REPORT

The application of EEA law to incentive schemes for attracting new electricity generation or demand-side investments in the security of supply interest

Prepared for the Norwegian Ministry of Petroleum and Energy

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APPENDICES

1 EXECUTIVE SUMMARY

1.1 Overview

This report provides a legal evaluation of the Norwegian authorities' rights under the EEA Agreement to establish incentive schemes to promote investments aimed at safeguarding security of electricity supply in certain regions.

More specifically, our mandate involves an assessment of the legal requirements imposed by internal electricity market legislation and the State aid provisions in the main part of the EEA Agreement on Norway as an EEA Member State. This assessment must be seen in relation to the category of measures recommended by Econ Pöyry in the economic report submitted at the same time as this report. The economic report proposes measures aimed at promoting investments in electricity production as well as in demand-side conservation. The report specifically focuses on tendering procedures as a means to award investment aid needed to ensure that the necessary investments are made.

Four overall topics are discussed in this report on the basis of our mandate and the proposals set out in the economic report. First, we consider the requirements imposed by Article 7 of the Electricity Directive, which specifically governs the application of tenders as an instrument to ensure security of electricity supply in the longer term. Second, the application of the public service obligation provision in Article 3 of the Electricity Directive to investment obligations imposed in the security of supply interest is considered. Third, the relevant provisions in the Security of Electricity Supply Directive, which partly overlaps and supplements the provisions of the Electricity Directive, are discussed. And, fourth, we discuss the application of the State aid provisions of the EEA Agreement to the envisaged incentive schemes.

1.2 The tendering procedure in Article 7 of the Electricity Directive

Article 7 of the Electricity Directive governs the Member States' use of tendering procedures aimed at attracting new supply-side or demand-side investments needed in the security of supply or environmental interest. Such tenders may for example relate to the award of investment aid to new construction or capacity expansions as proposed in the economic report. Aid or subsidies provided as a part of the tendering scheme is also subject to scrutiny under the State aid provisions of the EEA Agreement irrespective of whether the requirements in Article 7 of the Electricity Directive are fulfilled or not.

The provision in part requires Member States to make preparations for the potential launching of tenders in the security of supply interest, and in part restricts the Member States' rights to launch such tenders to situations where it is necessary in order to ensure security of supply.

Article 7 does not specifically require that an authorisation to build and operate new electricity production facilities is awarded as a part of a tendering procedure, but the authorisation requirements must not be detrimental to the transparency, objectivity and non-discriminatory application of the tendering alternative. Consequently, an authorisation procedure cannot be designed in such as way that it restricts the number of interested bidders ex ante or results in a renewed evaluation of the successful bidder ex post in a discriminatory manner.

A security of supply concern within the meaning of Article 7 can be defined as a concern that future demand is likely to outstrip supply with the effect that demand-side rationing must be imposed unless specific measures are introduced. The provision requires Member States to substantiate that new investment is necessary in order to avoid a risk of future electricity rationing and that such investments will not be carried out solely on the basis of the ordinary authorisation procedure. New investment is likely to be considered necessary if it can be established that future projected peak load may outstrip supply in a given region in a year with low precipitation, taking into account the potential for electricity imports to the region on existing transmission lines. Tenders may be launched if such investment is not carried out by market participants in absence of specific public incentive schemes.

The provision also imposes strict requirements on Member States concerning the clarification and advance publication of the tendering specifications in a potential tendering procedure.

The MPE, the NVE as well as other public or private bodies independent of the interests of the electricity sector may at the outset act as tendering authorities. In our opinion, Statnett may also most likely act as tendering authority, although this latter conclusion is subject to uncertainty given Statnett's involvement in reserve electricity production.

1.3 Services of general economic interest: Article 3 of the Electricity Directive

Article 3 of the Electricity Directive governs the Member States' award of public service obligations in the general economic interest to certain market participants. Such public service obligations may in principle also involve obligations to invest in electricity production or demand-side conservation techniques in order to safeguard security of supply in regions with a strained supply-demand balance.

Article 3(2) read in conjunction with Article 3(8) provides a sector-specific application of the exemption ground in Article 59(2) EEA. Provided that the conditions in Article 3 are fulfilled, Member States may derogate from, *inter alia*, the authorisation procedure in Article 6 of the Directive. Investment obligations aimed at ensuring security of supply, whether related to supply-side or demand-side investments, are likely to qualify as public service obligations in the general economic interest under Article 3(2) of the Directive provided that the necessary

investments are not carried out by market participants on the basis of ordinary market terms.

Despite the reference to electricity price levels in Articles 3(2) and 3(3) of the Directive, these provisions cannot, however, in our opinion be interpreted as allowing Member States to impose supply-side or demand-side investment obligations solely in the interest of reducing electricity market price levels.

Article 3(4) of the Directive requires that any public service compensation shall be granted in a non-discriminatory and transparent way. The provision does not explicitly require that public service compensation is awarded pursuant to a tendering procedure. Nevertheless, it is likely that Member States who award compensation to certain market participants in absence of such tender will be faced with a very strict burden of proof for substantiating that the award procedure has been carried out in a non-discriminatory and transparent manner. As is the case under the tendering procedure in Article 7 of the Electricity Directive, aid or subsidies provided in relation to the award of a public service obligation is also subject to scrutiny under the State aid provisions of the EEA Agreement irrespective of whether the requirements in Article 7 of the Electricity Directive are fulfilled or not.

1.4 State aid

National aid measure may be organised in conformity with the Electricity Directive and the *Altmark* doctrine in order to escape the state aid prohibition in Article 61(1) EEA.

Any incentive scheme structures in accordance with the *Altmark* criteria in order to escape classification as State aid is, however, likely to be subject to intense scrutiny by the Authority, where the strict interpretations adopted by the Commission will be applied correspondingly by the Authority. Consequently, we strongly recommend that such measures are notified in advance to the Authority.

