

EUROPEAN COMMISSION

Brussels, 28.11.2001

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**Subject: State aid No N 504/2000 – United Kingdom
Renewables Obligation and Capital Grants for Renewable Technologies**

Sir,

By letter dated 19 July 2000, registered by the Secretariat General of the European Commission on 25 July 2000 (SG(2000) A/9415/2), the United Kingdom notified the above mentioned scheme to the Commission. The Commission requested additional information on 13 September 2000 (D/54685), to which the UK authorities replied by letter of 24 October 2000 (registered 26 October, A/38860). The UK authorities extended the deadline for Commission consideration to 20 March 2001. At this stage major elements of the scheme (in particular the buy-out mechanism and eligibility criteria) had not been finally designed by the UK authorities. The extension aimed also to await orientation from the judgement of the European Court on Case C-379/98 PreussenElektra. The Court case was ruled on 13 March 2001. A meeting on the scheme was held thereafter on 29 March, which was followed by information sent on 12 April 2001 (A/34342). The Commission requested additional information on 1 June 2001 (D/52244), which was submitted after a meeting on 16 July 2001 by letter of 24 July 2001 (registered on 26 July, A/36038). Additional confirmations were given on 24 August 2001 (registered 29 August, A/36801).

Description

The scheme comprises two parts:

- A. an obligation on all licensed electricity suppliers to ensure that a proportion of electricity supplied is from renewable sources of energy, combined with a financial compliance mechanism;
- B. capital grants for investment in the more expensive longer term technologies for renewable energy.

The Right Hon Jack Straw MP
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A. *The Renewables Obligation*

An obligation shall be placed on all licensed electricity suppliers¹ in Scotland, England and Wales² to ensure that a proportion of electricity supplied to customers in Great Britain is from renewable sources of energy.

Suppliers will be able to meet their obligation in different ways:

- By physically supplying power from renewables generating stations;
- By purchasing green certificates independently of the power that gave rise to their issue;
- By paying the buy out price, which will be collected by a Fund and recycled to suppliers

The intention of the Renewables obligation ("*the Obligation*") is to provide a stable, long-term market to encourage investment in new renewable electricity generating capacity by developers.

The Obligation will come into effect on 1st January 2002³. The UK authorities notified the scheme for 10 years and agreed to end the scheme after the period of approval, if an extension to that period had not been previously agreed by the Commission, although they anticipate that they may re-notify the scheme prior to that time, in accordance with their stated intention to maintain the Obligation until 2027.

The legal basis for the Renewables Obligation are Clauses 61-64 of the Utilities Bill.

The profile of the Obligation:

In order to achieve the UK 10% renewable energy target by 2010, the profile of the Obligation will rise to 10.4% of electricity sales by 2010.

Obligation period	Obligation as percentage of total supplies
1 st January 2002 to 31 st March 2003	3.0%
1 st April 2003 to 31 st March 2004	4.3%
1 st April 2004 to 31 st March 2005	4.9%
1 st April 2005 to 31 st March 2006	5.5%

¹ All licensed electricity suppliers are private undertakings under the definitions of public undertakings contained in the transparency directive (OJ L 193 of 29.7.2000). At present there are about 40 licensed electricity suppliers.

² The Northern Ireland Executive is currently considering how renewables will be supported within Northern Ireland.

³ subject to State aid clearance and Parliamentary approval.

1 st April 2006 to 31 st March 2007	6.7%
1 st April 2007 to 31 st March 2008	7.9%
1 st April 2008 to 31 st March 2009	9.1%
1 st April 2009 to 31 st March 2010	9.7%
1 st April 2010 to 31 st March 2011 ⁴	10.4%

Definition of electricity from renewable sources:

The UK authorities notified electricity from the following sources to be eligible for the Obligation. Eligible stations must have been built or refurbished since 1990, when the UK government first supported renewable energy projects, on the basis that stations built prior to this date were constructed without support and are therefore viable without ongoing support. Exceptions to this are being made for mini-hydro stations and hybrid stations.

