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Brussels,
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PERMANENT REPRESENTATION OF
IRELAND TO THE EUROPEAN UNION
Rue Froissart, 89-93

1040 BRUXELLES

Subject: State Aid n° N 143/2004 - Ireland

The Secretariat-General would be obliged if you would forward to the Minister for Foreign Affairs, the enclosed letter from the Commission on the subject specified above.

For the Secretary-General,

Karl Von Kempis
Irish PRB
RECEPTION
Karl VON KEMPIS

RECEIVED

Encl. : C(2004) 2632 fin



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Karl VON KEMPIS

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EUROPEAN COMMISSION

Brussels, 14-07-2004
C (2004)2632 fin

**Subject: State aid N 143/2004 – Ireland
Public Service Obligation – Electricity Supply Board (ESB)**

Sir,

1. PROCEDURE

By letter of 18 March 2004, registered on 23 March 2004, the Irish authorities notified the Public Service Obligation imposed on Electricity Supply Board (ESB)¹. By letter of 19 April 2004 the Commission requested additional information which was submitted by the Irish authorities by the letter of 17 May 2004, registered the same day.

2. DESCRIPTION

2.1 Objectives

The purpose of the scheme is to procure the temporary stand-by peaking capacity to meet short-term generation requirements, i.e. to ensure the security of electricity in Ireland. The short-term measures to increase the **reserve capacity** to meet the peak demand are undertaken in the general economic interest.

The security of supply remains one of the central objectives of the Irish national energy policy. The demand for electricity is forecast to grow at an annual rate between 2.9% and 4.3% over the period 2004-2010. The required margin between the energy demanded and the

¹ The Irish authorities notified the Public Service Obligation as 'the request for a Decision of the Commission under Article 4 (2) of Council Regulation (EC) No. 659/1999. The Commission taking into account its procedural rules assessed the request as the regular State aid notification.

Mr Brian COWEN, TD
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energy supplied at peak times does not meet the standard required by the system operator due to higher than expected level of forced outages of plants².

The shortage of the reserve capacity is primarily addressed through the construction of two permanent facilities in the framework of the 'PSO in respect of new electricity generation capacity for security of supply' (State aid No N 475/2003³). Since the expected operation dates of the two permanent facilities are November 2005 and January 2006, the Irish authorities had to find a temporary solution for the provision of the reserve capacity. **This temporary solution in the form of the PSO imposed on ESB is the subject of the current notification.**

2.2 Legal basis

The PSO will be defined in the amendment to the principal PSO Order – Electricity Regulation Act 1999 (Public Service Obligations) Order 2002⁴. The statutory order amending the principal PSO Order is issued by the Minister under the Electricity Regulation Act 1999.

2.3 Structure, organisation of the PSO

The Transmission System Operator (TSO) identified in the Generation Adequacy Report 2003-2009 the short-term need for the additional capacity up to 150 MW in winter 2003 and 300 MW for winter 2004. The Commission for Energy regulation (CER) has therefore initiated short-term measures including the implementation by ESB of the demand side management programme and measures to improve ESB plants availability.

Given the urgency of measures to be taken, the CER requested ESB in its capacity of the Public Electricity Supplier⁵ (spring 2003) to secure the additional capacity through the combination of:

- (1) temporary mobile plant (104 MW),
- (2) contracted imports over the interconnector with the Northern Ireland (170 MW of capacity).

Temporary generation plant (Aghada)

The CER requested ESB to undertake the procurement process. The competitive process was conducted in accordance with the Directive No 93/38/EC⁶. Pratt & Whitney Power Systems (PWPS) were selected to supply two temporary generation units (2 x 52 MW)⁷. The CER reviewed the tender process and confirmed that the selected option was the most economically advantageous offer. The contract is structured around selling the PWPS generation units to ESB and buying them back at pre-agreed prices. This guarantees ESB 54%

² e.g. in February 2004 the margin between expected available, dispatchable generation capacity and the peak demand was typically 350 MW which is significantly lower than the required plant margin of 650 MW (a calculation based on the requirement to allow for loss of a major unit and its replacement).

³ State aid No N 475/2003 – Ireland, Public Service Obligation in respect of new electricity generation capacity for security of supply, OJ C 34, 7.2. 2004, p. 8

⁴ S.I. No 217 of 2002

⁵ At current stage of market opening the ESB supplies the vast majority of the 1.8 mil final customers in Ireland.

⁶ Council Directive 93/38/EEC of 14 June 1993 coordinating the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors, OJ L 199, 9.8. 1993, p. 84

⁷ The PWPS proposal was 12% more competitive than the alternative over an assumed 3 year operating period.

of the purchase value after 3 years of use and 44% of the purchase value after 4 years. ESB will sell the plant after a period of 2 to 4 years according to the instructions of the CER.

