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WORKING LANGUAGE

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**Subject: State aid N 56/2009
Aid for modernisation and replacement of electricity distribution networks
in Poland**

Excellency,

The Commission wishes to inform Poland that, having examined the information supplied by your authorities on the matter referred to above, it has decided to raise no objections to the aid measure.

I. PROCEDURE

1. By electronic notification of 03 February 2009, the Republic of Poland notified, the above-mentioned measure. The Commission asked additional information by a letter of 03 April 2009. Polish authorities submitted the requested information by letter registered on 06 May 2009 and by a letter registered on 19 June 2009.

II. DESCRIPTION OF THE MEASURE

2. The aid will be granted for modernisation and replacement of electricity distribution networks with the aim to reduce energy losses, which in Poland constitute almost 10% of gross energy generated. In absolute terms, in 2004 these losses amounted to 14 264 GWh of electricity, which is equivalent to continuous operation of a power station with a

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capacity in excess of 1600 MW at full attainable power for an entire year. By comparison for the West-European countries of the European Union, in 2003 the total electricity losses in the grid were, in absolute terms, about 150 TWh annually, which was 6.5% of total electricity demand. If grid losses in Poland could be reduced to a level of 6.5%, energy savings of the order of 5000 GWh annually would be achieved, which could be translated into a cutback of 4,328,400 tonnes of CO₂ emissions.

3. The aid is addressed to projects where, the greatest limitation of grid losses in electricity grids can be achieved, namely by replacing low-energy-efficiency transformers (providing a ca. 40-50% reduction in losses at such installations, depending on the condition of the replaced transformer and the type of new transformer), shortening very long stretches of line (by about 5-30%, depending on the voltage, the length of the line and its loading) and changing the cross-section of conductors to adapt them to current grid operating temperatures (by about 20%).
4. The projects receiving support will be chosen on the basis of open competitions ensuring most efficient value for money i.e. the most important criteria for project selection will be the amount of units of saved energy and the costs of saving one MWh of energy¹.
5. The potential beneficiaries of the scheme competing for aid will be the 14 regional electricity distribution network operators in Poland (DSOs). Out of the 14 regional DSOs, two are private companies and 12 are state-owned² and belong to state capital groups. The two private operators are RWE Stoen Operator S.A. and Vattenfall Distribution Poland S.A.
6. The 14 DSOs own the grids and operate as natural monopolies on the basis of concessions and are responsible by law for all losses of energy at the networks. The networks are open without discrimination to all producers of electricity by law. The DSOs do not carry on activities relating to the generation and sale of electricity but only to distribution of electricity. There is a legal unbundling of distribution networks in case operators are vertically integrated companies producing and distributing electricity i.e. network operators are operationally (i.e. in decision making process), organizationally and legally separated from companies trading or producing electricity. Due to regional separation the DSOs do not compete with each other. The consumers can therefore choose their electricity supplier; however cannot choose the distribution company.
7. Electricity distribution in Poland is regulated by concessions given by the national and independent Energy Regulator Office (ERO) to the operators. The concession fee is 0.0004% of the revenues of the preceding year of operators. The concessions can be annulled basically in cases when the operator is breaking the conditions of the concession or in cases of bankruptcy, division or mergers of the company. In case the network operator wishes to sell its network it needs to inform the ERO at least 18 months before it sells the network.

¹ The decision to select a project is based on fulfilling formal requirements and a number of points based on the following criteria with corresponding weights: readiness of the project (points 0-4, weight 4), reduction of energy losses (points 0-4, weight 4), costs of saving 1 MWh of energy (points 0-4, weight 3), project realised in the regions of eastern Poland where the infrastructure is in the worst shape (points 0-2, weight 1). The maximum points available for the amount of saved energy and the costs of saving energy are 28 whereas all other criteria amount to 18.

² The 12 non-privatised undertakings are part of capital groups: eight of PGE Polska Grupa Energetyczna S.A., two of Tauron Polska Energia S.A., one of ENERGA S.A. and one of ENEA S.A