- Renewable non-fossil energy sources (wind, solar, geothermal, wave, tidal);
- both new and refurbished hydroelectric stations of up 20MW capacity and also completely new stations of greater than 20 MW capacity. This is meant to enable refurbishment of smaller stations to go ahead, with an anticipated increase in capacity of 6-10% as a result and encourage some additional capacity above the 20 MW scale that would not otherwise be built by the private sector. An exception for this requirement is proposed for mini-hydro stations, with a capacity of 1.25MW or less, which are primarily privately owned by individuals or small-to-medium enterprises who do not have access to sufficient finance to carry out refurbishment without being initially eligible for the Obligation. This provision would affect around twenty such stations within Great Britain, a total combined capacity of under 10MW.
- biomass according to Article 2(b) of Directive 2001/77 on the promotion of electricity produced from renewable sources⁵. However, in accordance with Recital 8 of the said Directive, the UK authorities notified that energy from the incineration of non-separated municipal waste will not be eligible for the Obligation. Energy produced from the biodegradable portion on non-separated waste using advanced technologies such as gasification, anaerobic digestion and pyrolysis will be eligible. All this is said to be consistent, and to reinforce the waste treatment hierarchy.

⁴ The UK authorities plan for each subsequent period of 12 months ending with the period of 12 months ending on 31st March 2027 the profile to remain at 10.4%.

⁵ Directive 2001/77/EC of the European Parliament and of the Council on the promotion of electricity produced from renewable energy sources in the internal electricity market, adopted on 27 September 2001, not yet published.

Hybrid plants are eligible until 31 March 2011. The contribution of such plants is limited to 25% of an individual supplier's obligation. Only the energy derived from the biomass fuel will be considered towards a supplier's obligation and the fuel from a hybrid station must be at least 75% energy crop in origin from 1 April 2006.

Eligible stations:

The eligibility for the Obligation will be restricted to electricity from renewable sources as defined above from generating stations located within the United Kingdom, its territorial waters and continental shelf.

The UK authorities are concerned that imported electricity generated from renewable sources, where no reciprocal arrangement exists, would make no additional contribution to the achievement of the UK's carbon emission targets than imported electricity generated from fossil fuels. They are also concerned that it would prove impossible at the moment to ensure that renewable electricity imported from other Member States was genuinely renewable and had not received support in other Member States. They believe that the restriction is consistent with the decision of the European Court in the PreussenElektra case⁶ but once these issues have been resolved through developments such as harmonised European support for renewable energy and free access to other member states' energy markets, they will be able to reconsider the issue.

Exported renewable electricity would not attract Renewables Obligation Certificates, since the electricity will not be supplied to customers in Great Britain.

Green Certificates ("ROCs"):

ROCs, representing a metered unit of eligible renewable electricity that has been generated and then supplied by licensed suppliers to their customers in Great Britain, will be issued by the regulator (OFGEM). OFGEM will monitor data on the metered output of each accredited renewable electricity generator. Certificates will then be issued to those generators according to the quantity of such electricity produced and supplied. Generators will then be able to trade these certificates to licensed electricity suppliers with whom they have contracted. The certificate will act as proof that qualifying renewable electricity has been supplied by a licensed electricity supplier to their customers in Great Britain and therefore count for meeting the Obligation.

Suppliers may use certificates generated in the previous year to fulfill up to 25% of their obligation ("banking" of ROCs), but borrowing against future year's generation is not allowed.

⁶ C-379/98 of 13.3.2001. The Court took into account the environmental goal of the measure, the priority for the production of renewable energy, the still incomplete state of liberalisation in the electricity market and the particularities of the electricity market. As regards the difficulties in defining the source of origin of renewable electricity this argument will not any more be relevant when the Directive 2001/77/EC on electricity produced from renewable energy sources is transposed in the Member States. The other points remain.

The regulator, OFGEM, does not propose to monitor each certificate trade that occurs but will require a full audit trail to be available in case of suspected irregularity.

Certificates can not count towards targets under negotiated agreement for the Climate Change Levy. The UK authorities confirmed that trading between Renewables Obligation Certificates and certificates from the UK emission trading scheme will not be permitted without prior Commission approval.

In order to avoid infringement of the Internal Market rules, the UK authorities commit that they will accept certificates of supply (as opposed to certificates of generation)⁷ of electricity from renewable sources issued by the authorities of other Member States as being evidence of compliance with a supplier's renewables obligation, on the basis of bilateral agreements negotiated between the UK and those Member States. Where such bilateral recognition agreements are entered into, the UK would amend the implementing legislation for the Renewables Obligation in order to enable acceptance of such certificates by the UK authorities.

The buy out mechanism

Suppliers can instead of purchasing green electricity respectively green certificates pay the buy out price of 3p/kWh⁸. The funds collected from suppliers buying out of their obligation will be distributed on the basis of the amount of eligible renewable electricity supplied during that period by suppliers, up to the level of their Obligation.