If the *Altmark* criteria are not met, the Norwegian authorities are obliged not to put into effect a new aid measure before the Authority has approved the national measure. State aid measures which fall within the ambit of Article 61(1) EEA must, therefore, be notified to the Authority prior to its implementation. The Authority must then assess whether the notified measure constitutes state aid and, if it does, examine whether the notified measure is eligible for exemption.

The national aid measures as identified in the economic report may be found compatible with the functioning of the EEA Agreement based on Articles 59(2) or 61(3)c or thereof.

To the extent the aid measure is designed in such a way that the aid recipient only is granted a reasonable profit on its investment the Authority may declare an aid

instrument in the form of a public service obligation compatible with the functioning of the EEA Agreement based on Article 59(2) thereof.

Contrary to Article 59(2) EEA there is no requirement that the aid instrument is compensation for discharging a public service obligation. Consequently, the Norwegian authorities may in any event apply for derogation from the state aid prohibition under Article 61 3(c). This article will be applicable for all aid measures which are identified as alternative in the economic report. In other words, aid measures which objective is to increase supply, reduce consumption or both may be eligible for exemption under Article 61(3) c EEA. However, as the aid measures are not designed in detail yet, it is not feasible to provide an in-depth state aid analysis on the individual measures and its compatibility with the functioning of the EEA Agreement.

2 INTRODUCTION

2.1 Mandate

This report is prepared for the Norwegian Ministry of Petroleum and Energy ("the MPE") pursuant to a contract entered into on 6 February 2009.

Our principal mandate is to provide a legal evaluation of the Norwegian authorities' rights under the EEA Agreement to establish incentive schemes to promote investments aimed at safeguarding security of electricity supply. This assignment involves an assessment of incentive schemes relating to new investments in electricity production and demand-side management techniques needed to ensure the long-term balance between electricity supply and demand in specific geographical regions. The incentive schemes envisaged by the MPE primarily concern the launching of tenders to attract new supply-side or demand-side investments.

More specifically, our mandate involves an assessment of the legal requirements imposed by internal electricity market legislation and the State aid provisions in the main part of the EEA Agreement on Norway as an EEA Member State. The most relevant pieces of internal electricity market legislation for the purposes of the evaluations conducted in this report are the Electricity Directive[1] and the Security of Electricity Supply Directive.[2]

In addition to the legal assessment presented in this report, the MPE has also commissioned an economic analysis concerning the optimal design of potential subsidy schemes. The economic analysis is conducted by Econ Pöyry (hereinafter "the economic report"). The MPE has presupposed that the legal and economic advisors shall cooperate on the exchange of information in order to coordinate the contents of the reports. Two meetings have been arranged between the project teams of Econ Pöyry and Arntzen de Besche to this effect. The project teams have also cooperated by ways of telephone and e-mail contact throughout the project period. In addition, two status meetings where the MPE, Econ Pöyry and Arntzen de Besche have participated have been arranged during the project period.

2.2 Scope and outline

This report focuses specifically on the application of EEA law to public measures promoting new investments in order to safeguard security of supply in specific geographical regions.

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[1] Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, OJ L 176/37, 15.07.2003.

[2] Directive 2005/89/EC of the European Parliament and of the Council of 18 January 2006, OJ L33/22, 04.02.2006.

The economic report recommends three primary categories of measures which may be applied alternatively or in combination to safeguard the balance between electricity supply and demand in the longer term:

- Tendering procedures aimed at promoting new investments in electricity production. Technology neutral tenders for investment aid where market participants submit bids on the basis of the lump sum economic support needed to invest in new generating capacity or capacity expansions within a given time.

- Tenders for investment aid to district heating or heat pumps in regions with a strained electricity supply-demand balance, i.e. a demand-side tender scheme analogous to the supply-side tendering procedure mentioned above.

- An extension of the already existing Norwegian energy option model, comprising an extension in time and possibly in scope with specific targets for possible reductions in electricity demand in given regions.

Furthermore, as a secondary solution, the economic report proposes that cost-based compensation on the basis of direct negotiations may be considered as a last resort alternative if tendering procedures should not result in the desired outcome.

On the basis of these proposals and the requirements set out in the contract specifications, we will particularly focus on four main issues in the following.

First, Article 7 of the Electricity Directive specifically governs the application of tenders as an instrument to ensure security of supply. The requirements imposed by this provision are considered in detail in chapter 4 below.

Second, the more generally worded public service obligation provision in Article 3 of the Electricity Directive is also relevant for the rights of public authorities to impose specific security of supply obligations on certain market participants. The conditions in Article 3 concerning the qualification of investment obligations as public service obligations in the general economic interest are considered further in chapter 5 below.

Third, several of the provisions of the Security of Electricity Supply Directive are to some extent relevant for the assessments outlined above, and will therefore be considered in parallel to the relevant provisions of the Electricity Directive throughout chapters 4 and 5.

And, fourth, the application of the State aid provisions of the EEA Agreement to the envisaged incentive schemes are considered in chapter 6 below.

Our analysis is based on the understanding that the envisaged subsidy schemes will be implemented in a technology neutral manner, i.e. that the measures in question will not have as their aim to favour investments based on certain technologies or primary energy sources. This entails that the promotion of investments in the environmental interest will not be considered specifically in this report. It should, however, be emphasised that an increasingly amount of EU electricity market legislation is geared towards ensuring supply-side and demand-side investments aimed at reducing CO_2 emissions in order to combat climate change. This legislation can in principle also be relevant to the assessment of Member States' rights to promote investments which have as their effect to ensure security of supply, provided that the measures in question also promote environmental objectives. Further assessment of this relationship between measures promoting environmental and security of supply objectives is, however, beyond our mandate and the issue is therefore not considered further in this report.