8. The concession obliges companies to provide electricity in line with the rules specified in the Energy Law of 10.04.1997³, in particular providing undisrupted and high quality services for the smallest costs and respecting other legal regulations including those related to environment. Operators are subject to fines if they do not maintain the networks in required technical shape. Operators are required to estimate the fulfilment of these obligations and to report on current demand and forecast future demand for electricity in annual reports. These reports are verified each year by the ERO.
9. The distribution networks operators are required to ensure non-discriminatory access to the electricity distribution networks for all companies allowed producing or supplying electricity in Poland. The DSOs operators being within the structure of vertically-integrated undertakings, should, in terms of legal and organisational form and decision-making, remain independent of other activities not linked to electricity distribution in particular it should remain independent in terms of legal and organisational form and decision-making. Each year the Chairman of the ERO tests and monitors the degree of independence of DSOs and the equal treatment of vendors and customers.
10. The prices for distribution of electricity are tariffs entirely regulated by ERO and need its approval every year. The tariffs cover all running costs of companies distributing or transmitting electricity including costs of depreciation, modernisation and development of the networks, as well as costs of energy losses resulting from distribution of electricity. These costs are established on the basis of the amount of electricity ordered and sold.
11. Factors taken into account when setting tariffs (and their respective weights in 2008) are the following:
 - 1) Costs of purchasing services from transmission operator (35%)
 - 2) Operating costs (25%)
 - 3) Depreciation (15%)
 - 4) Capital value (10%)
 - 5) Energy losses (10%)
 - 6) Real estate tax (5%)
12. Tariffs cover as well a justified return on engaged capital of the operators. The ERO applies in respect to 14 DSOs comparative methods of evaluation of efficiency of operators carrying out the same business activities in similar conditions. The return on capital is not established on market terms but reflects investment needs necessary to operate the network. In practice the return on capital is calculated on the basis of the operators net assets increased by the investments and decreased by depreciation. Therefore the revenues of the operators do not directly depend on the level of rates or amount of electricity transmitted.
13. The DSOs or TSO cannot sell their services on market terms, for instance by selling access to the network at a non-regulated price to a producer of electricity. Investments costs for distribution of electricity cannot include costs of connecting new clients because the connection of new clients is regulated by separate tariffs and separate regulations and is not subject to the notified measure.

14. The aid is financed from Structural Funds under the Operational Programme Infrastructure and Environment 2007-2013, task 9.6. The maximum aid intensity for supported projects, from all sources of financing, will be 85% of the so called "financial gap" applicable to all projects financed from Structural Funds as laid down in the Structural Funds Regulation⁴. This method limits the aid to 85% of investment costs minus all foreseeable revenues resulting from operating the infrastructure after investment. The Regulation requires that the eligible expenditure on revenue-generating projects shall not exceed the current value of the investment cost, less the current value of the net revenue from the investment over a specific reference period for investments in infrastructure or other projects where it is possible to objectively estimate the revenues in advance. In other words the aid shall be limited to these costs of the project which are not possible to be financed from the revenues resulting from implementing of the project.
15. On the basis of the principles of "financial gap", Poland approved very detailed Guidelines for beneficiaries on how the funding gap needs to be calculated in respect to the aid under the scheme. In the notified scheme Polish authorities explained that the aid will not be regarded as engaged capital. Therefore the aid will not generate additional revenues for beneficiaries in terms of return of engaged capital. The aid is expected just to have an impact on the costs of operating the infrastructure; it will reduce costs of investments that the operators would need to undertake to maintain the network and limit energy losses and it will increase some like depreciation and property tax.
16. All calculations are done assuming that lifetime of the project is limited to its economical use i.e. its depreciation⁵.
17. As all revenues of DSOs are regulated, this is so-called regulated revenue approved by the Energy Regulatory Office. The level of this revenue is determined on an annual basis, based on plans for the tariff year and results for previous years. Due to the above, results determined in the ex-ante regulated revenue are regulated in subsequent tariff years. When the project implemented by the beneficiary generates the revenue not taken into account when signing the co-financing contract, the principles of reducing co-financing due or potential recovering of the funds are determined in Article 55.4 of Regulation No. 1083/2006 and "Guidelines on the method of making payments and settlements" issued by the Minister of Regional Development. In case of occurrence of circumstances that might result in reducing the level of maximum co-financing for the revenue-generating project, the beneficiary, not later than when filing the application for the final payment and then, three years after closing the operational programme, is obliged to notify the responsible authority of these circumstances, when necessary updating the information in this respect in accordance with "Guidelines of the Minister of Regional Development regarding selected issue related to preparation of investment projects, including revenue-generating projects". In accordance with the Act of 30 June 2005 on public finance and the co-financing contract, the competent authority controls fulfilment of the beneficiary's duties regarding the principles of calculation, surplus control and compensation recovery. In accordance with Article 211 of the Act on public finance, when co-financing received by the beneficiary was used contrary to its purpose or with a breach

⁴ Council Regulation (EC) 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999 (OJ L 210 of 31 July 2006, page 25)

⁵ In case of electricity networks this period is set at 30 years and in case of equipment for 10 to 15 years.

of procedures applying in respect to the project implementation, or its receipt was unjustified, or the amount excessive, it should be recovered in accordance with the procedure and principles defined in the aforementioned Act. At the same time, all documents and accounting entries related to the implementation of the project are verified by competent national institutions, European Commission and European Court of Auditors. The Beneficiary is obliged to ensure access to the documentation and submit to checks.