The mechanism of the buy out price serves a number of different purposes:

- The buy out price operates as an enforcement mechanism for the Obligation. It creates a commercial incentive for suppliers to purchase renewables when these are available at a price below the buy-out price and in this way acts to create a long term market for renewables which is greater than it would have been in the absence of the Obligation.
- The buy out price also operates to limit the cost of the renewables obligation to electricity consumers – if the cost of renewables electricity exceeds the buy out price, suppliers may choose to pay the buy out price instead of supplying renewables.

Under the distribution method proposed each supplier would receive £x/y for each unit of renewables actually supplied under the Obligation – as demonstrated by ROCs - (where x is the total amount of buy-out receipts and y is the total amount of renewables electricity supplied by all suppliers under their Obligation). This approach gives suppliers a stronger incentive to buy ROCs since the more ROCs they own, the greater will be their share of any buyout payments and the less their contribution to the buy out fund.

The UK authorities anticipate that there may be insufficient generating capacity in the early years of the Obligation to meet the demand that the Obligation will stimulate. In such a situation of

⁷ Certificates of origin certify the nature of electricity generated – the renewable energy source, the amount generated, when and where it was generated, but with no reference to the supply of that electricity. Certificates of supply certify that the electricity was supplied, in this case, to customers in Great Britain.

⁸ the price floats with the retail prices index.

short supply, suppliers could be willing to pay prices in excess of the buy-out price for renewable electricity: The money which a supplier can recycle from the buyout fund will allow him to pay a higher price than the buy-out price to the generator and still make a profit. The effect of this could therefore be that the benefit of the buy-out payments could (partly) end up with renewable generators. This would provide a further boost to renewables. This effect will be weaker the closer the supply of green electricity matches the demand.

In addition, the Commission notes:

The regulator will hold the buyout payments from the time those payments are made to it by suppliers until it pays out the payments. However, neither the State nor the State body will own the buyout payments. The revenues of this fund will be distributed to suppliers following key-predefined rules established by UK legislation. These rules leave no discretion to the regulator.

If a supplier fails to make its payments, they can only be taken to court by the regulator. Where a supplier does not fulfil its obligation, either by purchasing green electricity, green certificates or by paying the buyout price, a penalty system based on the existing licence regime for energy suppliers is put in place. It is a condition of the licence that suppliers meet their obligation. Where a supplier does not fulfil its obligation, the Government via the regulator takes action against the supplier and imposes a penalty on him. This penalty goes to the general Government account. Penalty money will not be redistributed to other suppliers. The penalty mechanism is a further element of the State ensuring the respect of the fund mechanism established and controlled by the State.

It can be said that the State body does not limit itself to carry out a purely accounting role but exercises a more managerial position, ensuring in particular that payments are made by suppliers.

Prices for renewables in the UK:

Under the fifth round of the Non-Fossil Fuel Obligation⁹, contracts were awarded for different technologies in the following price-bands:

Technology	Lowest contracted price (p/kWh)	Capacity weighted price (p/kWh)	Highest contracted price (p/kWh)
Landfill gas	2.59	2.73	2.90
Energy from waste	2.39	2.43	2.49
Energy from waste using CHP	2.34	2.63	2.90

⁹ State aid N 153/98, SG(98) D/7086 of 17.8.1998.

Small-scale hydro	3.85	4.08	4.35
Wind energy >0.995MW	2.43	2.88	3.10
Wind energy ↑0.995MW	3.40	4.18	4.60

Whilst these prices are indicative of the costs of renewable energy, a number of contracted projects have not been completed because they are no longer viable under this price regime. It is likely, therefore, that some actual costs are close to or above these contracted prices.

Average pool prices for electricity were 2.63 p/kWh in 1994/95 and 2.59 in 1998/99.

B. The Capital Grants

Grants will be made available under the Science and Technology Act, 1965, for investment in electricity generating stations using more economically marginal renewable sources, such as offshore wind, energy crops and small-scale biomass CHP projects.

The scheme is notified for ten years.

The budget for the grants will be £ 100 million, with £50m assigned to offshore wind projects, around £40m to biomass and energy crop power projects and £4m to small-scale biomass heat and CHP projects.

Capital grants are proposed only for demonstration plant offering new capacity.

The beneficiaries are undertakings that have invested in power stations to generate electricity from renewable sources of energy and sell the electricity generated in the competitive electricity supply market. Experience suggests that many of these undertakings will be small and medium sized businesses.