Contracted imports over the interconnector with Northern Ireland

The CER requested ESB to contract for capacity from Northern Ireland only to the extent that its costs were consistent with that indicated by the competitive process for the temporary generation units. The contract with the Northern Ireland Power Procurer (NIPP) extends from August 2003 to June 2005 with the option to prolong on a monthly basis until October 2006 on the same terms. ESB will pay for 170 MW of the exported capacity at all times and for the electricity when the plant (Ballyluford Unit 6 power station) is dispatched to deliver electricity to ESB. The costs of the imported electricity from Northern Ireland were benchmarked against the costs of additional temporary peaking units and the CER confirmed that the contract is the most economic option for securing additional capacity.

In January 2004, the CER requested ESB to examine options with the view of addressing further potential shortfall of 110 MW in available capacity over the next two years⁸.

Temporary generation plant (Rhode)

The plant to be provided at Rhode (104 MW) will be supplied by PWPS under the option agreement negotiated by ESB with agreement of the CER in 2003. This option agreement was subject to a procurement process conducted in accordance with Directive No 93/38/EC. The general terms and conditions of the supply remain the same as for the first (2003) supply. As in case of the temporary mobile plant at Aghada, PWPS will provide buyback guarantee for the plant of 55% of the purchase value after 2 years.

2.4 Compensatory mechanism

2.4.1 PSO levy

The costs of the short-term measures taken by ESB to provide the reserve capacity are now being recovered through the Public Electricity Supplier Tariff regulated by the CER. From 19 February 2005, when the Irish electricity market is fully liberalised, a new recovery mechanism in the form of the Public Service Obligation (PSO) levy collected from all customers will be established.

The levy methodology laid down in the Public Service Obligation Order 2002 which underlies the PSOs currently in operation⁹, previously assessed and approved by the Commission, will be applied also in case of the notified PSO. The CER will determine and certify the PSO levy amounts due.

2.4.2 Cost recovery

The CER will be responsible for ensuring that ESB is compensated only for the actual additional costs. The cost recovery principles were approved by the CER:

⁸ This has been identified in the Generation Adequacy Report for 2004-2010.

⁹ State aid No N 6/A/2001 Public service obligation imposed on the Electricity Supply Board with respect to the generation of electricity out of peat, OJ C 77, 28.3. 2002, p. 26; State aid No N 553/2001 Aid to promote renewable energy resources in Ireland, OJ C 45, 19.2. 2002, p.2; State aid No N 826/2001 Alternative Energy Requirements I to IV, OJ C 59, 6.3. 2003, p. 25

a) *temporary generation plant (Aghada)*: the capital costs incurred (net of present value of future disposal proceeds) will be annuitised over a 5-year period assuming a return on investment of 6% real, to be inflated in line with actual consumer price index in each year,

b) *imports from Northern Ireland*: the annual charge associated with the import will be annuitised over 5-year period assuming a return on investment of 3% real, to be inflated in line with actual consumer price index in each year,

c) *temporary generation plant (Rhode)*: the same approach as in a), in addition the CER has linked the capital cost recovery to improvements in availability of ESB plants.

The recovery of capital costs will be spread over the period until 2008.

The operating costs will be recovered annually as incurred. The operating costs will cease to be recovered on the expiry of the PSO, i.e. when the above-mentioned permanent generation facilities are on stream.

The amount to be recovered via the PSO levy in respect of the temporary generation plant at Aghada and the imports from Northern Ireland is estimated at the level of € 40 million. As regards the temporary generation plant Rhode, the amount to be recovered is estimated at the level of € 30 million.

The recovery models including the estimated amount of costs to be recovered each year form part of the notification. The CER will review these costs each year to determine the actual amounts recoverable.

The CER will ensure that any additional revenue of ESB above what is necessary to compensate the company for the PSO provision, including the revenue resulting from the subsequent sale of mobile generating units¹⁰ and the electricity produced¹¹, will be netted off against the actual costs incurred.

The final cost impact in terms of the PSO levy will depend on factors such as the actual termination date, foreign exchange fluctuations and the actual revenue earned through the electricity market price and the proceeds of the sale of the generating units.

2.5 Duration

The period of the PSO extends from 19 February 2005 (the date when the Irish electricity market is fully opened) until the date on which the full capacity of the two plants to be built on the basis of the Public Service Obligation in respect of new electricity generation capacity (State aid No N 475/2003) is available to the system. The expected operation dates are: 1 November 2005 for Aughinish Alumina and 31 January 2006 for Tynagh Energy Joint Venture.

