EUROPEAN COMMISSION

Brussels, 16.12.2003
C(2003)4488fin

Subject: **State aid N 475/2003 - Ireland**
Public Service Obligation in respect of new electricity generation capacity for security of supply

Sir,

1. PROCEDURE

1. By letter dated 10 October 2003 and registered by the Commission on 15 October 2003, the Irish authorities notified to the Commission the scheme related to Public Service Obligation in respect of new electricity generation capacity for security of supply (hereafter "the scheme").

2. DETAILED DESCRIPTION OF THE SCHEME

2. The purpose of the scheme is to ensure the security of electricity supply in Ireland in the framework of the continuous electricity demand growth in the country.

3. Ireland has partially liberalised its electricity market in February 2000, in accordance with Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity[1]. The market will be totally liberalised in 2005.

4. The last Generation Adequacy Report prepared by the Irish Transmission System Operator ("TSO"), is a source of information of the forecasted minimum generation capacity required to achieve an adequate supply and demand balance for electricity for the period 2003 to 2009.

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[1] OJ L 027, 30.1.1997, p. 20.

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5. In the aforementioned Report, TSO demonstrated that the Irish market would be faced with an important capacity shortfall from 2005 onwards. TSO pointed that a need for capacity will require 300 MW of additional plant installed by 2005, followed by 250 MW in 2007 and 150 MW in 2009. The estimated shortfall as of 2007 -550 MW-, is equivalent to about 10% of the currently installed capacity in the Republic of Ireland.

6. In response to the long-term capacity deficit and after consultations with industry, the Commission for Energy Regulation ("the CER") decided to launch a process aimed at facilitating the entry of 531 MW of new capacity to the national market at the earliest possible date.

7. In this effect, it was decided that up to ten years long Capacity and Differences Agreements (CADA) would be granted to generators that would undertake the construction of this new generation capacity.

8. The mechanism of the proposed CADA reflects the new, fully liberalised electricity market structure, in which all the electricity is sold and bought from the centralised “mandatory”, so-called Pool Market, which provides a ready power market for all buyers and sellers with a transparent spot market price based on supply and demand.

9. The CADA provide that :

   – Generators receive so-called capacity payments based on their capacity availability. These payments are period weighted to ensure an appropriate signal is provided regarding the value of being available at different times of the day/week/month.

   – Where the Pool price is superior to a price defined by the CADA as the "Strike price", then the generators must reimburse the difference between what they earned by selling the electricity to the Pool at Pool price and what they would have earned should the Pool price have been equal to the Strike price. The Strike Price is based on the short run marginal cost of a new combined cycle gas turbine (CCGT), i.e. the most efficient new plant.

   – Generators are entitled to the CADA for at most ten years. However, they may exit the contract at any time they wish.

10. It must be noted that the CADA do not imply that generators have to sell their electricity to a specific supplier. On the opposite, all electricity generated by CADA entitled generators is sold to and bought from the pool exactly like any other electricity. The CADA is a purely financial instrument, and in no way a product delivery contract.

11. In practise, the CADA financial instruments will be at present handled by the public electricity supply branch of the Electricity Supply Board ("ESB-PES"). ESB-PES was chosen as a last resort, as no supplier had expressed interest in handling these agreements. The CER however retains the power to transfer this handling charge to any other operator in the future.

12. ESB-PES handling the CADA means that it will be signing them with the CADA entitled generators, and that, as a party to these agreements, it will be paying the capacity payments and receiving the reimbursements from the generators, if any.

13. As noted above, this does not entitle ESB-PES to any specific right on the electricity generated by the CADA entitled generators.

14. ESB-PES will be compensated for the difference between the capacity payments and the reimbursements. The funds needed for this compensation will be raised via a levy that will be imposed on electricity consumers, and which will be based on their subscribed connection power, just as the levies put in place in relation to peat and renewable electricity generation that were previously notified to the Commission and approved by it[2]. The amount of the compensations to be paid as well as the proceeds of the levy will be approved and monitored by the CER.

15. ESB-PES does not get any compensation from the State else that the strict compensation of its losses, as described above. In particular, it does not receive any profit margin associated to this activity.