CHP projects will need to satisfy the existing good quality CHP criteria in order to be considered for any capital support. The definition of Good Quality CHP¹⁰ is based on Threshold Criteria, which must be met or exceeded in order for the whole of the Scheme to qualify as 'Good Quality'.

The CHPQA programme provides for a rigorous assessment of the energy efficiency and environmental performance of CHP Schemes. It is much more rigorous in this respect than simply assessing the overall efficiency of a CHP Scheme. In particular, the weighting given to the efficiency of power generation in the assessment procedures recognises the environmental benefits of using CHP rather than conventional energy generation technologies. In comparison, a conventional boiler system with a small amount of electrical power generation could achieve

¹⁰ Established by the UK's CHP Quality Assurance programme (CHPQA).

relatively high 'headline' energy conversion efficiencies, but offers much reduced environmental benefit compared to Good Quality CHP.

Threshold Criteria are set for Quality Index and Power Efficiency.

Power Efficiency (η_{power}) is the proportion of input energy which is converted to electrical or mechanical power (total annual power output divided by the total annual fuel input).

The Quality Index (QI) is a measure of the overall efficiency of a CHP Scheme, taking account of the efficiency of production of both heat and power. In the definition of the Quality Index, the quantity of power produced is weighted relative to the quantity of heat, given the greater energy and environmental cost involved in generating power.

The general definition for $QI = (X \times \eta_{power}) + (Y \times \eta_{heat})$ ¹¹

Quality Index (QI) Definitions for Various Sizes and Types of CHP schemes:

Size of scheme	QI Definition
$\leq 1 \text{ MW}_e$	$QI = 230 \times \eta_{power} + 125 \times \eta_{heat}$
$> 1 \text{ to } \leq 10 \text{ MW}_e$	$QI = 220 \times \eta_{power} + 125 \times \eta_{heat}$
$> 10 \text{ to } \leq 25 \text{ MW}_e$	$QI = 205 \times \eta_{power} + 125 \times \eta_{heat}$
$> 25 \text{ to } \leq 50 \text{ MW}_e$	$QI = 190 \times \eta_{power} + 125 \times \eta_{heat}$
$> 50 \text{ to } \leq 100 \text{ MW}_e$	$QI = 185 \times \eta_{power} + 125 \times \eta_{heat}$
$> 100 \text{ to } \leq 200 \text{ MW}_e$	$QI = 180 \times \eta_{power} + 125 \times \eta_{heat}$
$> 200 \text{ to } \leq 500 \text{ MW}_e$	$QI = 170 \times \eta_{power} + 125 \times \eta_{heat}$
$> 500 \text{ MW}_e$	$QI = 160 \times \eta_{power} + 125 \times \eta_{heat}$
Special Cases	QI Definition
Fuel Cell Schemes	$QI = 180 \times \eta_{power} + 125 \times \eta_{heat}$
Reciprocating Engine Schemes (including those in Combined Cycle Applications) $\leq 25 \text{ MW}_e$	$QI = 200 \times \eta_{power} + 125 \times \eta_{heat}$
Transitional arrangements for existing Steam Turbine and Reciprocating Steam Engine Schemes to April 2005	$QI = 240 \times \eta_{power} + 125 \times \eta_{heat}$

¹¹ X is a coefficient related to alternative power supply options. Similarly Y is a coefficient for heat generation, related to alternative heat supply options. The values for X and Y vary for different sizes and types of scheme.

Alternative Fuel Schemes	
Alternative Fuel Gases	$QI = 240 \times \eta_{power} + 125 \times \eta_{heat}$
Biogas, Waste gas or Waste heat	$QI = 300 \times \eta_{power} + 140 \times \eta_{heat}$
Biomass or solid or liquid Waste	$QI = 400 \times \eta_{power} + 140 \times \eta_{heat}$

Threshold Criteria for Good Quality CHP:

For Fuel Inputs under Annual and Initial Operation:

Normally, a scheme that qualifies as GQ CHP for its entire energy inputs is one where the Power Efficiency equals or exceeds 20%.

For Power Outputs under Annual Operation:

A scheme that qualifies as GQ CHP for its entire annual energy output is one where the Quality Index equals or exceeds 100.

For Power Outputs under Initial Operation:

A scheme that qualifies as GQ CHP for its entire annual energy output is one where the Quality Index equals or exceeds 95.