¹⁰ The estimates of the disposal proceeds are based on the minimum purchase price agreed in the contract, at an estimate foreign exchange rate. In the event that PWPS resells the plant at a higher amount than the amount set in the contract, then 50% of the additional proceeds will be refunded to ESB and netted off against the PSO costs.

¹¹ The revenue value is calculated by applying the regulated 'spill' tariff increased in line with the consumer price index each year. The Irish authorities note that it is difficult to precisely estimate the output from the temporary generation plants as, by their nature they will generally only run when other plant is not available. A load factor of 15% was assumed for the capacity provision over the interconnector with Northern Ireland and a load factor of 5% was assumed for the temporary generation plants (these plants have higher fuel costs).

3. ASSESSMENT

3.1 Existence of aid

3.1.1 *Altmark case law*

The Irish authorities refer to the case law of the European Court of Justice (*Altmark judgment*)¹² and suggest that the notified PSO measure does not constitute State aid within the meaning of Article 87 (1) of the EC Treaty since it represents a compensation for the services provided by the recipient undertaking in order to discharge public service obligations, so that this undertaking does not enjoy a real financial advantage and the measure thus does not have the effect of putting it in a more favourable competitive position than the undertakings competing with it.

However, for such compensation to escape the classification as State aid four cumulative criteria laid down in the *Altmark judgment* have to be complied with:

- *first condition*: ‘the recipient undertaking is actually required to discharge public service obligations and those obligations have been clearly defined’,
- *second condition*: ‘the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner’,
- *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’,
- *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 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’.

As regards the compliance with the fourth condition, the Commission notes that ESB which is entrusted with the PSO has not been selected in a public procurement procedure. Furthermore, the Irish authorities did not provide the information which would allow the Commission to determine whether the costs incurred by ESB correspond with costs of a typical undertaking, well run and adequately provided with means to meet the necessary public service requirements.

In the light of the above, the Commission comes to the conclusion that the fourth condition of the *Altmark judgment* does not seem to be met since the Irish authorities did not sufficiently substantiated the fact that the PSO is being discharged at the required level of cost-

¹² C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH*, 24.7.2003

efficiency¹³. Therefore, it cannot be excluded that ESB enjoys a real financial advantage which has the effect of putting it in more favourable competitive position than the undertakings competing with it.

Accordingly, the Commission concludes that the PSO measure does not comply with the all criteria quoted above and therefore does not escape to the qualification as State aid within a meaning of Article 87 (1) of the EC Treaty on the basis of the application Altmark case law.

3.1.2 State aid within the meaning of Article 87(1) of the EC Treaty

In order to ascertain that whether the PSO measure constitutes State aid within the meaning of Article 87 (1), the Commission has to identify the presence of following elements:

- use of State resources

The PSO levy payments are imposed on the electricity customers by the State through PSO Order. The payments are poured to the account controlled by the TSO and supervised by the CER, i.e. by entities representing the State. The CER determines the actual amounts to be paid each year from the PSO levy to ESB for discharging the PSO. The collected amounts are used to favour certain undertakings (ESB). According to the constant case law of the European Court of Justice¹⁴, such sums constitute State resources in the meaning of Article 87 (1) of the EC Treaty.

- economic advantage

In the absence of the information which would allow to conclude that the fourth condition of the Altmark judgement is fulfilled¹⁵, it cannot be excluded that ESB enjoys a real financial advantage connected with its economic activities linked with the PSO provision. The PSO measure thus may have the effect of putting ESB in more favourable competitive position than the undertakings competing with it.

- distortion of competition

The financial aid from the State, based on the exercise of its discretionary powers, may strengthen the position of ESB in relation to their competitors in the Community and therefore has potentially distorting effects on competition.

- effect on trade between Member States

The electricity produced by ESB might be subject to the intra-Community trade and therefore the aid is likely to affect trade between Member States, in particular taking into account the completion of the internal market in electricity¹⁶.

Accordingly, the Commission considers all criteria to be fulfilled and thus concludes that the PSO measure constitutes State aid within the meaning of Article 87 (1) of the EC Treaty.

¹³ the tender procedure did not take place, the Irish authorities did not submitted the data which would enable to determine the level of compensation for ESB on the basis of an analysis of the costs of a typical, well run undertaking adequately provided with means to meet the necessary public service requirements

¹⁴ See for instance case C-173/73, Italy vs. Commission, 2.7.1974 and case C-78/76 Steinike vs. Federal Republic of Germany 22.03.1997

¹⁵ more details in chapter 3.1.1

¹⁶ 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, OJ L 176, 15.7. 2003, p. 37

3.2 Legality of the aid

By notifying the PSO measure before its implementation, the Irish authorities complied with its obligation under Article 88 (3) EC Treaty.

