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### State Subsidies and Public Policy by C. Söderlund

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## **State Subsidies and Public Policy**

**The Swedish court rejects complainant's argument that a profit guarantee undertaken by the state in a share purchase agreement constitutes a state subsidy<sup>1</sup>**

*By Christer Söderlund, Partner, Advokatfirman Vinge*

### ***Background***

In 1995, Latvia decided to privatize Latvijas Gaze, a gas distribution company. For this purpose, Latvia's Privatization Agency – entrusted with this task – went out with a bid invitation, followed by a selection of prospective bidders. Of seven prospective bidders, two were invited to submit final bids, on the basis of which one of the bidders – a German consortium – was selected.

As a result of the privatization process, the German consortium acquired a majority shareholding in Latvijas Gaze. A share purchase agreement was entered into in 1997, in which also the target company, Latvijas Gaze, was a contracting party. The following provision of the share purchase agreement gave rise to the arbitration:

“End consumer prices (including tariffs) will cover all costs and a reasonable profit and the Company shall not be obligated to supply gas to new consumers, who do not cover the costs and reasonable profit. With the exception of the domestic end-consumer prices (including tariffs) the Republic of Latvia till not regulate gas prices (including tariffs).”

Latvijas Gaze considered that the regulated prices did not “cover all costs and a reasonable profit” and, invoking the above-cited contract provision, asked for damages. Latvia objected, *inter alia*, that the Privatization Agency, which had sold the shares on behalf of Latvia, could not regulate prices and that, in any event, the regulated prices had been set at levels which assured Latvijas Gaze of cost coverage and a reasonable profit.

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<sup>1</sup> Judgment of 4 May 2005 of the Svea Court of Appeal, Stockholm (Case No T 6730-03)

The Tribunal concluded that the regulation of prices had, in fact, deprived Latvijas Gaze of “reasonable profit” and awarded (reduced) damages.

### ***The setting-aside action***

Latvia applied to the competent Swedish court to have the arbitral award set aside.<sup>2</sup> Its main argument was that the “profit guarantee” constituted illegal state aid under Latvian as well as EU law. For this reason the “profit guarantee” violated fundamental principles of Swedish law<sup>3</sup>, so the argument went, and the Award should, therefore, be declared null and void. One may assume that Latvia was encouraged to advance this theory on the basis of the *Eco Swiss* case<sup>4</sup>, where the ECJ had considered a breach of competition rules rise to the level of public policy.

Latvia also argued that the Tribunal had failed to apply Latvian law – as was provided in the SPA – and that the Award, also for this reason, violated public policy.

In the event, the Swedish court did not have to consider whether the “profit guarantee” of the share transfer agreement constituted an illicit state subsidy, and, the more interesting question, whether such illicit undertaking would rise to the level of a violation of public policy.

After having rejected Latvia’s first-line defense that the “profit guarantee” did not constitute a financial undertaking, the Swedish court went on to make the following important observation:

[A] prerequisite which must be fulfilled in order for financial aid to be deemed to constitute state aid is that the recipient of the aid obtains a financial advantage, which the recipient would not otherwise have been awarded under normal commercial terms and conditions, i.e. the recipient is favoured. Pursuant to [Latvija Gaze’s] objection, in accordance with that which applies pursuant to EC law, the purport of this criterion may be deemed to be that no state aid shall be deemed to exist where the state’s undertaking is given in exchange for some commercially motivated counter-performance and the recipient therefore does not receive any advantage (see the European Court of Justice’s judgment dated 24 July 2003 in case C-280/00, *Altmark Trans GmbH and Regierungspräsidium Magdeburg v. Nahverkehrsgesellschaft Altmark GmbH*, paragraph 84 et seq.).

As appears from the evidence in this case, the Republic’s undertaking in the Agreement constituted a condition laid down in a share transfer agreement. The purchase price amounted to approximately SEK 200 million [appr. EUR 22 million, noted here]. It has not been suggested that the tender procedure took place otherwise than in competition between several bidders. In

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<sup>2</sup> Latvia had not contended in the arbitral proceedings that the relevant contract provision was null and void (however, to the extent that an issue is inarbitrable or against public policy, this would not be a requirement for an annulment of the award).