For Power Generation Capacity under Annual Operation:

The Threshold Criterion for existing GQ CHP Capacity is that the CHP scheme achieves a QI of at least 100 at its Maximum Heat Output under Normal Operating Conditions.

For proposed New Power Generation Capacity:

Threshold Criteria for proposed new GQ CHP scheme capacity, at design, specification, tendering and approval stages, are

Either $QI \geq 105$ and Power Efficiency $\geq 20\%$, both under Annual Operation

Or $QI \geq 110$ at MaxHeat and Power Efficiency $\geq 35\%$ under Annual Operation

The QI definitions shall be subject to periodic review to ensure that the values of X and Y remain applicable and appropriate for each size and type of CHP scheme, that certified GQ CHP will continue to provide significant environmental benefits compared to conventional energy supply alternatives and that the QI definitions provide a challenging threshold for all CHP schemes and promote continuous improvement of CHP plant.

Simplified arrangements will operate for small-scale CHPs (less than 2 Mwe) as regards metering, monitoring and reporting.

The aid intensity will be determined through a competitive process. The maximum investment aid will be equivalent to 40% of the additional capital costs of the renewable energy project compared to the costs of an equivalent combined-cycle gas turbine station.

The eligible costs for all projects include only land, buildings plant and equipment and do not include technology transfer costs.

The UK authorities undertook that if investment aid were received from other sources, such as other government aid programmes or European development aid, the level of capital grant awarded would be reduced to ensure that aid from all sources did not exceed this level.

The UK authorities undertook that where commitments have previously been made regarding cumulation of aid, particularly in respect of an exemption from the Climate Change Levy, these would be respected¹².

The UK authorities believe that the combination of operating aid (through the Renewables Obligation) and investment aid (through capital grants) will not lead to overcompensation. Whilst there are no current comparable offshore wind farms to base an assessment on, they believe that offshore wind will require a price of around 5.5-6p/kWh in order to be viable, with the costs of the additional capital investment accounting for 4p/kWh of that sum. Current prices for intermittent generation such as wind power are around 4p/kWh for long-term contracts, including the value of the Renewables Obligation Certificates. There is therefore a shortfall of around 2p/kWh for offshore wind. The maximum 40% investment aid would be worth around 1.6p/kWh, based on the above 4p/kWh cost of capital. As a result the UK authorities do not believe that the combination of operating and investment aid would lead to overcompensation.

OPINION OF THE UK AUTHORITIES

The UK authorities believe that the Obligation, aside from the buy-out mechanism which involves funds dispersed by a government body (albeit without discretion as to the dispersal), is not State Aid. The UK authorities are also of the opinion that the measure meets the conditions set in the Community guidelines on State aid for environmental protection¹³.

ASSESSMENT

Existence of aid

A. Renewables Obligation

On the applicability of Article 87(1) of the EC Treaty the Commission considers the following¹⁴. The obligation imposed by the UK government for all licensed electricity suppliers

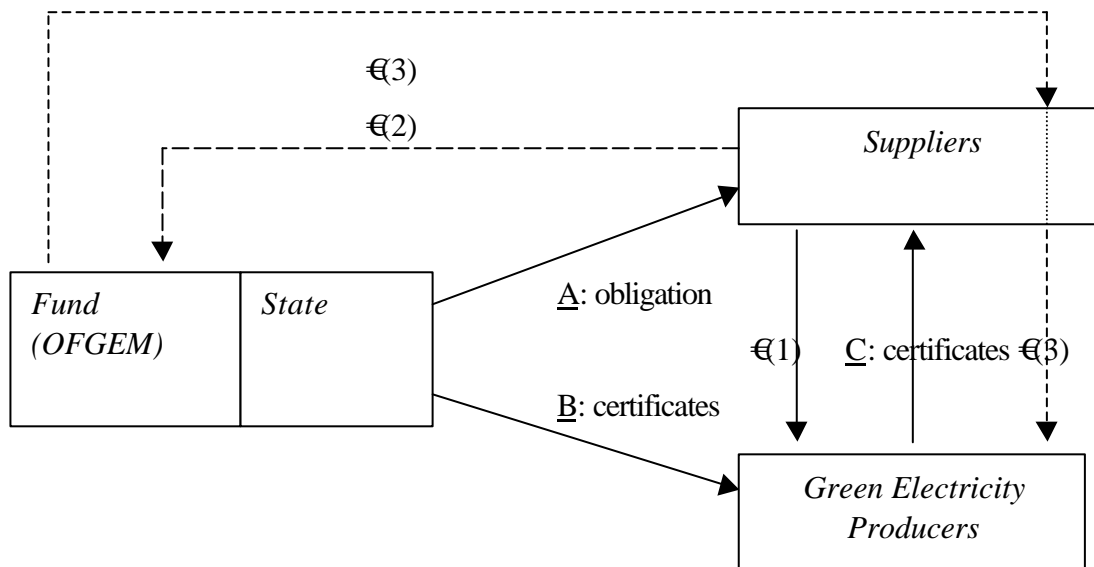
¹² The UK authorities undertook that companies under the Climate Change Agreements will not be allowed to receive other State aid for the investments necessary to fulfil the agreements (State aid N 123/2000 and N 197/2000).