18. The overall maximum budget for this measure amounts to 595,5 mln Polish Zloty (about 130 mln Euro)⁶. Poland notified the aid scheme until 31 December 2015. The scheme will only be put into effect subject to clearance by the Commission.
19. The Polish authorities consider that this support measure does not involve State aid because it does not mainly affect competition between Member States and due to the tariff setting mechanism it does not grant an advantage to the beneficiaries.

III. ASSESSMENT

Existence of State aid and legality

20. Article 87(1) of the Treaty provides that “*any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, shall, in so far as it affects trade between Member States, be incompatible with the common market*”.
21. The aid is granted from State resources as the allocation of Structural Funds is subject to the discretion of Poland.
22. As regards the presence of an economic advantage to beneficiaries of the scheme the Commission considered the following elements:

Advantage to the operators

23. The supply of electricity is regulated in Poland via concession contracts with operators owning the networks. The profits for operators taking into account investment needs and the tariffs for electricity distribution are under the control of the public authorities. Therefore the authorities are able to control the exact benefits which each beneficiary is receiving when operating the distribution network.
24. The amount of subsidy is calculated on the basis of the method of "funding gap" which ensures that only those investments costs will be financed by aid which will not be covered by any benefits generated by the operation of the improved network. Such approach aims to keep the tariffs for distribution and the operator's profits on the same level as if the investment would not be realised. Therefore the measure will enable operators to continue to provide distribution services of electricity for affordable prices to residential users and businesses, despite the investments in modernisation of networks. Whereas residential users are not subject to State aid rules, businesses in Poland will

⁶ The same budget applies for investments in electricity infrastructure which are not subject to this notification. Poland cannot predict how big will be the part of the budget for electricity distribution projects.

benefit indirectly from distribution services below prices which would be available on the regular basis i.e. if the investments would be financed from application of the tariffs.

25. The contemplated support for investments reduces the operating costs of operators. The subsidy can reduce the operating costs in two ways; 1) reduce costs of energy losses or 2) reduce maintenance and investment costs. However, the investment subsidy will not increase the engaged capital on basis of which the remuneration of the operators are calculated. Therefore the benefits can result from the reduction in operating costs but not from an increase in the remuneration of the engaged capital⁷.
26. Producers of electricity using the networks to supply their products may as well indirectly benefit from the investments because due to reduction in energy losses less electricity will be necessary to be produced to supply the same number of customers. However as the network operators are responsible for electricity losses and not the electricity producers, there will be no direct financial benefit for electricity producers from modernising the networks.
27. In cases where the beneficiaries of the subsidies are vertically integrated companies i.e. producing electricity and operating electricity distribution networks, they are likely to benefit from the aid because limiting of the energy losses will grant the additional production capacities for production units. As the vertically integrated companies plan the development of the networks the additional production capacities can have a direct effect on these development plants and therefore can lead to new customers. Hence, the production capacities supplying electricity to new customers would be made available because of the aid.
28. As Poland cannot at this stage identify if vertically integrated companies will benefit from the aid it cannot be excluded that the aid will give advantage within the meaning of Article 87(1) of the EC Treaty, to vertically integrated companies in terms of new production capacities. As the beneficiaries have direct influence on development of the networks the new production capacities can directly lead to new customers when the networks are modernised. As the financing by the State of a particular investment is considered conferring an advantage on the network operator, that advantage is selective.

Distortion of competition – affectation of intra Community trade

29. The market for distribution of electricity is by definition bound to the location of the network and therefore local by nature. In the same vein, it should be noted that networks designed for the distribution of energy to the population in a given area, just as heat and natural gas distribution networks, exhibit the properties of local "natural monopolies". It means that in all cases, it would be very unlikely that it would be economical to duplicate the network by creating a new one, even if of a much better quality than the existing one. Therefore the contemplated subsidies are unlikely to deter operators to invest themselves in new electricity distribution networks.

⁷ If the owner would decide to sell the electricity network it would not be able to request higher price as in the case if the network would not be modernised. This is because the subsidy does not increase the future profits to be generated by the assets, as compared to the situation where the subsidy would not have been granted (and the investments would not have been made).

