained in recital 237, the Commission takes the view that France has struck the right balance between the different obligations of demand-side response capacities without restricting their participation in the mechanism. Although the participation of the two types of demand-side response is not the same, the Commission takes the view that this differentiation is required in order to allow both types of demand-side response capacity to participate in the best possible way.

5.3.5.3. Explicit participation by foreign capacities

- (293) As described in recitals 119 to 125, in response to the concerns of the Commission and third parties, the French authorities have proposed a hybrid model involving the allocation of interconnection tickets that would, in time, allow foreign generation capacities to participate.
- (294) As explained in recital 239, the French authorities have proposed a suitable remedy that allows the explicit participation of cross-border capacities in the mechanism. This objection from the Commission has therefore been addressed.

- (295) The solution chosen by France for the explicit participation of cross-border capacities also allows interconnectors to be remunerated if this asset is scarce. The chosen solution therefore addresses the risk that the coupling of the markets identified by the Commission in recital 206 of the Opening Decision might be jeopardised ⁽³⁵⁾.

5.3.5.4. Information asymmetry between the dominant incumbent operator and its current and potential competitors

- (296) As explained in recitals 245 to 247 and in Section 5.3.4.1, the Commission had identified a risk that alternative suppliers, and particularly new entrants, might find it difficult to estimate their individual capacity obligations. In the light of the Commission's observations in those recitals, the French authorities have put appropriate measures in place to help suppliers better calculate their capacity obligations.
- (297) Moreover, in the initial version of the capacity mechanism, the various participants had little information about the over-the-counter trades, which meant that they lacked a full overview of the capacity price. France proposed remedies to improve the visibility of all trades for all operators, as described in Section 5.3.4.2. These measures include granting all operators access to the register of over-the-counter trades (anonymised) and bolstering the organised auctions.
- (298) This set of remedies ensures that operators other than the incumbent will have a better overview of their capacity obligations, on the one hand, and trading volume and prices, on the other. These measures greatly improve the transparency of the mechanism and therefore redress the information asymmetry in favour of the incumbent operator, which will be the biggest operator in the mechanism on both the capacity operator side and the supplier side.

5.3.5.5. Preference given to low-carbon generators

- (299) The Commission notes that, for new capacities, the French authorities are planning to introduce environmental criteria that will lead to preference being given to low-carbon generators (see recital 137).
- (300) These provisions comply with the EEAG ⁽³⁶⁾, which stress the need for such measures to give preference to low-carbon generators with equivalent technical and economic parameters.

5.3.5.6. Conclusion on potential distortions of competition and intra-EU trade

- (301) For the reasons given above, the Commission concludes that there is no longer a risk that the mechanism will unduly distort competition and/or intra-EU trade.

5.3.5.7. Time frame

- (302) Given that the French mechanism is the first decentralised capacity mechanism approved by the Commission under the EEAG and given that the necessity of the mechanism is highly dependent on the evolution of the energy market, a market that is still developing in a context of market liberalisation, the Commission takes the view that the mechanism must be time limited. The Commission considers that a duration of 10 years is reasonable and consistent with previous decisions ⁽³⁷⁾.

6. CONCLUSION

- (303) The Commission finds that France has unlawfully implemented a capacity market in France in infringement of Article 108(3) TFEU. However, in view of the different remedies proposed by France described above, the measure complies with the EEAG,

⁽³⁵⁾ As regards the mechanism's compliance with European Union rules, see paragraph 97 of the EEAG.

⁽³⁶⁾ See paragraph 233 of the EEAG.

⁽³⁷⁾ See, for example, Commission Decision C (2014) 5083 final of 23 July 2014, SA.35980 — GB capacity mechanism, recital 162.

HAS ADOPTED THIS DECISION:

Article 1

The capacity market implemented by the French Republic constitutes State aid that is compatible with the internal market under Article 107(3)(c) TFEU.

Article 2

The Commission authorises the aid scheme implemented through the capacity market for a maximum period of 10 years. Any scheme maintained at the end of this period must be re-notified.

Article 3

This Decision is addressed to the French Republic.

Done at Brussels, 8 November 2016.

For the Commission
Margrethe VESTAGER
Member of the Commission