¹³ OJ C 37 of 3.2.2001, p.3.

¹⁴ The assessment takes into account the Commission practice on similar cases, such as the Commission decision on State aid N550/2000 – Belgium, Green Certificates.

in Great Britain to possess a certain number of green certificates at the end of each compliance period will result in an additional income for producers of green electricity to cover a part of their production costs. It is therefore an advantage granted to these producers. The producers of green electricity are a specific group of electricity producers, who are active in trade between Member States. The position of these green electricity producers will be strengthened by this scheme, which may lead to a change in the market conditions for their competitors. This strengthening must be regarded as affecting that trade.

In order to decide that the notified measure on green certificates constitutes State aid, the Commission has to determine whether State resources are at stake. In the following (simplified) figure various cash flows and obligations in the notified green certificates measure are summarised:



The system starts with the obligation by the State for licensed electricity suppliers to purchase a certain amount of green certificates (obligation A). Recent ruling of the Court on the PreussenElektra case has shown that an obligation imposed on private electricity supply undertakings to purchase electricity produced from renewable energy sources at fixed minimum prices does not involve any direct or indirect transfer of State resources to undertakings which produce that type of electricity¹⁵. The obligation to purchase a specific amount of green certificates seems comparable to the obligation to purchase electricity produced from renewable energy sources at fixed minimum prices, hence no State resources in the meaning of Article 87(1) of the EC Treaty are at stake on this obligation.

The State offers the producers of green electricity the green certificates for free (B). The green electricity producers who have produced a certain amount of green electricity which has been supplied to customers in Great Britain will get an accordingly amount of green certificates in return. They can sell these certificates to the suppliers on the (future) green certificate market,

¹⁵ Judgement of the European Court of Justice 13 March 2001, C-379/98.

hence the State offers them intangible assets. However, the State does not seem to accept foregone revenues by offering the green certificates for free. The State only provides an authorised proof that the green electricity is actually produced. Hence, with regard to the provision of green certificates by the State to producers no State resources in the meaning of Article 87(1) of the EC Treaty are at stake.

When suppliers buy green certificates from producers of green electricity or traders (cash flow €(1) and certificates sales C), no State resources in the meaning of Article 87(1) of the EC Treaty are at stake, as these actions take place between private actors in the electricity market.

If suppliers fulfil their obligation without buying out, it can not be said that the buyout price, practically a fine they will not pay by fulfilling an obligation, is a loss of revenue for the State. No State resources are involved in such a situation.

Therefore the Commission concludes that, in principle, the obligation as such and as it is based on the green certificates system in this case does not constitute State aid within the meaning of Article 87(1) of the EC Treaty¹⁶.

If however, suppliers do not have a sufficient amount of green electricity certificates, they have to pay the buyout price, practically a fine, to a fund. In order to determine whether the buyout price amount is to be regarded as state resources, and thus state aid, it is necessary to assess the nature and the specific characteristics of the UK mechanism.

In this respect, the Court jurisprudence has established three cumulative criteria in order to assess the involvement of State resources where money is transferred by a fund¹⁷:

- The fund must be established by the State;
- The fund must be fed by contributions imposed by the State;
- The fund must be used to favour specific enterprises.

The Commission notes first that the fund is set up by the State and managed by Ofgem, the industry regulator, which is a State body (in the figure cash flow €(2)). The level of the buyout price is established by the State.

Secondly, the Commission notes that at least in the first years of the obligation, supply of renewables will fall short of the demand created by the Obligation. Therefore, some suppliers will have to pay the buyout price and will not have the possibility to choose between the options of the Obligation.