30. Although the electricity distribution networks in Poland belong to a variety of companies i.e. some belong to companies producing electricity and some to companies operating just the networks, all networks operators are obliged to ensure the third party access to their networks for all distributors holding concessions. Therefore different producers of electricity have free access to the networks.
31. In case of vertically integrated companies (producing and distributing electricity and other production activities) potential advantage from investments in modernisation of electricity networks could spread from distribution activities to production activities of such companies and distort competition on markets where such companies are active.
32. Moreover some of the beneficiaries belong to groups having commercial activities in other Member States. Therefore the measure may distort competition and trade because it may strengthen the financial position of undertakings active in other Member States.

Conclusion on existence of the aid

33. Taking the above into consideration the Commission concludes that the measure involves State aid within the meaning of Article 87 (1) of the EC Treaty.
34. By notifying the aid measure, the Polish authorities have complied with Article 88(3) of the EC Treaty.

Compatibility under Article 87(3)(c) of the EC Treaty

35. As regards support for electricity infrastructure aid for such projects does not fall within the scope of the 2008 Environmental Aid Guidelines⁸.
36. The Commission notes that the measure aims to modernise electricity distribution networks in Poland with no prospect for modernising the networks on regular commercial conditions i.e. financed from the tariffs, in the near and medium term. The Commission also notes that the measure does not fall under one of the existing frameworks and guidelines. The areas covered by the measure are all located within areas eligible under the European Regional Development Fund, as well as Article 87 (3) (a) assisted areas within the meaning of the Regional Aid Guidelines. However, while the aid to be granted under the notified scheme may qualify as aid for initial investment within the meaning of those Guidelines in so far as it benefits the network operators, the same cannot be said in respect of its impact on the electricity producers and business consumers of electricity, for whom the benefit is not linked to any initial investment. The Commission therefore considers that the assessment of the compatibility of the measure with the common market needs to be based directly on Article 87(3)(c) which 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 common market.

37. In order to be compatible under article 87(3)(c), 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 questions:

- (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)?
- (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?

Objective of Common Interest

38. 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.

39. The measure at hand aims at increasing primary energy savings by reducing energy necessary to distributing electricity and therefore reducing CO₂ emissions related to production of electricity. The EU institutions have recognised on many occasions that the protection of the environment and the reduction of CO₂ emissions are in the common interest of the Member States. In particular, the European Council made a commitment to achieve at least a 20% reduction in greenhouse gas emissions compared to 1990 and at least a 20% savings in energy consumption compared to the projections for 2020. Furthermore, Member States are obliged to adopt and aim to achieve an overall national indicative energy savings target of 9 % over nine years in accordance with Directive 2006/32/EC of the European Parliament and of the Council of 5 April 2006 on energy end-use efficiency and energy services and repealing Council Directive 93/76/EEC. An important factor to achieve the energy saving targets in Poland is modernisation of electricity distribution networks. Currently the process of energy distribution is accompanied by energy losses, which in Poland constitute almost 10% of gross energy generated. Achieving the level of energy losses of the West-European States of 6.5% would allow saving up to 4994 GWh of electricity. If grid losses in Poland could be reduced to a level of 6.5%, energy savings of the order of 5000 GWh annually would be achieved, which could be translated into a cutback of 4,328,400 tonnes of CO₂ emissions.

⁹ See para. 22 of the Presidency Conclusions of the Brussels European Council 11 and 12 December 2008, available at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/104692.pdf.

This is ca. 2.4% of CO₂ emissions from the energy industry. Achieving this targets which are in-line Common European Interest, would require substantial changes in construction of energy networks in Poland i.e. exchange of devices and shortening of electricity lines which were constructed in times of central planned economy and are therefore particularly inefficient.

40. Financing of these investments would require fundamental increase in tariffs for distribution of electricity if the investments would be financed by the operators. However Polish authorities argue that such increase in tariffs is impossible from the social point of view. Indeed the whole territory of Poland, entirely qualifies as an assisted region under the derogation laid down in Article 87(3)(a) of the EC Treaty, in conformity with the regional aid map for Poland¹⁰ with an Gross Domestic Product per capita in Purchasing Power terms is below 75% of EU average. Therefore the environmental and energy saving investments being in line with the EU energy saving targets can only be achieved with the assistance of aid.
41. It can thus be concluded that the Polish scheme aims at a well-defined objective of common interest.

Appropriate Instrument

42. With regard to the present scheme Polish authorities considered regulatory measures as an alternative to State aid i.e. legal enforcement of energy efficiency improvements on Polish electricity operators. However fulfilling of such mandatory improvements could only be financed via an increase in tariffs for electricity as any investments in infrastructure realised by a network operator can only be financed from tariffs. This would in turn increase prices for electricity for consumers, which has been considered to be socially unacceptable. The Commission considers that aid granted for the envisaged measures is an appropriate instrument to achieve the increase in environmental protection through saving on energy when distributing electricity.
43. Consequently, State aid is an appropriate instrument to achieve the envisaged primary energy savings.

