EUROPEAN COMMISSION

Brussels, 13.03.2001
SG (2001) 286845

Subject: State aid No N 797/2000 - United Kingdom
Enhanced Capital Allowances for energy efficient investments

Sir,

By letter dated 1 December 2000 (registered on 5 December, A/40207), the UK government notified the above mentioned measure. The Commission requested additional information by letter of 6 February 2001, which was submitted by letter of 21.02.2001 (registered A/31533, 22.02.2001).

1. Description of the measure

Enhanced capital allowances are intended to provide a tax-driven incentive to encourage investment by businesses in energy saving technologies.

The scheme covers equipment in the following technology classes provided it meets strict energy saving criteria:

- lighting
- pipe insulation
- boilers
- motors
- variable speed drives
- refrigeration
- combined heat and power
- thermal screens[1]

The use of such technologies will help businesses reduce their energy use, leading to lower carbon emissions. This is part of a larger raft of measures that are being introduced to ensure the United Kingdom will meet its target for reducing carbon emissions under the Kyoto Protocol, and to assist the European Union to meet its

[1] Thermal screens are for use in glasshouses. Enhanced capital allowances for thermal screens are not subject of this decision but will be dealt with separately.

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target. The measure will also help the United Kingdom move towards its domestic target of a 20% reduction in CO_2 emissions.

All businesses will be able to claim the enhanced capital allowances, regardless of size, industrial or commercial sector, or location. Similarly, no restrictions are imposed on the source the equipment in the qualifying technology classes. The scheme is open to manufacturers world-wide and is being publicised in the United Kingdom and abroad, including on international websites concerned with energy saving. Details of the application process were published in the OJEC.

Criteria Relating to Specific Technology Classes

Investments can qualify for enhanced capital allowances if the equipment meets specific energy saving criteria. These criteria will be published in an Energy Technology Criteria List, which will be reviewed annually. The criteria are based on European standards, where they exist. The UK confirmed that they will recognise equivalent standards in other Member States wherever UK standards are used for the purposes of assessing eligibility for Enhanced Capital Allowances.

Lighting: Lights and lighting systems can qualify for enhanced capital allowances provided they are machinery and plant and meet specified energy efficiency standards.

The List will include lighting products that are energy efficient for their specific applications and which can substitute for less efficient products to achieve energy savings. There are three main categories of lighting equipment:

- lamps that can be substituted for existing, less efficient types on a one for one basis;
- lighting fittings complete with required lamps and associated lamp control gear:
- lighting control equipment to limit the operation of lighting equipment according to need.

In particular, energy efficiency will be promoted by encouraging the replacement of inefficient T12 with T8 fluorescent lamps and obsolete, inefficient fluorescent luminaires with HF versions and the use of triphosphor fluorescent lamps.

Pipe Insulation: All insulation on pipework that qualifies as machinery or plant (mainly hot-water systems) that meets the recently revised BS5422 standard is eligible for enhanced capital allowances. This opportunity presented by enhanced capital allowances has been used to upgrade the standard to consider the environmental impacts of energy saving achieved by its use.

Boilers, motors, variable speed drives and refrigeration equipment will qualify only if the manufacturer certifies that the specific product meets the energy efficiency criteria. Details of the product must be submitted to the Department of the Environment, Transport and the Regions before the product can be included on the Product List. Enhanced capital allowances can be claimed on an investment only if the product is on the list at the time the expenditure is incurred.

Boilers: ECA will be available on the following types of boiler plant equipment:

- boilers
- automatic flow valves
- flue gas economisers
- condensing economisers
- oxygen trim controls
- fully closing inlet/exhaust dampers
- direct condensate injection
- sequence controls
- automatic TDS control
- blowdown heat recovery
- boiler modulation control systems / digital combustion controls

Expenditure on all boilers up to 400kW that are classified as gas condensing boilers under the Boiler Efficiency Directive 92/42/EEC of 21.5.92[2] is eligible for enhanced capital allowances. Expenditure on named boilers over 400kW will also qualify. Gas boilers must be over 80% efficient (gross) and oil boilers must be over 84% efficient (gross). The manufacturer must show that these efficiencies have been worked out using BS845 1987 and that the boiler has been built to BS2790.

Motors: Expenditure on motors can qualify for enhanced capital allowances if the motor is named in the List as having reached the required standard. All 2 and 4 pole motors between 1.1 - 90kW must meet the European CEMEP EFF1 efficiency ratings under the CEMEP Motor Efficiency Labelling Scheme. All other motors must meet the Water Industry Motor Efficiency Standards (WIMES).

Where a motor is incorporated into a larger machine, the qualifying expenditure is given by reference to a pre-determined table, the amount dependent on the size of motor. This is based on the original cost, but avoids an apportionment of the machine's purchase price to isolate the proportion referable to the motor.

Variable Speed Drives (VSDs): The only VSDs eligible for enhanced capital allowances are those installed for liquid or gas movement applications such as pumps, fans and compressors. The scheme is limited to those controllers designed specifically to vary the speed of a motor electronically.

Examples of eligible controllers are, controllers for switched reluctance motor drive systems, integrated motor/drive packages, and variable frequency controllers (inverters). But soft starters and dedicated energy optimisers which optimise induction motor excitation losses for single-speed motors are excluded.

The VSDs will be on a named Product List, and where incorporated into larger items of machinery, the eligible expenditure will be given by reference to tables, based on the motor rating and voltage.

Refrigerators: ECAs will be available on the following types of refrigeration equipment

- evaporative condensers
- liquid pure amplification systems
- automatic air purging systems
- refrigeration control systems with energy-saving, features
- night blinds & curtain strips for retail display cabinets
- automated permanent refrigeration leak detection system

[2] OJ L 167 , 22/06/1992 p. 0017 - 0028, corr. OJ L 268 , 29/10/1993 p. 0112 .

Further categories remain under development. Absorption cooling equipment driven by CHP heat is covered under CHP.

As with motors and VSDs, manufacturers will need to demonstrate that their products meet set criteria for each class of equipment. For absorption cooling equipment, claimants' certification will be provided by the Combined Heat and Power Quality Assurance scheme.

Combined Heat and Power (CHP): CHP schemes must be 'Good Quality' in order to qualify for enhanced capital allowances. The CHP Quality Assurance programme (CHPQA) provides a practical, determinate, and reliable method for the assessment, monitoring and certification of the various types and sizes of CHP scheme. This is based on the energy efficiency and environmental performance of CHP plant compared to good alternative energy supply options. CHPQA assessment and certification will determine the eligibility of schemes for CCL exemption and for enhanced capital allowances.

Enhanced capital allowances will also be available on expenditure incurred in improving existing CHP schemes where the resulting improvements meet set criteria. In this case, CHP can benefit from enhanced capital allowances in proportion to the scheme's Qualifying Power Capacity following the improvement, i.e. in proportion to the final good quality power capacity.

Combined heat and power equipment must be certified by the Department of the Environment, Transport and the Regions at the design stage as meeting the required standard before enhanced capital allowances can be claimed.

For CHP plant to benefit from the enhanced capital allowances their main intended business will be to provide heat and power for clearly identified users on site or to known third parties, and not to generate power for sale to or via unspecified third parties.

Exclusions

Expenditure on machinery or plant incorporated in certain assets or for certain purposes will not qualify for enhanced capital allowances, even though the technology appears on the List. In particular, the enhanced allowances will not be available for investment in long-life assets (assets which have an expected useful economic life when new of at least 25 years and which qualify for capital allowances at a reduced rate of 6%), assets, that are specifically outside the long-life assets rules such as ships, and cars (which are already subject to special rules that limit the amount of capital allowances that can be given).

Assets acquired for leasing will not qualify. Assets will be excepted from this rule if they are leased to users by Energy Services Companies (businesses that provide integrated energy management services). This will ensure the scheme accommodates normal commercial arrangements, in particular in relation to combined heat and power, which include the provision of equipment to reduce a client's energy needs.

Enhanced capital allowances will only be available for purchases of new (and not second-hand) equipment. This will ensure the incentive provided by the scheme is properly focused on technologies that are innovative and have yet to achieve major market penetration.

Administration of the List

It is intended much of the routine management will be carried out on behalf of the Government by the Carbon Trust. Under current proposals, this will be an independent, not for profit company of which the Government will have a controlling interest. It will verify whether individual products satisfy the criteria for inclusion on the list, monitor the impact of the scheme, and provide advice to Government on including new technologies and changing criteria.

Adding Products to the List

Named Products

Enhanced capital allowances may be claimed on investments in boilers, motors, variable speed drives and refrigerators only if the specific named product is on the Energy Technology List. It will be up to a manufacturer to apply to place its products on the List.

The manufacturer will send details of its product to the Department of the Environment, Transport and the Regions. Depending on the technology, this may be a product specification, external certification, or evidence of an appropriate internal testing procedure.

A product will become eligible for enhanced capital allowances from the date of its inclusion on the Energy Technology Products List. It is intended that the named product List should be updated on a quarterly basis.

Where a product is submitted and it is felt that the criteria are not met manufacturers can resubmit the product with further evidence. There is no limit to the number of times a product can be resubmitted.

The Carbon Trust will also audit a percentage of products as part of its quality control mechanism. Manufacturers will be notified that their product is being independently tested. The Carbon Trust will make any results available to the manufacturer. If the product meets the criteria it will be accepted for the List. If it fails to meet the criteria the manufacturer will be allowed to arrange another test with an organisation agreed with the Carbon Trust. If the product still fails to meet the criteria, the Department of the Environment, Transport and the Regions will inform the manufacturer of its intention to remove the product from the list.

Technology Standards

Most CHP, pipe insulation and lighting projects do not lend themselves to a named product List. Enhanced capital allowances will be available on investments in these technologies provided they meet prescribed energy efficiency standards.

Reviewing Criteria

- **Energy-saving** criteria ensure that the products on the List represent a significant improvement in energy performance over current standards. This is usually based on the relevant EU/UK certifying standards. Criteria will be set to cover the upper range of the efficiency distribution, taking account of the performance of individual product ranges or whole technologies.

- **Market penetration criteria** involve placing a cap on penetration so that product types will be removed from the List once established in the marketplace. Enhanced capital allowances are intended to stimulate innovation whilst allowing resources to be redirected to more deserving technologies once a technology has become standard.

- **"New" technologies** are those that either represent a significant advance on the previous generation, or that replace an existing technology with a more energy efficient alternative. Enhanced capital allowances are not intended to provide market confidence for products that have yet to be proven. However, they can be used to stimulate energy efficient technologies that have come on the market, but which have not made a major impact because of lack of knowledge or conservatism by end-users.

Updating Criteria and Technologies:

It is also proposed that the criteria will change over time and they will be reviewed annually to:

- add new technology groups that can offer real energy savings to business, which may be on the supply or demand side;
- modify the product and technology groups to keep within the scheme only those technologies which are at the forefront of energy savings, and to exclude technologies that have become standard as they penetrate the market;
- ensure the scheme remains cost-effective and within budgetary limits as new technologies are added.

The UK government undertook to notify to the Commission new technologies before including them in the list.

Form of the support: The scheme will provide support in the form of accelerated tax relief.

The scheme for enhanced capital allowances will enable businesses to take tax relief that they would be entitled to under existing law earlier than permitted under the current rules. A business will be able to write off immediately its expenditure on qualifying equipment against its taxable profits. The allowances are treated as if they were expenses of the business. They can reduce a trading profit, or create or increase a trading loss.

The scheme will build on existing statutory provisions, under which businesses may obtain tax relief, in the form of capital allowances, for their investment in machinery and plant. This relief is normally given at a rate of 25% a year on the reducing balance basis, which spreads the benefit over a number of years (about 90% of the cost is relieved in 8 years). Enhanced capital allowances will enable businesses to take relief on the full cost in the first year. The scheme will bring forward relief, so the capital allowances can be set against profits of a period earlier than would otherwise be the case.

Enhanced capital allowances will not change the overall tax liability of the business. They can reduce the business's tax bill of the year in which the investment is made. But the business will pay more tax in subsequent years because there is no balance of unrelieved expenditure carried forward to these years that could qualify for allowances.

The benefit to businesses of enhanced capital allowances comes from the deferral of tax. The maximum value of the tax deferral in net present value terms is about 6-7% of the value of the qualifying investment.

The **eligible costs** comprise expenditure incurred by the business on the provision of the particular equipment within the relevant technology class, together with direct costs related to their supply, such as installation costs.

Legal basis: Finance Act 2001.

Relationship with the Climate Change Levy (CCL)

Enhanced capital allowances operate in parallel with, and support other elements of the Climate Change Levy package, in particular the tax exemption for CHP and the tax reduction for companies entering into Climate Change agreements.

The climate change levy is chargeable from 1 April 2001 on the supply of electricity, gas, LPG and coal to any person, but excludes vehicle fuel and fuel for domestic use and use by charities. The levy is charged at prescribed rates for each source based on energy content.