Third, the fund favours certain enterprises, insofar as the suppliers contributing to the fund and those benefiting from the fund are not necessarily the same group of enterprises. The distribution is thus not a proportional partial compensation for the obligation, but may favour some enterprises within the obliged group. The entire mechanism also favours producers of "green

¹⁶ Even if it would constitute State aid, the Commission considers the aid to be compatible with Article 87(3)(c) of the EC Treaty as it is in line with the environmental aid guidelines (see arguments below on the compatibility of the fund mechanism with state aid rules).

¹⁷ Judgement of the European Court of Justice of 2 July 1974, C-173/73 Italy vs Commission and judgement of 22 March 1997, C-78/79 Steinike vs Germany.

electricity" by raising demand for their product, compared to other electricity producers. In addition, the UK authorities have information that suppliers are offering contracts to generators specifying that around 80% of buyout receipts paid to suppliers would be passed onto the generators by the suppliers. Green electricity producers are a specific group of electricity producers, who are active in trade between Member States. The position of these green electricity producers will be strengthened by this scheme, which may lead to a change in the market conditions for their competitors. This strengthening must be regarded as affecting that trade.

The Commission considers that State resources are involved and also all other criteria of State aid in the meaning of Article 87(1) are fulfilled. The measure would insofar constitute State aid within the meaning of Article 87(1) of the EC Treaty.

B. Capital Grants

The Capital grants are granted by the State and give specific producers of green electricity a competitive advantage over other green and conventional electricity producers. The grants therefore distort competition amongst electricity producers. In a liberalised market this may also lead to an effect on trade between Member States. Thus the Capital grants constitute State aid under Article 87(1) EC.

Legality of the aid:

Insofar as the measure constitutes State aid, the UK authorities have fulfilled their obligation according to Article 88(3) of the EC-Treaty by notifying the aid measure before its implementation.

Compatibility of the aid:

A. Renewables Obligation

Insofar as the measure constitutes State aid (i.e. the buyout mechanism), the following has been considered.

The aim of the notified State aid measure is environmental protection. Therefore, this measure will be assessed in the light of the Community guidelines on State aid for environmental protection¹⁸, hereafter "the environmental guidelines". In order to do justice to the economic effects, the assessment has to take into account for the compatibility assessment not only the buyout mechanism as such, but the entire mechanism of the scheme.

As regards potential aid to electricity suppliers from the buyout mechanism, the Commission takes into account the information provided by the UK according to which about 80% of the advantage will be transferred to green electricity producers. The Commission considers the remaining aid to be limited and necessary as a mean to run the system.

As regards aid to green electricity producers, the Commission has considered:

¹⁸ OJ C37, 03.02.2001, p. 3.

First of all, the Commission has to assess that the definition of renewable energy sources in the notified measure is compatible with the definition in point 6, subparagraph 8 of the environmental guidelines. It has to be noted that the definition applied by the UK authorities is not the one of the environmental aid guidelines, but corresponds to the definition of the directive on the promotion of electricity produced from renewable sources¹⁹. Footnote 7 of the environmental aid guidelines foresees that once the Directive has been adopted, the Commission will apply the definition of the final text.

In points 61 and 62 of the environmental guidelines specific attention is given to the introduction of green certificate systems. The environmental guidelines state that market mechanisms such as green certificate systems allow green electricity producers to benefit indirectly from guaranteed demand for their energy, at a price above the market price for conventional power. Where they constitute State aid, these systems may be authorized by the Commission if Member States can show that the support:

- A. is essential to ensure the viability of the renewable energy sources concerned;
- B. does not in the aggregate result in overcompensation for renewable energy;
- C. does not dissuade renewable energy producers from becoming more competitive;
- D. is limited to a duration of 10 years.

Ad A: The UK authorities demonstrate that support for renewable energy sources is required by looking at the market and the different technology bands as a whole. Under the previous support mechanism for electricity from renewable sources, the Non-Fossil Fuel Obligation, operators bided for contracts to supply renewable electricity at the bid price. The contracted prices were in the range of 2.3-4.6p/kWh, compared with a wholesale price for fossil-derived electricity of around 1.8p/kWh. Support is therefore required for renewable energy sources to be viable.

Ad B "No overcompensation": The UK authorities anticipate that the operation of a competitive market for renewable energy will minimise the real costs of achieving their renewables targets. The buy-out mechanism sets an effective price cap on electricity from renewable sources, in order to protect consumers. If the obligation can be met at a lower cost then competition in the market will reduce prices to the point that just ensures that sufficient capacity is available to meet the targets. The marginal price will just match that required. Further development of renewable sources which tend to be cheaper than the marginal price will therefore be encouraged and this will tend to increase the capacity available but increase their marginal cost as projects further up the resource-cost curve come on line.