16. The CER organised a competition process in order to select the operators of the new CADA supported plants. The competition is basically a bidding process, whereby the CADA support is allowed to the bidders that offer the best (in this case, cheapest) conditions for capacity payments. ESB was excluded from the competition, in particular in order to facilitate new entries in the Irish market.

17. The competition attracted much interest, with as much as seven potential bidders. The winner(s) should be announced on December 2003, in order to aim for the entry into service of the first plants in 2006.

3. ASSESSMENT

18. The Commission has analysed the existence of State aid within the meaning of Article 87(1) of the EC Treaty both at the electricity generators' level and ESB-PES' level.

3.1. Concerning the existence of State aid to the electricity generators

19. The Commission notes that in its Judgement of 24 July 2003, in case C-280/00[3] (hereafter "the Altmark Judgement"), the Court held that:

> " (…) w*here a State measure must be regarded as compensation for the services provided by the recipient undertakings in order to discharge public service obligations, so that those undertakings do not enjoy a real financial advantage and the measure thus does not have the effect of putting them in a more favourable competitive position than the undertakings competing with them, such a measure is not caught by Article 92(1) of the Treaty*".

[2] Commission decisions on State aid Cases N 6/A/2001 – Ireland – Public Service obligations imposed on the Electricity Supply Board with respect to the generation of electricity out of peat (*OJ C 77, 28.3.2002, p. 26*); N 553/01 – Ireland – Aid to promote renewable energy resources in Ireland (*OJ C 45, 19.2.2002, p. 2*); and N 826/01 – Ireland – Alternative Energy Requirements I to IV (*OJ C 59, 6.3.2002, p. 25*).

[3] Judgement of the Court of 24.07.2003 in case C-280/00, *Altmark trans Gmbh, Regierungsprasidium Magdeburg and Nahverkehrsgesellschaft Altmark Gmbh*

20. The Court lies down four cumulative conditions that must be satisfied for a compensation to escape qualification as State aid within the meaning of Article 87(1) of the EC Treaty. The Commission has analysed the effect of the scheme on generators in light of each of each of these four conditions.

21. **First condition:** "*the recipient undertaking is actually required to discharge public service obligations and those obligations have been clearly defined*".

22. The Commission considers that the measures undertaken by the Irish authorities in order to ensure an adequate security of supply must be understood as an imposing on generators an obligation of general economic interest which consist in bringing to the Irish electricity grid new electricity reserve generation capacity in order to be sure to be able to meet the electricity demand in the future at any time of the year, including in peak periods.

23. In this respect, the Commission takes note of the following:

24. Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC[4] makes clear and explicit reference to the fact that Member States may impose services of general economic interest in relation to security of electricity supply.

25. Its preamble states that (Recital 23) "*in the interest of security of supply, the supply/demand balance in individual Member States should be monitored (…). Such monitoring should be carried out sufficiently early to enable appropriate measures to be taken if security of supply is compromised*". It notes further on that (Recital 26) "*The respect of the public service requirements is a fundamental requirement of this Directive (…)*".

26. Furthermore, paragraph 2 of its Article 3 states that "*Member States may impose on undertakings operating in the electricity sector, in the general economic interest, public service obligations which may relate to security, including security of supply (…)*".

27. Besides, the Commission has recently expressed concerns as regards security of supply within the European Union in view of the recent crisis, particularly in Italy[5]. In this context, the Commission emphasised the necessity of new capacity in the future and presented some new ideas comprising among others the proposal of a new directive on security of supply in the electricity market.

28. To end with, the Commission notes that electricity is a product that is vital for the economy and even for the everyday life of European citizens. Electricity breakdowns have huge, sometimes life threatening, impact. Ensuring that no such breakdown occurs even in peak demand periods and under all weather conditions is therefore clearly necessary for the public interest.

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4 OJ L 176, 15.07.2003, p. 37.

5 *La coupure d'électricité en Italie*, Note d'information de Mme de Palacio. SEC(2003) 1079.

29. In view of the above, the Commission considers that ensuring security of supply can be considered as a legitimate objective of general economic interest..

30. However, this legitimate objective can be achieved by different means, whose impact on competition and trade between Member States may be very different.