Incentive Effect

44. The aid granted for the envisaged measures provides the necessary incentive effect. State aid provides an incentive effect if the aid changes the recipients' behaviour towards reaching the objective of common interest. According to the Polish authorities the system of calculating the tariffs for distribution of electricity does not provide enough incentives for companies to invest in modernisation of the electricity distribution networks. This is because the investments necessary to reduce energy losses from 10% to 6.5% are major investments changing the whole networks system. To finance such investments the networks operators would need to increase significantly the engaged capital, far above the "business as usual" maintenance costs. According to the tariff setting mechanism in order to receive remuneration on such increase engaged capital the tariff would need to increase to a level which is unacceptable for the regulator from social point. Therefore the costs of the environmental costs and energy saving costs cannot be internalised by the consumers.

¹⁰ State Aid N 531/2006 – Poland – Regional aid map for 2007-2013.

It follows that in order to achieve the desired environmental and energy saving effect the foreseen investments can only be financed by a support from the State. In that regard the Commission considers that the aid scheme will provide a significant incentive for companies to invest into modernisation of the distribution networks for electricity. This will in turn lead to a reduction in the use of primary energy sources as well as to a reduction of CO2 emissions thus reaching an objective of common interest. Furthermore the projects will be selected on the basis of an open competition. The criteria presented by Poland ensure that the aid will be granted to projects, which ensure the best energy saving for least costs.

45. Therefore it can be concluded that the scheme will provide for the necessary incentive effect.

Proportionality

46. A State aid measure is proportional if the measure is designed in a way that the aid as such is kept to the minimum and if the beneficiaries are selected in a non-discriminatory, transparent and open process. As regards proportionality of the aid, the amount of the aid will be calculated on the basis of the “funding gap” and therefore all the benefits which can be predicted for the lifetime of the project will be deducted from the aid and will be financed by the operators. Such contribution of the beneficiary goes beyond the timeframe of the Environmental Aid Guidelines which require deducting benefits calculated in the first 5 years only. Moreover as the aid will be granted on the basis of an open competition it is ensured that only the most efficient projects will benefit from the aid i.e. projects resulting with best value for money.
47. In view of the above it can thus be concluded that the State aid granted for the envisaged measures is proportional, that the aid is limited to a minimum and that the selection process is non discriminatory, transparent and open.

Distortion of Competition and Balancing Test

48. The possible distortions of competition and trade resulting from the State aid for the envisaged measures are limited, so that the overall balance with regard to the objective of common interest is positive.
49. The markets of electricity distribution are local markets and it is very unlikely that the contemplated subsidies, in so far as they contribute to an upgrading of existing networks, have the effect of deterring operators to invest themselves in new electricity distribution networks. Therefore the aid granted is unlikely to distort competition in the market for distribution of electricity.
50. As explained above vertically integrated companies may derive some additional benefits from the aid in getting new customers if they correlate the investments with the expansion of own network. Therefore it cannot be excluded that the aid may distort competition on markets where companies distributing and producing or trading electricity are active. However, the aid scheme ensures that the aid is proportionate and the aid amount is limited to the minimum necessary.

51. At the same time, the scheme ensures the positive environmental effects of the aid. The procedure of choosing the projects benefiting from the aid ensures that the primary energy savings are done in an efficient way and gives highest environmental benefits for the value of funds invested.
52. Therefore it can be concluded that the possible distortions of competition and trade resulting from the State aid for the envisaged measures are limited, and that the overall balance with regard to the objective of common interest is positive.

Conclusion

53. The Commission thus concludes that the aid scheme is compatible with 87 (3) (c) of the EC Treaty.

IV. CONCLUSION

54. The Commission has accordingly decided not to raise objections to the notified measure, because the aid can be found compatible with the common market in accordance with Article 87 (3) (c) of the EC Treaty and Article 61 (3) (c) of the EEA Agreement, since it pursues an objective of common interest in a necessary and proportionate way.
55. The Commission reminds the Polish Authorities that, in accordance with article 88 (3) of the EC Treaty, plans to refinance, alter or change this aid have to be notified to the Commission pursuant to provisions of the Commission Regulation (EC) No 764/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 (now 88) of the EC Treaty (OJ L 140, 30.4.2004, p.1).
56. If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:
http://ec.europa.eu/community_law/state_aids

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

European Commission
Directorate-General of Competition
State Aid Registry
B-1049 BRUSSELS
Telefax n°: + 32-2-296.12.42

Please, mention the name and number of the case in all the correspondence.

Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission