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**PUBLIC VERSION
WORKING LANGUAGE**

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Subject: State aid 675/2009 – Tender for Aid for New Electricity Generation Capacity (LV)

Dear Sir,

1. PROCEDURE

1. By letter dated 2.12.2009, registered on the same day, the Latvian authorities notified the Commission that they intend to grant aid by way of tender to an undertaking for the construction and operation of new base load capacity in the form of a solid fuel/LNG thermal power plant.

2. DESCRIPTION OF THE AID

2. Latvia wants to grant aid by way of tender for the construction and operation by 2015 of a 400 MW thermal power plant running on solid fuel (coal, brown coal, peat, biomass or a mixture of these primary energy resource types) or on in Latvia regasified LNG (hereafter: Solid Fuel/LNG TPP). The aid should be granted in the form of capacity payments between 2015 and 2025. The winner of the tender will be obliged to operate the plant at least for 6000h a year.

2.1. Background and Objective

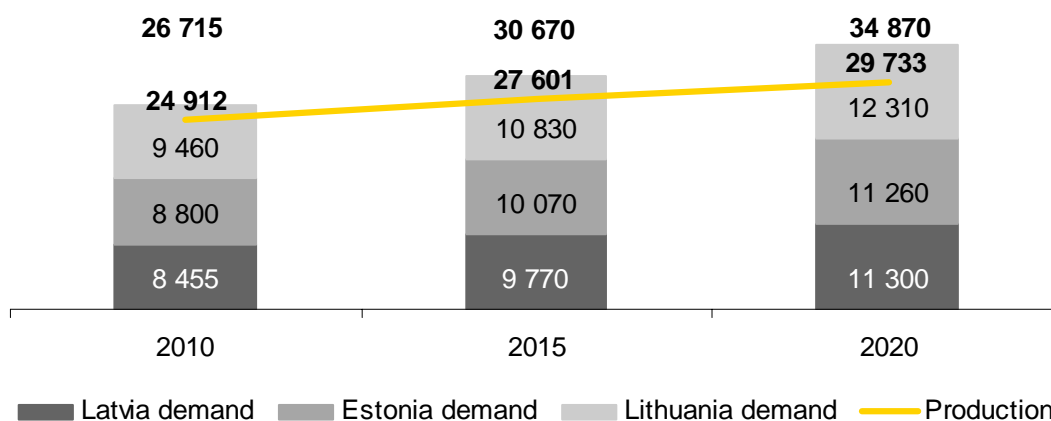
3. According to the Latvian authorities Latvia is facing an electricity supply shortage because the demand for electricity is expected to rise in a way that it might not be met by

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the available supplies at all times of the year. In that context the Latvian authorities submitted the following data in the table below which shows the increasing dependency on electricity imports as a result of an electricity generation deficit. According to the data provided the deficit will reach 1803 GWh in 2010, 3069 GWh in 2015 and 5107 GWh in 2020.

Figure 1 - Electricity consumption and production projections up to 2020 in the Baltic States (GWh)



Data source: Latvian TSO, ETSO, IAEA, Lithuanian Energy institute, OU Pohivork (data extrapolation)

4. According to the Latvian authorities two of the drivers of this generation deficit are the decommissioning of the Ignalina nuclear power plant (hereafter: Ignalina NPP) in Lithuania at the end of 2009 and the renovation of the Narva oil-shale power plant (hereafter: Narva TPP) probably as of 2016. The closure of the Ignalina NPP plant will reduce the available capacity in the Baltic region by approximately 1300 MW and the renovation of the Narva TPP will reduce the available capacity by almost 1000 MW. Latvia submits that the projections for the coming years indicate an overall growth in the available capacity but points out that this increase is not sufficient to satisfy the steeper increase in demand. Also, the information provided by Latvia shows the limited statistical validity of the consolidated annual figures. Hydro power production plays a significant role in the region. However, the installed capacity is not available at a constant rate throughout the year, but is subject to strong seasonal fluctuations depending on the water levels. At the same time demand is subject to seasonal fluctuations mostly depending on the exterior temperature. It follows that the capacity deficit is less pronounced during times of relatively high water levels and temperatures (e.g. late spring) while it is disproportionately higher than the statistical average indicates during times where low water levels coincide with low temperatures (e.g. in early winter).
5. The Latvian authorities submit that Latvia will increasingly rely on electricity imports, especially in times of peak demand. At the same time the Latvian authorities argue that Latvia is likely to face serious restrictions to imports i.a. because of the physical limitations of the existing interconnections to the neighbouring electricity markets. In that regard the Latvian authorities submit that the Baltic States, although well interconnected with each other – are rather isolated from other European Member States as can be seen from the figure below.