<sup>3</sup> Section 33, first para., (1) of the Swedish Arbitration Act

<sup>4</sup> ECJ Judgment of 1 June 1999. – *Eco Swiss China Time Ltd v Benetton International NV*. – Case C-126/97.

light of the aforesaid, and since [Latvija Gaze] was also a party to the Agreement, the Republic's undertaking – as it has been interpreted by the arbitral tribunal – must be deemed to be a part of a commercial arrangement between, among others, the Republic and [Latvija Gaze]. Accordingly, the evidence in this case does not provide support for the conclusion that the compensation, which the Republic has been ordered to pay to [Latvija Gaze] in the arbitral award, shall be deemed to constitute financial aid in the sense ascribed to that term in section 5 of the [Latvian] Act on State Aid. Accordingly, the evidence adduced in the Court of Appeal thus leads to the conclusion that neither the undertaking which the arbitral tribunal construed from the first sentence of Article 9.3 of the Agreement nor the damages awarded constitute illegal state aid pursuant to the provisions of the [Latvian] Act on State Aid. In light of the aforesaid, there is no reason to determine whether the Republic's undertaking pursuant to the arbitral award may be deemed to constitute state aid under the provisions of the EC Treaty.

### *Comments*

It must be admitted that the plaintiff's approach was of rather an innovative nature. The idea that the disputed clause was counter to public policy had not been raised in the arbitral proceedings. There is no doubt that the Swedish Court's observations were well reasoned, and its decision to uphold the Award correct.

### *Fundamental principles of public policy*

The case might possibly have offered considerably more interest, if it had been held that the “profit guarantee”, in fact, constituted an illegal state subsidy in view of the outcome of the Eco Swiss case. If a violation of the mandatory competition rules of the European Union is held to constitute a violation of public policy – which the ECJ found that it had – would then also an illicit state subsidy suffer the same fate?<sup>5</sup>

I do not think so. The matter of state aid is more complicated than so. In the ECO Swiss case – and where competition rules are implicated generally – there are two or more private entities which engage in the illicit conduct. In the case of state aid, it is the state itself, which has undertaken the act which it now (itself!) invokes as an abomination, sufficient to taint the entire Award. This issue was not, as far as

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<sup>5</sup> In my view there is no doubt that the conclusions of the ECJ in the Eco Swiss case went too far; while anti-competitive practices certainly are reprehensive, they are a long shot from amounting to breach of the “most basic notions of morality and justice” ( *Parson & Whittermore Overseas Co. v. Société Générale de l'Industrie du Papier*, 508 F. 2d 969 (2d Cir.1974)), Sensibly, Swiss jurisprudence has taken a different cue on this question (see the Swiss Federal Court decision of 8 March 2005, 132 III 289. It should also be noted that the condemnation of anti-competitive practices is by no way absolute under EC law; in fact, there is a number of so-called block exemptions, where competitive practices, indeed, have the blessing of EU and such practices may also be tolerated in specific instances by the EU Commission. There is also in my view another troubling aspect of this case. If the violation amounted to a breach of public policy, how could a time limit for lodging an appeal defeat a challenge? Maybe this is to say a peculiarity of Dutch procedural law, but an award violating international public policy should necessarily be void *ab initio* and impervious to any procedural deadline.

can be seen, raised in the setting aside action, but it would seem that this would be counter to some emanation of the principle *ex turpi causa non oritur actio*.

It would also cause a quite problematic situation and seemingly encroach on principles of *comity*, if a court in a third country should – by invalidating an arbitral award – give expression to the view that dispositions undertaken by a state party to arbitration would constitute illegality.

#### *Failure to apply Latvian law*

Latvia also contended that the Tribunal, by failing to apply Latvian law, disregarded a legal provision “which is mandatory in consideration of third parties or a public interest which embodies a particularly important legal norm”. The Swedish court summarily disposed of this contention by noting that the mere fact that the Tribunal did not explicitly refer to Latvian law did not allow the conclusion that it had failed to apply Latvian law.<sup>6</sup>

#### ***Conclusion***

So, as stated, there is no reason to question the approach taken by the court in evaluating the nature of the disputed contract provision. One can possibly question the propriety of issuing a “profit guarantee” in view of the state’s likely interest to rein in the important question of pricing of critical services within its own jurisdiction – and not expose such a policy matter to international arbitration – in a monopolistic market, but that is a matter well outside the scope of this specific case.

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<sup>6</sup> This may be compared to the same court’s rejection of the Czech Republic’s objection on the same basis in the well-known *CME v. Czech Republic* case (Case No T8735-01), where the court opined that “it must rather be the question of intentional disregard of the agreed law” to constitute an excess of mandate