The CCL legislation exempts input fuels and output power of "Good Quality Combined Heat and Power (CHP) systems". "Good quality" is defined according to a technical standard, which is also applied to define eligible CHP investments for Enhanced Capital Allowances.

The CCL legislation also reduces the tax rate for companies entering into "Climate change agreements". The enhanced capital allowances scheme does not rely on these industry sector agreements for the Climate Change Levy, nor is it conditional on the negotiated discount agreements. Under the proposals, enhanced capital allowances may be claimed by any business that invests in a technology on the List, regardless of the nature of the business or the use of the technology in that business (provided that the equipment is machinery or plant in the relevant trade). The state will exercise no discretion over who can claim the enhanced capital allowances.

Duration of aid: The scheme for enhanced capital allowances is open ended.

Under the proposals, investments can qualify for enhanced capital allowances following the publication of the Energy Technology Criteria List and the related Product List which contain details of the eligible machinery and plant. However, no claims could actually be made until the enabling legislation becomes law following its passage through Parliament. It is anticipated this will be in summer 2001.

Budget: The Government estimates that the Exchequer costs of the scheme will be about £100 million in 2001/02 and £140 million in 2002/03. These costs represent the reduction in revenue received by the Exchequer each year as a result of giving allowances earlier than they would otherwise be available. Future costs will depend on take-up and how the List evolves.

2. Assessment of the measure

The Commission assessed the existence of aid in the meaning of Article 87(1) of the EC Treaty:

The enhanced capital allowances allow companies to benefit from the deferral of tax. By this, they gain an advantage compared to the tax burden distributed in time as they would normally have to bear.
This advantage is financed by State resources insofar as the State renounces income that it normally could obtain.

The Commission assessed in particular if the measure aids certain undertakings or the production of certain goods:

1. The scheme applies in all UK, and is therefore not regionally specific.

2. The enhanced capital allowances for energy efficient investments can be claimed by all businesses, regardless of size, industrial or commercial sector, or location.

3. The scheme gives automatic rights to the companies, and excludes any discretion of the UK authorities in granting these rights.

4. The tax benefit is given for purchasing certain energy efficient technologies. The eligible technologies respectively products are defined on the basis of objective criteria, applying EU standards where they exist and otherwise national standards.

5. The technologies subject of this decision are

- lighting
- pipe insulation
- boilers
- motors
- variable speed drives
- refrigeration
- combined heat and power

The technologies listed above are not restricted by their nature for the use in specific sectors of the economy.

Enhanced capital allowances for combined heat and power systems will be available for all companies except for companies whose core business is electricity production, insofar as they use the CHP system to produce electricity to be sold to unknown end users. This restriction ensures that the support does not favour an application of CHP which may be beneficial for specific companies, namely companies active in the electricity production sector[3].

Apart from this specific use, CHP is a technology widely used in different sectors of the economy, where businesses wish to increase energy efficiency of their economic activity and the enhanced capital allowances are available for any of them.

The definition of "Good Quality CHP" which is applied in order to define CHP systems eligible for accelerated depreciation is based on objective criteria, measuring the environmental friendliness of the system. The standard does not favour CHP systems used in certain sectors in relation to others.

6. No restrictions are imposed on the source of equipment in the qualifying technology classes. The scheme is open to manufacturers world-wide, and is being publicised in the UK and abroad. The eligibility criteria for equipment are objective technical standards.

The enhanced capital allowances are therefore a general regulatory measure affecting the economy as a whole within the UK. They do not favour certain undertakings using the listed technologies and neither does the scheme favour certain producers of the eligible technologies.

The enhanced capital allowances for energy efficient investment thus are not granted to certain undertakings or to the production of certain goods.

Such a conclusion is in line with the Commission notice on the application of the State aid rules to measures relating to direct business taxation[4] and in particular its points 13 second indent and 14 last sentence.

3. Conclusion

The Commission has accordingly decided that the measure as described and assessed above does not constitute State aid according to Article 87(1) of the EC Treaty.

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[3] In the German State aid case N555/2000 (SG(2000)D/109283 of 14.12.2000), aid was given to a specific type of CHP systems, namely without heat extraction. The aid favoured a specific type of gas and steam turbine plants, being used predominantly to generate electricity for feeding into the grid. Therefore, the Commission decided that the measure constitutes State aid in the meaning of Article 87(1) of the EC Treaty.

[4] OJ C 384 of 10.12.1998, p.3.

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Yours faithfully,

For the Commission

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