Figure 2 – Electricity interconnections between the Baltic States and their neighboring countries



6. The Latvian authorities explained that there are currently no significant interconnections to Poland and only a small 350 MW interconnection to Finland which faces congestion problems. Furthermore, the Latvian authorities provided information according to which Finland is a net importer of electricity herself and unlikely to have sufficient excess electricity for exports to the Baltic region in times of peak demand (e.g. in winter months). The Latvian authorities concede that there are currently projects envisaged to improve the interconnection to Finland (ESTLINK II) and to construct interconnections to Sweden (SWEDLINK) and Poland (POLINK). However, these projects are still subject to political and commercial negotiations and it seems unclear when they will materialise. The Latvian authorities further acknowledge that there are important interconnections to Belorussia and Russia. Indeed, the information provided by Latvia shows that the electricity grids of the Baltic Member States are fully integrated into the Russian north-western electricity network (so-called 'North-Western Ring'). However, the available data suggests that this network had not been initially designed for big long term imports. Therefore these interconnections are already now subject to a risk of congestion and seem to be insufficient to carry additional capacity in times of peak demand, especially in view of a possible need for increases in imports as a result of the closure of the Ignalina NPP and the renovation of the Narva TPP. Finally, the Latvian authorities submit that even if the interconnections would be sufficient, there are indications that the Russian north-western region and Belorussia are often subject to an electricity generation deficit themselves especially in winter months. The Latvian authorities argue that in such times of peak demand it cannot be excluded that Russian and Belorussian electricity

suppliers might give priority to the needs of their respective deficit regions rather than ensuring exports to meet peak demand in the Baltic region.

7. The Latvian authorities thus conclude that there is a need for the construction of additional capacity in Latvia in order to meet peak demand in the coming years. However, the Latvian authorities note that currently no investor seems prepared to make the necessary investments due to a market failure. The information provided by Latvia suggests that investors might be discouraged by the fact that the construction of a new NPP in Lithuania is envisaged for 2020 so that any investor would also face strong competition from possibly cheaper nuclear electricity as of 2020. Furthermore the Latvian authorities submit that investors might fear the seasonal competition from cheap hydro power especially in spring time when water levels are high. These circumstances might make it more difficult to operate profitably throughout the year. Finally, the Latvian authorities submitted information showing that – unlike the other EU electricity grids – the electricity grids of the Baltic Member States are fully integrated into the Russian North-Western-Ring as mentioned above. According to Latvia potential investors might be discouraged by competition from Russian or Belorussian electricity generators which are subject to different standards and produce electricity at lower prices¹. The Latvian authorities suggest that these circumstances act as a disincentive to investments in the Baltic region.
8. In view of the above the Latvian authorities submit that Latvia has to take the necessary measures to balance supply and demand in order to ensure security of electricity supply. Since the Latvian authorities consider energy efficiency and demand side management measures as insufficient to address the problem Latvia submits that a tender for the construction and operation of new capacity is the best way to ensure that the desired amount of capacity is constructed to meet the future needs for electricity supply. In order to reduce dependency on a single fuel source and to diversify the energy mix Latvia intends to grant the aid to a thermal power plant running either on solid fuel or on in Latvia regasified LNG. However, in case of the construction of a solid fuel thermal power plant at least 10% of the total volume of the energy resources utilised (expressed in tonnes) shall be biomass.

2.2. National Legal Basis

9. According to the Latvian authorities the national legal basis of the tender is laid down in Article 23 of the Latvian Electricity Market Law. The Latvian authorities submit that the Latvian Electricity Market Law implements Directive 2001/77/EC², Directive 2003/54/EC³, Directive 2004/8/EC⁴ and Directive 2005/89/EC⁵. According to the Latvian

¹ See IAEA, Analysis of Energy Supply Options and Security of Energy Supply in the Baltic States (hereafter: IAEA Analysis of Energy Supply Options and Security of Energy Supply in the Baltic States), February 2007, p. 132 (Figure 5.7) and p.133 (Table 5.16), available at: http://www.iaea.org/OurWork/ST/NE/Pess/assets/TE_1541_balticstudyFeb07.pdf, last visited 21.12.2009.

² Directive 2001/77/EC of the European Parliament and of the Council of 27 September 2001 on the promotion of electricity produced from renewable energy sources in the internal electricity market, OJ L283, 27.10.2001, p.33.

³ 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 L176, 15.7.2003, p.37 (hereafter: Directive 2003/54/EC).

⁴ Directive 2004/8/EC of the European Parliament and of the Council of 11 February on the promotion of cogeneration based on a useful heat demand in the internal energy market and amending Directive 92/42/EEC, OJ L52, 21.2.2004, p.50.

⁵ Directive 2005/89/EC of the European Parliament and of the Council of 18 January 2006 concerning measures to safeguard security of electricity supply and infrastructure investment, OJ L33, 4.2.2006, p.22 (hereafter: Directive 2005/89/EC).

authorities the tender will be carried out on the basis of specific regulations adopted by the Latvian Cabinet of Ministers on 22 December 2008 for the purpose of this tender.