3 INVESTMENTS IN THE SECURITY OF SUPPLY INTEREST – THE LEGAL FRAMEWORK

3.1 Overview

Both the main parts of the EEA Agreement and secondary law provisions incorporated into the Agreement are relevant in determining the public authorities' scope for adopting electricity market investment incentive schemes.

With respect to the main parts of the EEA Agreement, the State aid provisions are of particular importance for the assessment of subsidy schemes such as those proposed in the economic report. Other parts of the Agreement, such as the free movement provisions, may in principle also be of relevance to certain incentive schemes such as for example feed-in tariffs.[3] Such schemes have, however, not been recommended in the economic report and we will therefore focus exclusively on the State aid provisions under the main part of the Agreement in the following. The State aid provisions in the EEA Agreement are equivalent to the parallel provisions in the EC Treaty and form a part of the internal electricity market.

EU – and consequently also EEA – secondary law regulation of the internal electricity market has gradually become more wide-ranging and complex over the past decade. The internal electricity market can generally be described as an internal electricity market without frontiers in which free movement of is ensured in accordance with the provisions of the EC Treaty (and the EEA Agreement).[4] The Electricity Directive and the Security of Electricity Supply Directive are the measures of most relevance to the present study among those adopted at EU level and subsequently incorporated into the EEA Agreement in order to improve the

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[3] See in particular the Court of Justice's decision in case C-379/98, *PreussenElektra*, [2001] ECR I-2099, at paras 69-81.

[4] Article 14(2) of the EC Treaty ("EC").

operation of the internal electricity market. These measures will therefore be commented upon in more detail below.

Other parts of the internal electricity market legislation, such as the Electricity Regulation, are of little direct relevance to the potential measures discussed in this report, and will therefore not be considered further in the following.[5] Moreover, internal electricity market legislation adopted on the basis of Article 95 EC is supplemented by a number of legislative measures adopted on the basis of the environmental competences conferred on the Community by Article 175 EC. These measures include, *inter alia*, the RES Directive,[6] the Cogeneration Directive[7] and the Energy Services Directive.[8] The prevailing RES Directive will be replaced by the newly adopted new RES Directive 2009/28/EC, which is also expected to be incorporated into the EEA Agreement.[9] These directives may in principle affect Member States' design of security of supply investment subsidy schemes through their measures aimed at promoting investments in the environmental interest.[10] The Directives are, however, not directly relevant to the technology neutral national incentive schemes envisaged and discussed in this report, and will therefore not be discussed further here.

3.2 The Electricity Directive

The prevailing Electricity Directive was adopted in 2003 primarily on the basis of Article 95 EC, and subsequently incorporated into the EEA Agreement by the EEA Committee's decision 2 December 2005. The overall objective of the Directive is to improve the operation of the internal electricity market.[11] The energy-specific aims of the Directive are indirectly set out in Article 3(1), which requires Member States to ensure "that electricity undertakings are operated in accordance with the principles

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5 Regulation (EC) No 1228/2003 of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity, OJ L176/1, 15.7.2003. Incorporated into the EEA Agreement by decision of the EEA Committee 2 December 2005.

6 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 L283/33, 27.10.2001. Incorporated into the EEA Agreement by decision of the EEA Committee 8 July 2005.

7 Directive 2004/8/EC of the European Parliament and of the Council of 11 February 2004 on the promotion of cogeneration based on a useful heat demand in the internal energy market and amending Directive 92/42/EEC, OJ L52/50, 21.02.2004. Incorporated into the EEA Agreement by decision of the EEA Committee 8 December 2006.

8 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/EC, OJ L114/64, 27.04.2006.

9 Directive 2009/28/EC of the European Parliament and of the Council of 23 April 2009 on the promotion of the use of energy from renewable sources and amending and subsequently repealing Directives 2001/77/EC and 2003/30/EC, OJ L140/16, 05.06.2009.

10 See Henrik Bjørnebye, Finn Arnesen, Ivar Alvik and Ola Mestad, *EØS-rettslige rammer for revisjon av energiloven, Utredning til Olje- og energidepartmentet 9. juli 2007*, available at url <www.regjeringen.no/nb/dep/oed/dok/rapporter_planer/rapporter/2007/EOS-rettslige-rammer-for-revisjon-av-ene.html?id=488574>, pp. 26-48 for an overview and brief description of the secondary law regulation of the internal electricity market.

11 Case C-439/06, *Citiworks*, [2008] ECR I-3913, para. 38 and case C-239/07, *Julius Sabatauskas and Others*, NYR, para. 31.

of this Directive *with a view to achieving a competitive, secure and environmentally sustainable market in electricity*".[12]

The scope of the Directive is broadly defined. Article 1 provides that it seeks to establish "common rules for the generation, transmission, distribution and supply of electricity", thus representing the regulatory backbone of internal electricity market legislation. In the following we will, in accordance with our mandate, focus on the provisions of particular importance for the promotion of investments in new electricity generation or demand-side measures in the security of supply interest.

The Electricity Directive builds on a regulatory distinction between competitive production and supply activities on the one hand and grid activities subject to monopoly control on the other. This distinction corresponds to the regulatory approach underlying the Norwegian Energy Act and, more generally, most energy legislation in regimes where competition has been introduced in energy markets.

The Electricity Directive and its predecessor, the now repealed Electricity Directive 96/92/EC, are based on a gradual introduction of competition. With effect from 1 July 2007, Member States were required to ensure that their markets were open to full competition, i.e. a system where all customers are free to purchase electricity form the supplier of their choice.[13] By contrast to the Norwegian system, where full competition was introduced with effect from 1991, the introduction of competition is therefore a relatively new phenomenon in many EU Member States. The internal electricity market as such is consequently still very much in its making.