31. The first priority should normally be to ensure that policies are in place to control growth in demand. Such an approach is cheaper, works faster and is in line with the commitments of the European Union relating to emissions of greenhouse gases. It is only one these avenues have been exploited that Member States should look to measures on the supply side.

32. In many cases, security of supply can be guaranteed by simply developing new interconnection infrastructure between Member States or by increasing the capacity of the existing interconnections. This solution would generally be more rational since it allows the correct functioning of the internal market, reduces market distortions and gives to the Member States the possibility to share reserve capacity. For the same reason this approach would generally reduce the need of reserve capacity at the level of each individual Member State.

33. Interconnections between Member States are a particular priority in order to allow for a higher level of competition between existing companies. Without additional interconnectors the principles of market opening may become meaningless as companies consolidate their position in particular regions of the European Union and the market becomes segmented. This was recognised in the conclusions of the Barcelona summit in March 2002 where, in response to the Commission's Communication on European Energy Infrastructure, COM (2001)775, Heads of State and Governments endorsed the idea of a target for electricity interconnection equivalent to 10% of installed generation capacity. Investment in transmission networks is also needed to ensure that the network can cope with additional demand without European citizens and businesses falling victim to frequent interruptions in supply or blackouts.

34. However, the Commission recognizes that the specific geographical situation of some Member States would not allow to meet security of supply shortfalls via the increase of interconnectors in an economically rational way.

35. In such cases, it is the Commission's view that meeting security of supply via the setting up of sufficient reserve capacity generation can be considered in itself as a service of general economic interest, to the extent that:

- A clear distinction is made between "normal" capacity and "reserve" capacity generation. The former being the capacity that the market would spontaneously provide to cover expected demand (or expected increases of demand) under normal market and regulatory conditions. Indeed, in a liberalised market, as with other products, private investors are expected to ensure that sufficient capacity is available to meet demand. In general terms, the price mechanism is the way that this is expected to be achieved in the competitive market. As prices rise investment will become viable and either more capacity will come on stream, or demand will be constrained. A transparent and reliable price mechanism for wholesale electricity is sufficient in this

respect. The provision of (or the increase of) normal capacity generation cannot be considered a Service of General Economic Interest.

- The "reserve" capacity is the additional capacity that would not be spontaneously provided by normal market forces but is considered necessary in order to meet peaks of demand. One may indeed wonder whether investors are prepared to invest in peaking capacity to cover the very highest periods of demand or incidents where a large proportion of other generation is not available. It is arguable that such investment might not occur because such events are infrequent and their occurrence is unpredictable. Accordingly there may be a case for governments to provide further measures, in addition to market mechanisms, to ensure adequate capacity is available. This may be achieved through a combination of setting targets for the level of reserve capacity or equivalent measures, for instance on the demand side, and by taking measures to ensure these targets are met, either through incentives or obligations on electricity undertakings. In cases where part of the foreseen reserve capacity shortfall only would not be met by market forces alone, only the part that would not be met should be the object of a service of general economic interest.
- The need for new reserve capacity is clearly and quantitatively demonstrated;
- It does not exceed reasonable standards of capacity reserve;
- Provisions have been made to manage demand and to enable the use of existing interconnectors to mitigate part of the capacity shortfall if possible;

36. In the present case, the Commission takes note of the following points:

37. Firstly, in view of its particular geographical position, Ireland cannot only rely on interconnectors to mitigate capacity shortfalls in medium term. Indeed, the only economically possible prospect for interconnection between Ireland and the rest of the Union in medium term is interconnection with the United Kingdom via Northern Ireland. Now Northern Ireland is itself not in overcapacity, and is relying on its interconnector with Scotland.

38. Secondly, the Irish authorities have distinguished between "normal" capacity and "reserve" capacity generation and have brought sufficient evidence that there is indeed a need for urgent reserve capacity increase in the Irish network in order to ensure security of supply. The Irish authorities also brought convincing evidence of their efforts to manage demand and as to the quantification of the electricity supply shortfall, which leads to the necessity to build new plants.

39. The urgent need for the 531 MW capacity to be supported is clearly and objectively establish by the TSO General Adequacy Report 2003-2009. This report uses in particular internationally recognised methods to quantify the need for capacity reserve, based on lost of load expectation. These methods aim at ensuring that the average total disconnection for a customer does not exceed certain duration per year. Ireland uses a standard value of 8 hours per year for lost of load expectation.