2.3. Beneficiaries

10. The beneficiary will be selected through a competitive bidding process. According to the Latvian authorities the grant will be awarded on the basis of the cheapest offer, i.e. the Latvian authorities intend to choose the applicant requiring the least amount of aid. However, the Latvian authorities submit that tender rules also require i.a. previous experience in conventional plant construction and operation in order to ensure a smooth and effective construction and operation of the plant, i.e. applicants have to prove experience in the construction and operation of solid fuel or LNG fired power plant in at least one State being member of the EU, EFTA or the WTO. Since there are currently no incumbent Baltic electricity companies fulfilling this criterion, the Latvian authorities submit that this will enable another significant market player to enter the Latvian electricity market.

2.4. Budget

11. The Latvian authorities submit that the budget of the aid will be determined through the competitive tender. It should be noted that it is difficult to make reliable assumptions with regard to the main economic parameters of the project. In particular, the development of the world price for coal, the ETS costs for carbon and the Baltic market price for electricity between 2015 and 2025 are subject to many uncertainties. In view of the above the Latvian authorities submitted that the aid could vary between [...] and [...] annually and between [...] and [...] over ten years, depending on the assumptions of the applicants with regard to the different parameters mentioned above. However, the Latvian authorities submit that an open and transparent tender will ensure that the bidders minimise the amount of aid, i.e. bidders will require no more than what is needed to recover their investment plus the usual profit margin in this sector. Furthermore, the Latvian authorities submit that the aid will stop as soon as the investors' electricity price exceeds the base load electricity price of another solid fuel dominated electricity market for two consecutive years. This should avoid overcompensation in a situation where the price levels are high enough to recover the investment without the aid. The Latvian authorities suggest that the price level of the German European Energy Exchange (EEX) is a suitable reference for a solid fuel dominated electricity market. In any case the Latvian authorities submit that the tendered aid amount will not be changed in the retrospect in case the economic parameters (including the ETS costs) have been underestimated by the beneficiary.

2.5. Aid Instrument and Funding

12. The support will be granted to the beneficiary in the form of a direct grant. The aid will be paid in monthly tranches. The Latvian authorities submit that once the beneficiary is chosen the granting of the aid will be subject to a number of conditions. In particular, the aid will be subject to deductions if the beneficiary fails to provide the agreed minimum capacity of 6000 h annually to the market. According to the information provided the aid will not be financed through the general budget of the State, but through an increase in the transmission service tariffs. Thus the costs will be covered by Latvian transmission system users through parafiscal charges which the TSO will attribute to the beneficiary. However, the Latvian authorities submit that the TSO is owned by the State since it is a

* Covered by the obligation of professional secrecy.

100% subsidiary of the State owned electricity utility (AS Latvenergo). Furthermore, the rules and conditions of the cost inclusion in the transmission tariffs for the consumers as well as the rules and conditions of the payments to the beneficiary are set up by the State.

2.6. Duration

13. As to the duration of the measure the Latvian authorities submit that the aid will be granted from 30 June 2015 until 30 June 2025. According to the Latvian authorities the aid will be subject to deductions if the capacity is brought into operation later than 30 June 2015. Furthermore, if the aid is brought into operation later than the 31 December 2016, the investor loses the right to receive the payments. The Latvian authorities further submit that the aid will be granted to the investor no longer than until 30 June 2025. Moreover, the Latvian authorities explained that the Tender Regulation lays down detailed rules and conditions according to which the payments may be terminated or reduced earlier. In accordance with the Tender Regulation the payments will be reduced if the beneficiary produces less than the required 6000h/ year at 400 MW or even terminated if the beneficiary produces less than 4000h/ year at 400 MW. Furthermore, the aid will stop if the investors' electricity price level exceeds the base load electricity price of the EEX for two consecutive years.

2.7. Cumulation

14. With regard to cumulation the Latvian authorities submit that the aid cannot be cumulated with additional aid received from other local, national or EU schemes (e.g. Structural Funds) to cover the same eligible costs.

3. ASSESSMENT

15. The Commission has examined the proposed amendment in accordance with Article 107 et seq. TFEU⁶ and Article 61 et seq. EEA Agreement⁷ and has decided not to raise objections to its implementation.