Electricity production is primarily governed by Chapter III of the Directive, which sets forth an authorisation procedure and a tendering procedure in Articles 6 and 7, respectively. Article 6 requires Member States to adopt an authorisation procedure as the primary regulatory instrument for the construction of new electricity generating capacity. Article 7 allows Member States to derogate from the authorisation procedure by ways of launching tenders or equivalent procedures to attract new investments necessary to ensure security of supply or environmental protection. Article 7 and its relationship to the authorisation procedure in Article 6 is commented upon in more detail in chapter 4 below.

In addition, the general public service provision in Article 3 of the Directive opens up for an exemption from Article 6 when necessary to perform public service obligations in the general economic interest. Such public service obligations may in principle also involve investment obligation in the security of supply interest, as we will revert to in more detail below in chapter 5.

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[12] Emphasis added.
[13] Articles 21(1)(c) and 2(12) of the Electricity Directive.

The Electricity Directive's choice of an authorisation procedure as the principal vehicle to attract new investments also to some extent signifies the regulatory perception that investments as a main rule should be market-based in order to ensure security of supply in the most cost-efficient manner.[14] The Directive's approach therefore raises the question of under what conditions Member States may derogate from the authorisation procedure, for example by ways of launching tendering procedures, in order to guarantee regional supply security.

The third internal energy market package originally proposed by the Commission of the European Communities ("the Commission") in September 2007 was adopted by the Council of the European Union on 25 June 2009, following the European Parliament's vote in April.[15] This package includes a number of important new legislative texts concerning the internal energy market, including a new Electricity Directive which will replace the prevailing Directive. The final text of the new Electricity Directive has yet to be made public at the time of submitting this report.[16]

The new Electricity Directive is also EEA relevant, and is likely to be incorporated into the EEA Agreement. The new Electricity Directive text includes significant changes to some of the provisions of the existing Directive. The most important amendment proposals concern the unbundling of transmission system operator activities from competitive generation and supply activities and new and stricter requirements for the organisation of independent national energy regulators. The latter amendments concerning the organisation of the national energy regulator are likely to be of most interest to the possible future organisation of the Norwegian market. The proposal does, however, not appear to involve significant substantive amendments to Articles 3, 6 and 7 of the prevailing Electricity Directive except for a renumbering of the provisions. Given that the new Directive is not yet published at Community level and has yet to be incorporated into the EEA Agreement, we will in the following only discuss the prevailing Directive.

3.3 The Security of Electricity Supply Directive

The Directive concerning measures to safeguard security of electricity supply and infrastructure investment ("the Security of Electricity Supply Directive") was adopted at Community level in January 2006 on the basis of Article 95 EC. It was subsequently incorporated into the EEA Agreement by the EEA Committee's decision 8 June 2007.

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[14] See, for example, the Commission's general observation on the regulatory ideas in DG COMP's energy market Sector Inquiry, COM(2006) 851 final, 10.01.2007, p. 4.

[15] See press release Rapid IP/09/1038, 25 June 2009.

[16] A provisional version of the draft Electricity Directive adopted by the Parliament on 22 April 2009, prior to the recent Council vote, is available at url <www.europarl.europa.eu/oeil/file.jsp?id=5533232&fromfiche=1206&mailer>.

Article 1(1) sets forth that the Directive "establishes measures aimed at safeguarding security of electricity supply so as to ensure the proper functioning of the internal market for electricity" and to ensure, *inter alia*, an adequate level of generation capacity and an adequate balance between supply and demand. Article 1(2) underscores the Directive's market-based approach to attaining these aims by providing that the Directive "establishes a framework within which Member States are to define transparent, stable and non-discriminatory policies on security of electricity supply compatible with the requirements of a competitive internal market for electricity".

The Security of Electricity Supply Directive overlaps and supplements the regulation in the Electricity Directive of relevance to supply-side and demand-side investments. Articles 3 and 5 are the most relevant provisions of the Security of Electricity Supply Directive with respect to national measures adopted to ensure the long-term balance between electricity supply and demand. Article 3 sets forth the Directive's general approach by requiring Member States to ensure a high level of security of supply through the facilitation of a stable investment climate and by defining the roles and responsibilities of market participants and regulatory authorities. These general obligations are supplemented by more specific requirements relating to the maintenance of a balance between supply and demand in Article 5.

The Security of Electricity Supply Directive is arguably open to criticism for including a number of vague provisions, including the wording of Articles 3 and 5. Nevertheless, the European Commission is determined to ensure that Member States communicate the national provisions implementing the Directive. Following the EU Member States' deadline for transposition of the Directive by 24 February 2008, the Commission has so far issued reasoned opinions for failure to communicate national implementing provisions to seven Member States, including Sweden.[17]

3.4 The relationship to the provisions of the EEA Agreement

Several substantive provisions in the main part of the EEA Agreement may in principle be of relevance for the design of national incentive schemes aimed at promoting new electricity market investments. Electricity is to be regarded as goods within the meaning of the EEA Agreement.[18] As illustrated by the Court of Justice's decision in *PreussenElektra*, the free movement provisions of the EC Treaty (and, correspondingly, those of the EEA Agreement) may for example be of relevance for the design of certain categories of feed in-schemes.[19] It is also possible to envisage that a given incentive scheme, depending on its design, in principle may be affected

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[17] Commission press release Rapid, IP/09/184, 29 January 2009. See also the Commission press release Rapid IP/09/582, 14 April 2009, concerning actions to bring the Czech Republic and Poland to the Court of Justice for the non-implementation of the Security of Electricity Supply Directive.

[18] See case C-393/92, *Almelo*, [1994] ECR I-1477, para. 28 with respect to Article 28 EC. This reasoning applies correspondingly under the EEA Agreement.

[19] Case C-379/98, *PreussenElektra*, [2001] ECR I-2099.

by the other free movement provisions as well as other parts of the Agreement such as the competition rules.

The EEA Agreement provisions of most practical interest to the envisaged incentive schemes considered in this study are the State aid provisions, which are considered in more detail below in chapter 6. The application of the State aid provisions of the Agreement to national incentive schemes such as tendering procedures can in practice involve many similar assessments to those carried out under the provisions of the Electricity Directive and the Security of Electricity Supply Directive. This does not mean, however, that the latter Directive provisions replace or pre-empt the application of the State aid provisions of the EEA Agremeent. On the contrary, a measure will have to be assesses on the basis of the State aid rules as well.

The preamble to the Electricity Directive underscores that Member States are under an obligation to notify State aid awarded for the fulfilment of public service obligation under the general State aid provisions.[20] This entails that the State aid provisions of the EEA Agreement apply irrespective of whether the public service conditions of the Electricity Directive are fulfilled or not. This approach also applies correspondingly to the relationship between the conditions for launching a tendering procedure under Article 7 of the Directive and the State aid provisions of the Agreement.

The Security of Electricity Supply Directive builds on a similar approach to State aid, as emphasised by Article 5(2) and para. 12 of the preamble to the Directive. Consequently, economic incentives provided by Member States to promote new electricity market investments are in principle subject to a double test comprising on the one hand the conditions in internal electricity market legislation and on the other the requirements of the general State aid provisions of the EEA Agreement.

4 THE TENDERING PROCEDURE IN ARTICLE 7 OF THE ELECTRICITY DIRECTIVE

4.1 Introduction

Article 7(1) of the Electricity Directive requires Member States to "*ensure the possibility, in the interests of security of supply, of providing for new capacity or energy efficiency/demand-side management measures through a tendering procedure or any procedure equivalent in terms of transparency and non-discrimination, on the basis of published criteria."* Member States may, however, only launch such procedures if the generating capacity being built or the energy efficiency measures taken on the basis of the authorisation procedure in Article 6 are insufficient to ensure security of supply. Article 7(2) includes a corresponding right to launch

[20] Recital 29 of the preamble to the Electricity Directive.

tendering procedures in the interests of environmental protection and the promotion of infant new technologies.

Article 2(24) of the Electricity Directive defines a tendering procedure as "*the procedure through which planned additional requirements and replacement capacity are covered by supplies from new or existing generating capacity*". Although the definition fails to mention demand-side measures as a means to improve the supply-demand balance, it follows clearly from the wording of Article 7(1) of the Directive that the latter measures are also covered by the tendering provision. Consequently, the provision at the outset covers the tendering based incentive schemes proposed in the economic report on both the supply-side and the demand-side.

The wording in Article 7(1) of the Directive entails that the provision partly requires Member States to make preparations for the possible launching of tenders in the security of supply interest, and partly restricts the Member States' rights to launch such tenders to situations where it is necessary in the security of supply interest. Based on our mandate, we will focus on the extent to which Member States have a right to launch tenders (or equivalent procedures) in the security of supply interest. This assessment raises a number of questions which will be discussed in the following.

First, the requirement that tenders can only be launched if measures taken on the basis of the authorisation procedure are insufficient to ensure security of supply raises the question of how to understand the relationship between the authorisation provision and the tendering provision of the Directive. This relationship is discussed below in section 4.2. Second, the wording of the provision raises the question of how to define the procedures which may qualify as tendering procedures or procedures "*equivalent in terms of transparency and non-discrimination*". This question is dealt with in section 4.3. We will then discuss the conditions for launching a tendering procedure in section 4.4 before the Member States' choice of tendering authority is dealt with in section 4.5. Section 4.6 concludes the chapter.

4.2 The relationship to the authorisation procedure

4.2.1 The relationship between authorisation and tendering procedures in the Electricity Directive

The primary procedure for public involvement in new supply-side investments follows from Article 6 of the Electricity Directive, which requires Member States to adopt an authorisation procedure for the construction of new electricity generating capacity. This procedure shall be conducted in accordance with objective, transparent and non discriminatory criteria which shall be made public.

Norway applies authorisation procedures for the building of new electricity generation through the construction and operating licence requirement in Section 3-1 of the Energy Act as well as through the more specific hydropower licence

requirements in the Industrial Concession Act, the Watercourse Regulation Act and the Water Resources Act. The question in the following is how these authorisation procedures may be combined with tendering procedures when necessary to ensure security of supply.

The now-repealed Electricity Directive 96/92/EC left it to the Member States' discretion whether to apply an authorisation procedure or a tendering procedure as the main instrument for the construction of new electricity generation capacity.[21] The prevailing Directive 2003/54/EC signifies an important change in this approach by only exceptionally allowing Member States recourse to the tendering alternative. The main reason for this choice appears to be that most Member States in any case had already opted for an authorisation procedure under the first Electricity Directive, thus leaving the tendering alternative redundant.[22] It has, however, been suggested in legal literature that the prevailing Directive's choice of authorisation procedures as the main process for building new electricity generation capacity also can be perceived as a more fundamental change signifying that the market is now left to ensure that supply meets demand.[23] The reasoning behind this suggestion is that an authorisation procedure leaves it to the market participants to plan and apply for a permit to build the necessary electricity generation capacity. A tendering procedure launched by public authorities, on the other hand, transfers the choice of which projects to realise to the public and consequently introduces an element of central planning.

As a general point of departure, provisions which opens up for exceptions from the main rules of Community legislation are often subject to strict interpretation by the Community Courts. On the other hand, it follows from the case law of the Court of Justice that any Community measure adopted on the basis of the Article 95 EC, such as the Electricity Directive, must genuinely have as its object the improvement of the conditions for the establishment and functioning of the internal market.[24] This entails in practice that the provisions of the Directive must contribute to ensuring the free movement between EEA Member States or to eliminating appreciable distortions of competition in order to be validly based on Article 95 EC.[25]

The procedure in Article 7 of the Electricity Directive contains transparency and non-discrimination requirements similar to those enshrined in the authorisation procedure in Article 6. The principal internal market rationale for only exceptionally allowing Member States recourse to tendering procedures must therefore be based on the reasoning that the launching of tendering procedures in practice entails greater

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21 Article 4 of Directive 96/92/EC.

22 See along these lines Proposal for a Directive of the European Parliament and of the Council amending Directives 96/92/EC and 98/30/EC concerning common rules for the internal market in electricity and natural gas, COM(2001) 125 final, 13.03.2001, p. 34.

23 Christopher W. Jones, *EU Energy Law. Volume 1: The Internal Energy Market* (2nd ed., 2006), p. 14.

24 Case C-376/98, *Germany v Parliament and Council*, [2000] ECR I-8419, para. 84.

25 See further the reasoning of the Court of Justice in case C-376/98, *Germany v Parliament and Council*, [2000] ECR I-8419, paras 96-114.

risks of discrimination, for example to the benefit of a national incumbent, than the application of an authorisation procedure. Given the indirect nature of these potential effects of launching a tendering procedure, it is possible to argue that the exception in Article 7 from the authorisation procedure requirements in Article 6 should be subject to a less strict interpretation than what would ordinary be the case.

4.2.2 The granting of licences to successful bidders under a tender

A particular question which arises in light of the Norwegian licensing requirements is how to combine the granting of the necessary construction and operating licenses with the award of a contract under a tendering procedure. While we in this section 4.2.2 are dealing with this issue from the internal market legislation angle, in section 4.2.3 below we have set out the main challenges that this particular issue gives rise to from a Norwegian legislation perspective.

The coordination of tendering procedures and licensing requirements is not specifically addressed by the internal electricity market directives. The only indication of how these procedures are envisaged to be coordinated follows from the reference in Article 7(3) third subparagraph last sentence to the authorisation criteria in Article 6(2). This reference may be read as an indication that an authorisation is assumed to be awarded to the successful bidder as a part of the tendering procedure, but the provision does not require that such approach is adhered to. On the other hand, the non-discrimination principle as enshrined in, *inter alia*, Articles 7 and 3(1) of the Electricity Directive as well as Article 3(4) in the Security of Electricity Supply Directive may impose some restrictions on how the procedures are coordinated.

For example, a tendering procedure in which the procurement specifications require that eligible bidders have already been granted the necessary permits could in effect greatly reduce the potential number of bidders and thereby potentially be in breach of the non-discrimination principle. On the other hand, a process where the successful bidder is required to apply for an authorisation subsequent to the tendering procedure could potentially open up for a re-evaluation of the bidder which also opens up for a risk of allegations of arbitrary discrimination.

It should be emphasised that the non-discrimination requirements in internal electricity market legislation do not as such prohibit the application of a licensing procedure in addition to a tendering procedure. The conditions only require that the authorisation procedure is structured in such a way that it does not directly or indirectly discriminate between the interested bidders in a tendering procedure. The specific design of a tendering procedure should therefore be considered carefully on the basis of the non-discrimination principle.

4.2.3 Combining a tender procedure with the Norwegian licensing requirements – the main challenges

As mentioned in section 4.2.1 above, authorisation procedures are in place in Norway which set out license requirements for the construction and operation of energy production facilities.

Due to the fact that a thorough assessment of how a tender procedure can be combined with the licensing requirements falls outside the scope of our mandate, we will in this section only address the issue from a high-level approach and merely point at some possible scenarios.

The main problem that arises when combining the authorisation procedures with a tendering procedure is that the granting of a license implies the use of discretionary administrative powers, to be exercised within the legislative frame mainly provided by the Energy Act and the Energy Regulation. It is assumed that from the authorities' point of view, restrictions on these discretionary powers following from pre-license award decision circumstances such as the outcome of a tendering procedure should in general be avoided as much as possible.

On this basis, we assume that if a tendering procedure was to be designed in such a way that the successful bidder had a legal claim on receiving the license required under the Energy Act, this would imply an undesired restriction on the authorities' decision-making under the authorisation procedure. To avoid this, one could require the successful bidder to apply for a license and to follow the normal authorisation procedure subsequent to the tendering procedure. However, this would entail a risk that the tendering procedure might not be able to deliver the desired outcome; the successful bidder could risk not to receive the required licenses and the consumption of time on the complete authorisation procedure could be counter productive towards the goal of improving the security of supply situation, ref also the risk of allegations of arbitrary discrimination mentioned in section 4.2.2.

On the opposite end of the scale, another alternative could be to limit the access to the tender procedure to those companies that had already obtained a license to construct and operate a production facility capable of mitigating the relevant security of supply issue. Such a solution would not imply restrictions on the decision-making relating to the granting of licenses, but would, in addition to the possible discrimination issues mentioned in section 4.2.2 above, result in a resource-demanding case handling and decision making process in which the authorities would have to carry out a complete licensing procedure for several different facilities aimed at achieving the same objective; the introduction of (a pre-defined) generation capacity in a certain area capable of providing increased security of supply. Following the tendering procedure, this solution would leave all but one of the licenses useless. This implies that the granting of licenses would have to be conditional upon the result of the tendering procedure. It is questionable whether such a solution entails an appropriate use of resources.

Provided that it is an objective to avoid complicated adjustments of the existing regulatory framework, we believe that both the two possible solutions referred to above are far from optimum. A middle course could be tested; a requirement for participation in the tender procedure could be that all bidders have prepared and sent their prior notifications ("*forhåndsmelding*") including the necessary proposal for an impact assessment study. This would not take away entirely the risk of placing restrictions on the exercising of discretionary power, and the disadvantages of an extensive use of resources, but these undesirable effects could be greatly reduced – at least if the award to the successful bidder was made conditional upon a future granting of licenses and it was made absolutely clear that a possible award shall not entail any implicit promises for the later decision making relating to the licenses.