40. Section 5 of the Report outlines the capacity shortfall under various scenarios. The base scenarios are driven by three different demand growth scenarios, making a total of 9 possibilities. It is apparent from all scenarios that capacity shortfall will indeed occur if no action is taken. In its conclusion, the TSO states that the system could be brought within standard with an extra 300 MW in 2004, followed by 250 MW in 2007 and 150 MW in

2009. However, under the worst scenario of high growth and low availability, the plant requirement would be even larger.

41. The 531 MW to be built under the scheme by 2007 are therefore the minimum amount necessary to ensure security of supply.

42. Thirdly, a 531 MW capacity represents about 10% of the forecasted average peak demand in Ireland. This margin seems reasonable in view of the characteristics of the Irish market.

43. Fourthly, the tender organized by the Irish authorities for the selection of the new capacity operators allows competitors the plants of which are based outside Ireland to compete, to the extent that they can prove that they are or will be physically in a position to actually provide electricity to Ireland via interconnectors. The Commission notes that one of the bidders is actually planning to build its plant in Northern Ireland in the United Kingdom and to use the interconnector with the Ireland for this purpose.

44. Fifthly, the very structure of the CADA that will be awarded to the generators that will be selected to build the capacity provides that these generators will have to reimburse the difference between what they earned by selling the electricity to the Pool at Pool price and what they would have earned should the Pool price have been equal to the Strike price. As the Strike price is based on the Best New Entrant price, that is, the generators' own generation cost, this means that these generators will have to reimburse all benefits that they would have received from the market should the CADA not exist. In particular, in the situation where these benefits would be sufficient to repay their investment costs, that is, in the situation where market forces would have been sufficient to trigger the entry of the generation capacity without any State intervention, the CADA structure will result in generators repaying all the state support and therefore receiving none. More generally, the CADA structure will result in generators receiving only exactly the support that is necessary to go beyond what market forces alone would have achieved.

45. In view of the above, the Commission concludes that the first condition of the Altmark Judgement is fulfilled.

46. **Second condition:** "*the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner*".

47. The competitive process organised by the CER was carried out in an objective and transparent manner. The details defining all indispensable parameters were established *ex ante* in the tender documents which were provided to potential bidders. The parameters were described by the CER well before they are signed, and in any event many years before the plants start to operate and any payment to the generators is given.

48. In view of the above, the Commission considers that the second condition of the Altmark Judgement is fulfilled.

49. **Third condition:** "*the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations*".

50. The Commission notes that the Irish electricity market will be fully liberalised in 2005. At the time the new capacity concerned by the scheme is available (2006 at best), there will be no more captive customer in the Irish market. It will therefore be difficult in principle for generators to recover any type of overcost linked to out of the market capacity reserve from captive users.

51. On these premises, the Commission considers that the absence of overcompensation of the costs incurred in discharging the obligation of service of general economic interest results from the very structure of the Irish pool market, the CADA and the competition held to attribute them.

52. Indeed, the CADA parameters provide for the reimbursement by the generators of proceeds resulting from selling electricity to the Pool at a price above the Strike price. As this Strike price is based on the Short Run Marginal Cost (SRMC) of best new entrants, that is, the SRMC of the wining generators themselves, the selected generators will not generate profit out of the sale of their electricity.

53. They will therefore aim at recovering their investment costs -plus a reasonable profit- via the capacity payments.

54. As the competition is open, transparent, and has attracted many bidders, the Commission considers that the bidders will minimise the capacity payments they request, that is, require no more than the repayment of their investment plus the standard profit margin which is expected in this sector of the industry.

55. In view of the above, the Commission considers that the third condition of the Altmark Judgement is fulfilled.

56. **Fourth condition**: "*where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations"*.

57. The Commission notes that the CADA will be awarded in result of a transparent, competitive process, which will ensure that the lowest possible price is delivered.

    In the present context the Commission has to verify whether the characteristics of the procurement procedure at stake are such as to actually "allow for the selection of the tenderer capable of providing those services at the least cost to the community". This is a material analysis which is different and goes beyond the mere respect of the applicable public procurement rules.