3.1. Presence of State Aid Pursuant to Article 107(1) TFEU

16. The aid for the construction and operation of the envisaged Solid Fuel/LNG TPP constitutes State aid within the meaning of Article 107(1) TFEU.
17. A measure constitutes State aid under Article 107(1) TFEU if it fulfils four conditions. Firstly, the measure is funded by the State or through State resources. Secondly, the measure confers an advantage to the recipients. Thirdly, the measure favours selected undertakings or economic activities. And fourthly, the measure affects trade between Member States and distorts or threatens to distort competition in the internal market.
18. In the case at hand it can be noted that the aid is funded through a parafiscal levy imposed by the State controlled transmission system operator on the consumers. The Latvian authorities indicated that the aid might not constitute State aid because the funds are channelled from the consumers through the TSO to the beneficiary without passing

⁶ With effect from 1 December 2009, Articles 87 and 88 of the EC Treaty have become Articles 107 and 108, respectively, of the Treaty on the Functioning of the European Union (hereafter: TFEU). The two sets of provisions are, in substance, identical. For the purposes of this Decision, references to Articles 107 and 108 of the TFEU should be understood as references to Articles 87 and 88, respectively, of the EC Treaty where appropriate.

⁷ The following assessment is based on both the TFEU and the EEA Agreement, but for reasons of simplification, in the following assessment it will only be referred to the TFEU provisions.

through the State budget. However, the Latvian authorities submitted that the TSO is owned by the State since it is a 100% subsidiary of the State owned AS Latvenergo. Furthermore, the rules and conditions of the cost inclusion in the transmission tariffs for the consumers as well as the rules and conditions of the payments to the beneficiary are set up by the State. The funds are thus controlled by and imputable to the State and therefore constitute State resources⁸. The beneficiary will also gain a competitive advantage which he would not have obtained under normal market conditions. This advantage consists not only in the actual payments received but also in the possibility to make a profit that goes beyond a mere compensation. This could be the case where the electricity prices in Latvia rise above the beneficiary's net production costs (i.e. the costs of production plus a reasonable profit minus the capacity payments)⁹. For these reasons, while the tender is generally capable of ensuring that the amount of aid is minimised, in the particular case at hand it cannot be excluded that there might be an advantage. The aid can therefore be considered to constitute an advantage for the winning bidder. Furthermore, the aid is selective since it is only granted to the winner of the tender. Finally, the aid has the potential to affect the trade between Member States and to distort competition because the beneficiary will be active in the production of electricity, i.e. a sector where trade between Member States takes place. The support granted to the beneficiaries thus constitutes State aid pursuant to Article 107 (1) TFEU.

3.2. Legality of Aid

19. By notifying the measure before its implementation, the Latvian authorities have fulfilled their obligation according to Article 108 (3) TFEU. Any disbursements will only be made after the authorisation of the notified measure by the Commission.

3.3. Compatibility of the Aid with Article 107 (3) (c) TFEU

20. Since the measure does not fall within the scope of the Environmental Aid Guidelines¹⁰, the Commission has assessed the aid directly under Article 107 (3) (c) TFEU. This provision states that "*...aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest...*" may be considered to be compatible with the internal market.

3.3.1. Analysis

21. In order to be compatible under Article 107 (3) (c) TFEU, an aid must pursue an objective of common interest in a necessary and proportionate way. In this regard, the Commission considers it appropriate to assess the following criteria:
 - (1) Is the aid measure aimed at a well-defined objective of common interest (i.e. does the proposed aid address a market failure or another objective of common interest)?

⁸ Case C-482/99, French Republic v Commission (Stardust Marine), 16.5.2002 [2002] ECR I-04397.

⁹ In this context it should be noted that the case at hand differs from a previous case (Case N475/2003 – Ireland - Public service obligation in respect of new electricity generation capacity for security of supply, 16.12.2003, OJ C34, 7.2.2004, p.8.), in which the Commission found that aid for electricity generation capacity could under certain circumstances fulfil the so called Altmark criteria as developed by the European Court of Justice (Case C-280/00, 'Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH', 23.7.2003 [2003] ECR I-07747). However, contrary to the Irish case which was restricted to the support of peak capacity, the present measure also encompasses support of normal capacity.

¹⁰ Community Guidelines on State Aid for Environmental Protection, OJ C82, 1.4.2008, p.1.

- (2) Is the aid well designed to deliver the objective of common interest? In particular:
- (a) Is the aid measure an appropriate instrument, i.e. are there other, better-placed instruments?
 - (b) Is there an incentive effect, i.e. does the aid change the behaviour of firms?
 - (c) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?
- (3) Are the distortions of competition and the effect on trade limited, so that the overall balance is positive?

3.3.2. Security of Supply as an Objective of Common Interest

22. The aid measure has to aim at a well-defined objective of common interest. An objective of common interest is an objective which has been recognised by the EU as being in the common interest of the EU Member States. According to Directive 2005/89/EC¹¹ "*(t)he guarantee of a high level of security of electricity supply is a key objective for the successful operation of the internal market ...*" Moreover, 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 common interest. It can thus be concluded that security of electricity supply is well defined objective of common interest. The Commission notes that the same benefits regarding security of supply could also be guaranteed by the same measure but leaving more flexibility on the combination and type of generation capacity (eg other energy sources, diversified capacity mix) to be granted State Aid.