There are obviously other solutions as well, some of which are more exotic than others, such as e.g. establish a state owned single purpose vehicle that applies for necessary licences and then subsequent to the award of the license, is transferred (as an asset sale or a share sale) to the successful bidder. Common for most is that they require amendments to existing legislation (one could i.e. design and implement a whole new combined licensing and bidding process) and going further in this direction would rapidly take us far outside the scope of our task.

4.3 Tendering procedures and equivalent procedures

4.3.1 The object of the tender

Neither Article 7 nor the definition in Article 2(24) of the Electricity Directive provides a clear definition of what should be the object of a potential tender launched by public authorities. Moreover, by also including other procedures "equivalent in terms of transparency and non-discrimination", Article 7 leaves the tendering authority a wide margin of discretion in defining what to put on tender.

With respect to tendering procedures launched to promote new investments in electricity generation, one way to structure a tender is that interested parties are invited to bid for a long-term power purchase contract. The successful bidder will then enter into a contract for the supply of electricity to the relevant public authorities at the tender price on the terms set out in the invitation for tender. Depending on contract duration and price structure, such contract may provide the predictability needed for an investor to carry out investments which would not have been executed on the basis of ordinary market conditions. Another way to structure a tender would be launch a tender for the building and subsequent operation of a predefined electricity production facility as such, where interested parties bid for who will be able to build the facilities for the least amount of public investment aid. Yet another alternative is the approach proposed in the economic report, where lump sum investment support for new production (through new construction or capacity expansions) up to a predefined amount of TWh is put on tender, and support is

granted to the bidder which requires the lowest subsidy amount (provided that the tender specifications are fulfilled). This alternative is described in more detail in sections 3.2 and 4.2 of the economic report.

Tenders on the demand-side may for example relate to contracts for interruptible load which may be called by the relevant authorities in situations with a strained supply-demand balance.[26] As emphasised in the economic report, a similar scheme is already in operation by the Norwegian TSO Statnett as one of Statnett's instruments to mitigate a strained balance between supply and demand. The economic report proposes an expansion of this scheme, as further described in section 5.3 of that report.

4.3.2 Equivalent procedures

Article 7 of the Electricity Directive also permits Member States to implement other procedures "equivalent in terms of transparency and non-discrimination". The provision does not elaborate on the nature of the procedures which may be perceived under this alternative.

Article 5(2)(f) of the Security of Electricity Supply Directive also refers to tendering procedures and equivalent procedures as provided under Article 7(1) of the Electricity Directive as a possible means to maintain the balance between supply and demand. This reference as such is of no separate legal significance. Recital 10 of the preamble to the Security of Electricity Supply Directive does, however, provide some examples of potential procedures by setting forth that:

> *"Measures which may be used to ensure that appropriate levels of generation reserve capacity are maintained should be market-based and non-discriminatory and could include measures such as contractual guarantees and arrangements, capacity options or capacity obligations. These measures could also be supplemented by other non-discriminatory instruments such as capacity payments."*

Several similar measures are mentioned by the Commission in one of its interpretative notes to the Electricity directive, where the following alternatives are provided: keeping capacity standby for reserve purposes, capacity payments, capacity requirements (which are synonymous with capacity obligations as mentioned in the preamble cited above), reliability contracts, capacity subscriptions and long-term contracts.[27]

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[26] See further 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, pp. 5-8 for an overview of different forms of supply-side and demand-side tenders and equivalent procedures.

[27] 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, pp. 6-7.

With respect to procedures on the demand-side, the Commission note mentions interruptible load, energy efficiency measures taken by suppliers, energy efficiency measures at generation plants and real-time cost information to consumers (i.e., metering applications and fuses with two way communication).

The open-ended wording of Article 7 does, however, not rule out that other procedures than those mentioned above may also be applied under the tendering provision, provided that they are equivalent to a tendering procedure in terms of transparency and non-discrimination. On the other hand, tenders for the construction of for example district heating as an alternative to electric heating, as proposed in section 4 of the economic report, is in our opinion beyond the scope of the Electricity Directive and will therefore not be governed by Article 7.

4.4 Conditions for launching a tendering procedure

4.4.1 Overview

Article 7(1) of the Electricity Directive provides that a tendering (or equivalent) procedure can only be launched "if on the basis of the authorisation procedure the generating capacity being built or the energy efficiency/demand-side management measures being taken are not sufficient to ensure security of supply". This condition raises two overall questions. First, the requirement raises the question of how "security of supply" should be defined within the meaning of the provision. Second, it is necessary to establish in what situations the investments carried out on the basis of the authorisation procedure are deemed "not sufficient" to ensure supply security. These two questions are discussed further below in sections 4.4.2 and 4.4.3, respectively.

4.4.2 Defining "security of supply" within the meaning of Article 7(1) of the Directive

Security of supply is a multi-faceted notion. Numerous attempts have been made to define the term in literature, policy reports and expert opinions, often with differing results.[28] In its Green Paper on security of energy supply from 2000, the Commission described the term as follows:

> *"The European Union's long-term strategy for energy supply security must be geared to ensuring, for the well-being of its citizens and the proper functioning of the economy, the uninterrupted physical availability of energy products on the market, at a price which is affordable for all consumers (private and industrial), while respecting environmental concerns and*

[28] See Kim Talus, "Security of Supply – An Increasingly Political Notion", pp. 125-150 in Bram Delvaux, Michaël Hunt and Kim Talus (eds.), *EU Energy Law and Policy Issues* (2008), in particular at pp. 127-130, with further references for a recent overview of different attempts to define the notion in literature.

looking towards sustainable development, as enshrined in Articles 2 and 6 of the Treaty on European Union."29

The uninterrupted physical availability of energy products undoubtedly falls within the ambit of the security of supply notion. It is, however, less obvious that the other elements described in the broad definition above, such as affordable energy prices, should be included in the definition as it is applied in Article 7(1) of the Electricity Directive. The definition provided in section 1.2 of the economic report provides an example of a more narrow approach to the understanding of the term.