3.3 Compatibility of the aid

The Commission has assessed the compatibility of the PSO measure according to Article 86 (2) of the EC Treaty. The assessment is based on the compliance with the following criteria:

- nature of the service and its definition

The PSO to provide the reserve capacity to meet the peak demand is undertaken in the interest of security of electricity supply. The security of supply can be regarded as a service of general economic interest in some circumstances which are met in the present case. This conclusion is in line with the previous Commission decision concerning the security of electricity supply in Ireland (N 475/2003¹⁷) where the PSO addressed the lack of capacity through the construction of permanent generation facilities. The obligation to provide the reserve capacity of a certain volume is defined sufficiently clearly. Rights and obligations of ESB and the authorities involved will be laid down in the Statutory PSO Order. The specific situation of Ireland is taken into account as well as the limited amount of MW covered by the scheme.

In the view of the above mentioned arguments, the Commission considers that the PSO measure constitutes a service of general economic interest and is clearly and adequately defined.

- attribution of the remit

The PSO will be imposed on ESB in the form of the Statutory PSO Order made by the Minister under the Electricity Regulation Act 1999. The same regulatory approach was used in case of other PSOs in the energy sector currently in operation which were approved by the Commission¹⁸.

The Commission therefore considers that ESB will be officially entrusted by the PSO through the PSO Order.

- necessity and proportionality

The costs of the short-term measures taken by ESB to provide the reserve capacity are now being recovered through the Public Electricity Supplier Tariff regulated by the CER. From 19 February 2005, when the Irish electricity market is fully liberalised, a new recovery mechanism in the form of the PSO levy collected from all customers will be established. The CER will determine and certify the PSO levy amounts due.

To ensure the proportionality of the PSO measure, the recovery going beyond the net costs of the PSO provision, i.e. the overcompensation, shall be prevented.

¹⁷ OJ C 34, 7.2. 2004, p. 8

¹⁸ State aid No N 6/A/2001 Public service obligation imposed on the Electricity Supply Board with respect to the generation of electricity out of peat, OJ C 77, 28.3. 2002, p. 26; State aid No N 553/2001 Aid to promote renewable energy resources in Ireland, OJ C 45, 19.2. 2002, p.2; State aid No N 826/2001 Alternative Energy Requirements I to IV, OJ C 59, 6.3. 2003, p. 25

The CER will be responsible for ensuring that ESB is compensated only for the actual additional costs, the parameters of which have been clearly identified in advance. The recovery models including the estimated amounts to be recovered each year form part of the notification.

The rate of return allowed for purposes of the reserve capacity provision seems to be reasonable: 6% for mobile generation units (i.e. 1.5% lower than the allowed rate of return for ESB Power Generation 'normal' activities), 3% for imports from Northern Ireland.

The amount to be recovered via the PSO levy in respect of the temporary generation plant (Aghada) and the imports from Northern Ireland is estimated at the level of € 40 million. As regards the temporary generation plant (Rhode), the amount to be recovered is estimated at the level of € 30 million.

The CER will ensure that any additional revenue of ESB above what is necessary to compensate the company for the PSO provision, including the revenue resulting from the subsequent sale of mobile generating units and the electricity produced, will be netted off against the actual costs incurred.

On the basis of the above, the Commission considers the condition of proportionality to be fulfilled provided that the recovery process is regularly monitored on an ex post basis. The Irish authorities made a commitment to submit annual reports on the implementation of the PSO measure which will allow the Commission to verify of only the actual costs incurred are being recovered by ESB.

- no effects on trade contrary to the interests of the Community

The limited interconnection of Ireland with the outside energy networks, the duration of the PSO and the fact that the PSO concerns only the reserve capacity reduce the effects of the PSO measure on the intra-Community trade.

Accordingly, the Commission considers that the PSO measure has only limited effects on trade and is not contrary to the interests of the Community.

On the basis of the above-mentioned considerations, the Commission concludes that all conditions of Article 86 (2) of the EC Treaty are met and the PSO measure is therefore compatible with the EC Treaty.

4. CONCLUSIONS

The Commission has decided to consider the measure 'Public Service Obligation – Electricity Supply Board (ESB)' to be compatible with the EC Treaty in application of Article 86 (2) of the EC Treaty.

The Commission reminds the Irish authorities that, in accordance with Article 88(3) of the EC Treaty, all plans to refinance, alter or change this scheme have to be notified to the Commission.

The Commission notes that the Irish authorities made a commitment to submit annual reports on the implementation of the proposed PSO measure which allows the Commission to verify that that only the actual costs incurred in discharging the PSO are being recovered.

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

Mario Monti
Member of the Commission