3.3.3. Evidence of a Risk to Security of Supply

23. Aid can only be granted if there is evidence of a risk to a Member States security of supply. According to Directive 2005/89/EC "*'security of electricity supply' means the ability of an electric system to supply final customers with electricity*"¹². In that regard the Latvian authorities provided information on substantial risks to the ability of the Latvian electric system to supply final customers with electricity. The Latvian concerns relate to, the actual supply deficit and the high dependency on non-stockable fuels (i.a. natural gas)

Growing Demand Not Met by Expected Available Supplies

24. Firstly, the Latvian authorities provided information according to which the increasing demand for electricity in the Baltic States will not be met by the future available supplies in that region. The data provided by the Latvian authorities shows that the Baltic States are physically well interconnected amongst each other, but separated from the neighbouring European Member States for lack of physical interconnections. The effective isolation of the Baltic region has been repeatedly recognised by the

¹¹ Recital 1 of Directive 2005/89/EC.

¹² Article 2 (b) of Directive 2005/89/EC.

Commission, most recently in the Second Strategic Energy Review¹³, the Baltic Energy Market Interconnection Plan¹⁴ and in the European Economic Recovery Plan¹⁵.

25. According to the information provided the demand for electricity in the Baltic region will rise considerably from 26715 GWh in 2010 to 30670 GWh in 2015 and to 34870 GWh in 2020. At the same time production will only increase marginally from 24912 GWh in 2010 to 27601 GWh in 2015 to 29733 GWh in 2020. This results in an excess demand of 1803 GWh in 2010, 3069 GWh in 2015 and 5137 GWh in 2020 on an annual basis. However, the consolidated annual figures are of limited statistical validity. The installed hydro power capacity is subject to strong seasonal fluctuations depending on the water levels while the demand is subject to seasonal fluctuations mostly depending on the exterior temperature. Therefore the actual capacity deficit is not equally spread through the year but rather disproportionately higher than the annual figures indicate when low water levels coincide with low temperatures (e.g. in winter months).
26. At the same time the Latvian authorities showed that it will be difficult to cover the excess demand with imports from other European Member States. The only significant connection between the Baltic States and other European Member States is the above mentioned 350 MW cable connecting Estonia with Finland (ESTLINK). Even though this cable could in theory provide a considerable amount of electricity to the Baltic region, the interconnection does not suffice to meet the expected growth in demand on an annual basis and even less so on a seasonal basis when high demand coincides with low hydro production as described above. Moreover, the Commission is aware of the recent outage of Estlink which demonstrates possible risks with regard to the reliability of such interconnections¹⁶. Finally, even if the interconnection would be sufficient, the information provided shows that Finland is unlikely to generate sufficient excess electricity to cover the excess demand of the Baltic States.
27. The other option for the Baltic States would be to cover the excess demand through electricity imports from Russia or Belorussia. In this context it can be noted that the electricity grids of the Baltic Member States are physically integrated into the Russian controlled 'North-Western-Ring'. However, the available data suggests that this network had not been initially designed for big long term imports and therefore the cross sections are often loaded at the maximum which reduces the reliability of the entire system, increases the number of occasions of emergency reserve activation as well as the risk of blackouts. The expected load growth in the Baltic area could result in these limitations becoming increasingly critical for the reliability of supply in the Baltic States. Furthermore, the information provided suggests that the total installed capacity in Russia might significantly decrease until 2020 due to plant age. Furthermore, Latvia provided information according to which in case of a deficit in the north-western region of Russia or in Kaliningrad it cannot be excluded that priority might be given to cover the needs of these regions rather than to cover the demand in the Baltic States.
28. It can thus be concluded that Latvia is subject to considerable risks to its security of electricity supply, because the expected increase in demand might not be met by the expected available supplies.

¹³ See Communication from the Commission on the Second Strategic Energy Review (An EU Security and Solidarity Action Plan), 13. November 2008, COM(2008)781.

¹⁴ See Memorandum of Understanding on the Baltic Energy Market Interconnection Plan, signed by, Denmark, Germany, Poland, Finland, Sweden, the Baltic States and the Commission on 17 June 2009, available at: http://ec.europa.eu/energy/infrastructure/doc/2009_bemip_mou_signed.pdf (last visited 5 November 2009).

¹⁵ See Regulation (EC) No 663/2009 of the European Parliament and of the Council of 13 July 2009 establishing a programme to aid economic recovery by granting Community financial assistance to projects in the field of energy, OJ L 200, 31.7.2009, p. 31.

¹⁶ Platts European Power Daily, Volume 11, Issue 223, 17 November 2009, p.9.