However, the Commission notes that in the first years of the Obligation, supply of green electricity will probably not be sufficient to meet the demand created by the Obligation. Prices may therefore tend towards the buy-out price and suppliers will therefore "buy out" some of their obligation. The resulting buyout fund would be returned to suppliers. In this situation, overcompensation to electricity generators at the aggregate level cannot immediately be ruled out.

¹⁹ adopted on 10.9.2001, not yet published.

According to UK information suppliers are offering contracts to generators specifying that the suppliers would pass around 80% of buyout receipts paid to suppliers onto generators. Since the amount of the buyout fund that suppliers and generators would receive is dependent on the amount of renewable electricity supplied, it can be assumed that this will act as a strong stimulus to develop additional generating capacity and therefore secure a greater share of the buyout fund. The recycled buyout payments would therefore be reinvested into new generating capacity, which will lead in the medium term to stronger competition and decreasing prices, acting against overcompensation.

The Commission takes into account the need of the UK to build additional capacity for renewable energy in order to meet its targets. Overall it can be assumed that the design of the scheme itself will prevent overcompensation at the aggregate level, this being seen in a double sense. Firstly, the system will prevent overcompensation in the aggregate of the different producers. Secondly, while the system will overcompensate producers in the beginning, the market mechanism will prevent in the aggregate of the duration of the scheme overcompensation. The Commission notes the undertaking of the UK authorities to review the operation of the buyout recycling mechanism after 5 years and considers this undertaking to be an important element of its assessment.

Ad C "Competitiveness": The mechanism as described should by itself be an incentive to increase capacity. Once sufficient capacity is available to meet the obligation, competition between generators should increase. Competitiveness of green electricity generators should also be ensured as the UK authorities opted for the same treatment for all eligible sources of green electricity and thus did not create "niches" by a banded approach. A certain protection is however introduced for some more expensive green technologies, which are at the current stage of development not yet competitive.

Ad D "Duration": Although it is the intention of the UK authorities to continue the scheme for a longer period, they agreed to limit it first to 10 years and gave the necessary commitments to ensure the respect of this limit if the Commission does not approve a continuation of the scheme later on.

Complying with all criteria set by points 61 and 62 of the environmental aid guidelines, the Renewables Obligation is compatible with Article 87(3)(c) EC.

As regards the Directive on the promotion of electricity produced from renewable energy sources, the Commission draws the attention of the UK authorities in particular to the obligation to introduce certificates of origin at the latest two years after entering into force of the directive. The Commission considers that the certificates of origin will remove a major obstacle for the free movement of green electricity. The Commission reserves its right to review the scheme once Member States are bound to provide certificates of origin. The Commission will then assess in particular the further justification of the restrictions imposed on imported green electricity and green certificates. The Commission will if necessary propose appropriate measures in order to ensure the respect of Community rules.

B. Capital Grants

Point 31 of the environmental aid guidelines establishes that investments in the combined production of electric heat and power may also qualify under these guidelines if it can be shown

that the measures are beneficial in terms of the protection of the environment because the conversion efficiency is particularly high, because the measures will allow energy consumption to be reduced or because the production process will be less damaging to the environment. The criteria under the CHPQA ensure the environmental benefit of the scheme. The proposed aid intensity of 40% is in line with point 31 of the environmental aid guidelines.

Point 32 of the environmental aid guidelines foresees that investments to promote renewable sources of energy are deemed equivalent to environmental investments undertaken in the absence of mandatory Community standards and the acceptable rate of aid for investment in support of these forms of energy is therefore 40% of the eligible costs. The maximum aid intensity proposed under this scheme complies with the environmental aid guidelines.

The aid intensity is calculated in relation to the eligible costs of investments as defined in point 36 of the environmental aid guidelines. The eligible costs are defined as extra investment costs, which is in line with point 37 of the environmental aid guidelines.

The measure fulfills the requirements of the environmental aid guidelines and is therefore compatible with Article 87(3)(c) EC.

DECISION.

The Commission has accordingly decided to consider the scheme insofar as it constitutes State aid to be compatible with Article 87(3)(c) of the EC Treaty.

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European Commission
Directorate-General for Competition
Directorate G.2
Rue de la Loi/Wetstraat, 200
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Yours faithfully,

For the Commission

Mario MONTI

Member of the Commission