58. The Commission notes first of all that the process was launched by the Irish independent energy sector regulator.

59. In particular, the Commission notes that the tender leaves no discretional margin to the public authorities as to the choice of the winners.

60. A notice was published in advance in the Official Journal of European Communities. Subsequently the invitation to tender was published at the national level, in the Internet page of the regulator and was made available at all the operators that had previously expressed and interest on the basis of the notice published on the OJCE, which ensures that every potential bidder could present its candidature.

61. The tender has two phases. The first phase consists in a selection of technically suitable offers based on transparent and objective criteria defined beforehand, such as the capability of the candidate to be linked to the Irish network, either directly in Ireland, or, if abroad, in a way that ensures that the capacity will be available to Ireland.

62. The second phase, comprising six candidates, consists in evaluating the price offered by the candidates. Price computation is based on an objective, transparent and defined beforehand method. The CER selects the candidates that have offered the lowest price until it reaches the requested capacity amount. It has no margin of negotiation, and cannot select candidates in a discretionary way.

63. As a matter of fact, seven applications were submitted at the first stage. One of the candidates, being no more interested in tender conditions withdrew its candidature. It is also worth noting that competition also attracted bids from generators outside Ireland.

64. In view of the above, the Commission considers that the fourth condition of the Altmark Judgement is fulfilled.

65. As all four conditions of the Altmark Judgement are met, the scheme involves no State aid within the meaning of Article 87(1) of the EC Treaty to the generators.

3.2. Concerning the existence of State aid to ESB-PES

66. For a State support to be qualified as State aid within the meaning of Article 87(1) of the EC Treaty, it must meet four cumulative criteria: it must be selective, it must give a competitive advantage to its beneficiary, it must have an actual or potential effect on trade between Member States, and it must involve State resources.

67. The Commission notes that ESB-PES is only a financial intermediate in the scheme. It gives and receives a certain amount of money to the generators, and is compensated, where necessary, via the levy. In this respect, it does not provide any specific electricity supply service, and should be viewed in this framework as a vehicle of the sums transferred by the scheme rather than an electricity system operator.

68. The Commission has examined whether this activity of ESB-PES as a financial intermediate could economically result in providing an advantage to ESB-PES with regards to its competitors.

69. In this respect, the Commission first notes that the CADA give no right whatsoever to ESB-PES as to the electricity generated by the CADA entitled generators. This electricity will be sold by the generators to the pool, and bought by any supplier from the pool, at pool price, with no priority being granted to ESB-PES.

70. Should ESB-PES indeed buy this electricity, it will have to pay the pool price for it. Economically, this electricity would cost ESB-PES a total price equal to the pool price plus the capacity payments minus the difference payments reimbursed by the generators to ESB-PES, if any.

71. Consequently, the one and only the hypothesis when ESB-PES could eventually increase its profits via the scheme takes place in the situation where the difference payments would exceed the capacity payments.

72. However, under such a scenario, the CADA would result in a financial loss for the generators. They would therefore choose step out of the CADA, as the CADA give them right to.

73. There is therefore no economically plausible scenario under which ESB-PES could receive any financial advantage through the scheme.

74. This conclusion is reinforced by the fact that ESP-PES had to be designated by the CER as a last resort choice to handle the CADA.

75. Indeed, although the CER publicly advertised for the need for suppliers handling the CADA, no supplier (including ESB-PES itself) volunteered to manage them, which shows that none of these saw any prospect of economic advantage in handling them.

76. In relation to the aforementioned, the Commission considers that ESB-PES derives no competitive advantage from the scheme. It should be viewed as a vehicle of the funds indispensable to introduce the new capacity on the national market.

77. The existence of a competitive advantage constituting one of the four cumulative criteria necessary to consider that there is State aid, the Commission therefore concludes that the proposed scheme includes no State aid to ESB in the meaning of Article 87(1) of the EC Treaty.

4. CONCLUSION

The Commission has accordingly decided not to raise any objections to the scheme since it constitutes no State aid within the meaning of Article 87(1) of the EC Treaty.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://europa.eu.int/comm/secretariat_general/sgb/state_aids

Your request should be sent by registered letter or fax to:

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Yours faithfully,

For the Commission

M. MONTI
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