High Dependency on Non-Stockable Energy Supplies

29. Moreover, the Latvian authorities submit that Latvia lacks the diversification necessary to ensure an adequate level of security of supply since she will be increasingly dependent on direct electricity imports as well as on imports of gas for the production of electricity from one single source of energy. According to the information provided by the Latvian authorities the electricity produced from gas almost exclusively imported from Russia accounted for more than 15% of the annual Baltic electricity consumption in 2007. The dependency on gas as a dominant fuel source for electricity production was until now balanced by oil-shale electricity production (approximately 45% of annual consumption), nuclear electricity production (approximately 35% of the annual production) and hydro electricity production (approximately 10% of annual consumption). However, with the decommissioning of the Ignalina NPP the missing capacity is likely to be replaced by Lithuanian gas fired power plants dependent on fuel imports from Russia. On the basis of these figures the dependency on gas as the dominant fuel source for electricity production could under unfavourable conditions increase to more than 45% on an annual basis and approximately 50% in peak times. Furthermore, with the expected growth in demand and the envisaged refurbishment of the Estonian Narva TPP as off 2016 the dependency on gas for electricity production can be expected to rise further. The dependency on one single source for gas has been criticised in the past i.a. by the International Atomic Energy Agency (hereafter: IAEA) as a threat to the security of supply of the Baltic States¹⁷. It follows that the situation of the Baltic region in general and the situation of the Latvian electricity market in particular seem quite specific in terms of security of supply compared to other European Member States.

Conclusion

30. It can be concluded that in view of the information provided by the Latvian authorities there is a risk to the Latvian security for energy supply.

3.3.4. Market Failure

31. In a liberalised market, the market forces should normally provide the necessary incentives for private investors to build sufficient capacity in order to cover the expected increases in demand. In general terms, the price mechanism is the way that this is expected to be achieved in a competitive market. As prices rise investment will become viable and either more capacity will come on stream, or demand will be constrained. Thus, in order to justify the granting of State aid Member States have to demonstrate that these market incentives do not work and that the lack of capacity is due to a structural market failure which cannot be repaired by other means. In that respect the Latvian authorities provided information indicating that in the particular case at hand the market forces are insufficient to create the necessary incentives for investors to build the capacity needed.

Unwillingness of Investors to Invest

32. According to the information at hand the Latvian electricity market should under normal market circumstances provide for sufficient incentives to invest into new capacity to cover the expected demand. According to the Latvian authorities Latvia has implemented the respective EU directives regarding the liberalisation of the electricity market and there are no legal and administrative barriers preventing new market players from entering the Latvian electricity market. Furthermore, the Latvian authorities provided information according to which the need for new capacity is well documented and widely known. However, these circumstances have not been sufficient to incentivise investors to build the additional capacity needed.

¹⁷ IAEA Analysis of Energy Supply Options and Security of Energy Supply in the Baltic States, p. 6.

Constraints

33. Latvia suggests that certain circumstances discourage investors to actually construct additional capacity. The information provided by the Latvian authorities suggests that any potential investor in the Baltic market is likely to face at least the following three constraints which individually or collectively seem to threaten investors' ability to recover their investment and make a reasonable profit within the lifetime of the investment.
34. Firstly, investors face an 'annual' time constraint in the sense that they might only have a few years to recover the costs of their investment. If the construction of the envisaged Solid Fuel/LNG TPP would start in 2010 it is not likely to go on-stream before 2015. But already from 2018 on the plant might face competition from cheap nuclear electricity provided by the newly built Lithuanian NPP. In such a scenario the investor would de facto only have 5 years to recover his investment until he would face strong competition from possibly cheaper nuclear energy.
35. Moreover, investors seem to face a 'seasonal' time constraint because of the competition from cheap hydro power during certain periods of the year, especially in spring time when Latvian hydro power plants run at their optimum capacity providing the Latvian market with significant amounts of cheap hydro power. During the summer time the water levels sink and the production of electricity from hydro power decreases accordingly. In autumn and winter the water levels tend to increase until they reaches its peak in the following spring again. As a result any potential investor can only be sure to recover his costs at an optimum rate during the summer period while cheaper hydro power weakens his competitive situation in autumn and winter and seriously threatens it in spring time.
36. Besides, unlike the other EU electricity markets, the electricity grids of the Baltic Member States are fully integrated into the Russian North-Western-Ring and some of the data provided suggests that potential investors might be discouraged by competition from Russian or Belorussian electricity generators which produce electricity at lower prices¹⁸.

Conclusion

37. Thus, in view of the special circumstances described above, market forces do not seem sufficient to provide the necessary incentives for potential investors to invest in new electricity capacity.

3.3.5. Appropriate Instrument

38. The aid granted must be an appropriate instrument to achieve the envisaged level of security of supply. An instrument is appropriate if there are no other less distortive instruments to achieve the same results. Directive 2003/54/EC provides for two options to ensure security of supply in the case of a market failure¹⁹. Firstly, Member States can take demand side measures by energy efficiency/demand-side management measures. Secondly, Member States can tender for new capacity. As a general rule Member States should focus on energy- efficiency/demand-side measures to cover their demand because these instruments are usually less distortive. Only if these options are not capable of achieving the necessary level of security of supply, should the Member State turn to supply-side measures²⁰.

¹⁸ Latvia provided information according to which electricity prices in Russia are significantly lower than in the EU, partly due to lower prices for primary energy fuels (see IAEA Analysis of Energy Supply Options and Security of Energy Supply in the Baltic States, p. 132 (Figure 5.7) and p.133 (Table 5.16).

¹⁹ Art. 7 (1) of Directive 2003/54/EC.

²⁰ See Case N475/2003 – Ireland - Public service obligation in respect of new electricity generation capacity for security of supply, 16.12.2003, OJ C34, 7.2.2004, p.8.

Energy Efficiency/Demand Side Management Measures

39. Member States should look into the options of taking the appropriate energy efficiency/demand side management measures to improve their security of supply situation before promoting the construction of new capacity²¹. In that respect the Latvian authorities pointed out that suitable energy efficiency/demand side management measures in Latvia are essentially limited to improving the effectiveness of heat supply systems and promoting energy efficiency of public housing. This, however, would merely reduce the production of heat in CHP plants which would in turn tend to lead to less production of electricity in these plants. Furthermore, the Latvian economy is still in the process of catching up with the European average and this process seems to make a certain growth in energy demand inevitable. Energy efficiency/demand side management measures are therefore not sufficient to ensure security of supply in the special situation of Latvia.

Solid Fuel or LNG as Fuel Choice

40. The data provided further shows that the low level of diversification is a cause for concern in the Baltic region²². In this context the IAEA specifically encouraged the construction of a solid fuel/LNG fired TPP for the case of Latvia²³. It can be noted that LNG regasified in Latvia as well as coal and/or biomass are fuel sources that would meet the Latvian need to diversify her energy imports and to reduce dependency on a single dominant supply source, whilst including, to the extent possible in view of the security of supply objective, an environmental component²⁴.

Conclusion

41. It can therefore be concluded that the tendering for the construction of new capacity in the form of a Solid Fuel/LNG TPP is the appropriate instrument to address the market failure and ensure security of electricity supply.

3.3.6. Incentive Effect

42. The aid granted to the beneficiary must provide for the necessary incentive effect. State aid provides an incentive effect if the aid changes the recipients' behaviour towards reaching the objective of common interest. The Latvian authorities provided credible information according to which currently no investor would build the necessary capacity without the aid²⁵. In particular it should be noted that the investment risks being unprofitable without the aid due to the strong competition from cheap hydro electricity, from Russian electricity imports as well as possibly from cheaper nuclear electricity as soon as the new Lithuanian NPP is constructed²⁶. It can therefore be concluded, that the envisaged aid is suitable to overcome these concerns and is thus capable of influencing investors in a way that they will build the required capacity.

²¹ European Commission, Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Natural Gas – Measures to Secure Electricity Supply, 16.1.2004, p. 7 et seq., available at http://ec.europa.eu/energy/gas_electricity/interpretative_notes/doc/implementation_notes/security_of_electricity_supply_en.pdf, last visited 19.11.2009 (hereafter: Note on Measures to Security of Supply).

²² See paragraph 29 above.

²³ IAEA Analysis of Energy Supply Options and Security of Energy Supply in the Baltic States, p. 10 (Table S.1).

²⁴ With regard to LNG the Commissions Second Strategic Energy Review notes at p.5 that sufficient LNG capacity is '*... particularly important for Member States currently overwhelmingly dependent on a single gas supplier*'. With regard to coal the same document notes at p.14 that coal '*...remains an essential component of Europe's domestic energy supply (...). It is available in large quantities from numerous suppliers around the world, and it can be relatively easily stored*' (see Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Second Strategic Energy Review, An EU Energy Security and Solidarity Action Plan, 13.11.2008, COM(2008) 781 final).

²⁵ See paragraphs 32 et seq. above.

²⁶ See paragraphs 32 et seq. above.

3.3.7. Proportionality

43. A State aid measure is proportional if the aid as such is kept to the minimum and if the beneficiaries are selected in a non-discriminatory, transparent and open process.

Selection Process

44. The Latvian authorities provided sufficient information according to which the selection process is non-discriminatory, transparent and open. In particular, the Latvian authorities submitted, that the tender procedure complies with the relevant EU provisions (e.g. participants of the tender are not discriminated based on their place of establishment; requirements put forward in the tender regulations are not such as to favour only particular bidders, etc.) and will be in line with the procedures provided by Directive 2003/54/EC, Directive 2005/89/EC and Directive 2004/17/EC. Furthermore, it can be noted that there are no indications of non-transparent or discriminatory behaviour. It can thus be concluded, that the selection process will be non-discriminatory, transparent and open.

Aid limited to the Minimum

45. The Latvian authorities provided sufficient information on how the amount of aid granted will be kept to a minimum. As shown above, the aid will be granted to the beneficiaries in a genuinely competitive bidding process on the basis of clear, transparent and non discriminatory criteria. It can thus be concluded that the aid will – a priori – be limited to the minimum. Also, the Latvian authorities confirmed that the amount of the aid will be under constant monitoring and subject to reduction or complete cessation as soon as particular market conditions which render the aid no longer necessary are attained (i.e. certain price level of the electricity in Latvia is reached). It can therefore be concluded that the Latvian authorities provided sufficient information to the extent that the aid will be kept to a minimum.

Conclusion

46. In view of the above it can thus be concluded that the envisaged measure is proportional, since the selection process is non discriminatory, transparent and open and the aid is limited to a minimum.

3.3.8. Distortion of Competition and Trade and Balancing

47. The distortion of competition and trade resulting from the State aid should be limited, so that the overall balance with regard to the objective of common interest is positive.

Distortion of Competition and Trade

48. With regard to the distortion of competition it should be noted that the granting of the aid will constitute a financial advantage for the beneficiary as compared to his competitors. Such an advantage is particularly distortive where it keeps inefficient firms afloat or where it reinforces existing market power and encourages exclusionary behaviour. In that regard it can be noted that the Latvian authorities submitted that the tender requires applicants i.a. to provide a sound financial background and to have experience in the construction and operation of a solid fuel or LNG fired power plant in at least one State being member of the EU, EFTA or the WTO. The Latvian authorities note that currently none of the players in the Baltic region fulfil these criteria so that the tender will bring a new player to the Baltic region. Furthermore the envisaged capacity of 400 MW is rather limited. According to the information provided the newly constructed capacity will bring an additional 4% of generation capacity to the Baltic region that will account for approximately 8% of the actual electricity generation in that area. Compared to the respective market shares of the three Baltic incumbents the new player will have rather

small role in the Baltic region. Finally, it should be noted that the financial aid is kept to the minimum through the competitive selection process.

49. With regard to the effects on trade it should be noted that – from a general point of view - the consequences of launching a tender in peripheral markets will tend to be more limited to the national markets while the launching of a tender in a non-peripheral Member State does not only cause an intervention on the market in the country in question, but might also lead to disparities on the internal market regarding Member States that rely on different measures to ensure security of supply. In that regard it can be noted that the Latvian electricity market can be described as a peripheral market due to its geographical isolation. The effects of the measure on the trade of electricity between Member States are more or less confined to the effects on the trade with Latvia's Baltic neighbours, Estonia and Lithuania. For these reasons the distortion of competition and the effect on trade resulting from the tender will be limited.

Balancing

50. The overall balance of the aid measure is positive. As described above the distortion of competition and the effect on trade is limited. On the other hand the aid measure will increase the level of security of supply. Furthermore, the aid will also bring more competition to the Baltic region, both by supporting a new generator as well as by promoting a new fuel type. Should the tendering result in building a power plant fuelled by fossil fuel such as coal, then this could be regarded arguably as not being in line to EU Climate Change policies and objectives. However, the exceptional situation Latvia is facing in terms of energy security of supply affected by e.g. isolated position and dependency in Russian imports has been taken into account. Furthermore, the Latvian authorities have confirmed that the aid mechanisms do not further interfere with other market based instruments providing incentives for lowering carbon emissions and thus e.g. ETS costs cannot be ex-post compensated by additional state aid, even if they would eventually be higher than expected during the bidding process. In view of the above the Commission finds that the negative effects of the measure on competition and trade are outbalanced by the positive effects of the aid so that the overall balance of the measure is positive.

3.3.9. Conclusion

51. It can thus be concluded that the aid for capacity payments for the construction and operation of the envisaged Solid Fuel/LNG TPP is compatible with Article 107 (3) (c) TFEU.

4. DECISION

52. The Commission has accordingly decided not to raise objections to the notified measure, because the aid can be found compatible with the internal market in accordance with Article 107 (3) (c) TFEU and Article 61 (3) (c) of the EEA Agreement.
53. The Commission reminds the Latvian authorities that, in accordance with Article 108 (3) TFEU, plans to refinance, alter or change this aid have to be notified to the Commission pursuant to provisions of the Commission Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty (now Article 108 TFEU) (OJ L 140, 30.4.2004, p.1).

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State Aid Greffe
B-1049 Brussels
Fax No: (0032) 2-296.12.42

For the Commission

Neelie KROES
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