The Electricity Directive does not provide a precise definition of the notion. The definition of "security" in Article 2(28) as meaning "*both security of supply and provision of electricity, and technical safety*" does not provide much guidance for the understanding of the concept. The definition of "supply" in Article 2(19) as meaning "the sale, including resale, of electricity to customers" read in conjunction with the definition of "customers" in Article 2(7) as comprising both wholesale and final customers implies that the security of supply notion not only focuses on end-users. However, the definitions do not provide any guidance on the question of in which situations a security of supply concern is deemed to arise.

The Security of Electricity Supply Directive marks the first attempt to define "security of electricity supply" within internal market legislation. This definition could in principle act as a source of inspiration for the understanding of the term under the Electricity Directive, but is unfortunately not very informative. Article 2(b) of the Directive defines the concept as "*the availability of an electricity system to supply final customers with electricity, as provided for under this Directive*". Not only is this description subject to criticism for providing a circular definition, but the adoption of a "final customers" perspective is also inconsistent with the more general customer perspective (i.e., including both wholesale and final customers) adopted by the Electricity Directive.

In its case law concerning security of supply, the Court of Justice has applied a strict approach to the understanding of the notion, holding that public security considerations which may justify an obstacle to the free movement provisions of the Treaty "include the objective of ensuring a minimum supply of petroleum products at all times". This exemption ground may, however, only be relied upon "*if there is a genuine and sufficiently serious threat to a fundamental interest of society*".[30] This approach appears to be applied correspondingly with respect to ensuring a minimum supply of electricity.[31]

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[29] Commission Green Paper: Towards a European strategy for the security of energy supply, COM(2000) 769 final, 29.11.2000, p. 2.

[30] Case C-503/99, *Commission v Belgium*, [2002] ECR I-4809, paras 46-47. See also in particular case 72/83, *Campus Oil*, [1984] ECR 2727, paras 34-35, which was the first case where the Court of Justice assessed security of supply as an exemption ground.

[31] Case C-463/00, *Commission v Spain*, [2003] ECR I-4581, para. 71.

The Court's strict interpretation of security of supply as a public security ground must be viewed in relation to the limited room for exemptions allowed from the fundamental free movement provisions of the EC Treaty. Arguably, an exemption from Article 6 of the Electricity Directive by ways of launching a tender under Article 7 does not raise the same concerns with respect to free movement restrictions as an exemption from the Treaty provisions. The Court's interpretation should therefore not be applied *mutates mutandis* to the understanding of the term under Article 7 of the Electricity Directive. In our opinion, the application of the tendering procedure is therefore not necessarily limited to situations where there exists "*a genuine and sufficiently serious threat to a fundamental interest of society*".

On the other hand, it is not obvious that any interruption of electricity supply to customers should qualify as a security of supply concern. Some risk of minor supply interruptions will always exist within an electricity system and it would not be economically feasible to invest in sufficient generation facilities and infrastructure to avoid every such risk.

One possible approach, which has some support in the Security of Electricity Supply Directive, would be to permit tenders in the security of supply interest in situations where there is a risk that the market will not clear for an unacceptable length of time each year, i.e., that demand will outstrip supply so that electricity rationing has to be imposed on customers. As emphasised above, Article 5(2)(f) of the Security of Electricity Supply Directive provides that Member States may introduce tendering procedures as one of several possible measures to maintain the supply-demand balance. The "balance between supply and demand" is defined by Article 2(d) of the Directive as "*the satisfaction of foreseeable demands of consumers to use electricity without the need to enforce measures to reduce consumption*". Consequently, one may in our opinion argue that a projected future situation where demand is likely to outstrip supply with the effect that rationing must be imposed qualifies as a security of supply concern within the meaning of Article 7(1) of the Electricity Directive. This means that an anticipated general risk of rationing, as defined in section 1.2 of the economic report, in principle may justify a tendering intervention in order to avoid that a future need for rationing arises, provided that the other conditions in Article 7 are fulfilled.

An important question is whether not only projected electricity supply interruptions, but also a concern that electricity prices will rise to unreasonable levels due to a tight supply-demand balance may qualify as a security of supply concern within the meaning of the Directive. The wording of Article 7 of the Electricity Directive does not provide any guidance in this respect.

In our opinion, the market-based point of departure which to some extent underlies the Electricity Directive, and is more strongly advocated by the Security of Electricity Supply Directive, supports the solution that tenders should not be allowed in the interest of reducing electricity prices. Allowing tenders in such situations

would in effect lead to a situation where investment decisions could be manipulated in order to ensure reasonable prices rather than having prices trigger new investments. Another matter is that high prices may signify a strained supply-demand balance which requires new investments in order to avoid future supply interruptions. Increasing electricity prices on its own right, however, is in our opinion not sufficient to substantiate recourse to a tendering procedure.

4.4.3 The necessity requirement: "not sufficient to ensure"

The security of supply definition provided above entails that a tendering procedure may only be launched if on the basis of the authorisation procedure the generating capacity being built or the energy efficiency measures being taken cannot be expected to be sufficient to ensure the future balance between supply and demand without a need to enforce rationing.

Security of supply problems due to insufficient electricity production can arise either as a result of generation capacity constraints or as a result of insufficient primary energy source supply. The Norwegian electricity system dominated by hydropower resources raises primarily energy-based security of supply concerns. Since Norwegian electricity supply relies almost entirely on hydropower, years with low precipitation may have a significant impact on the supply situation. This situation may possibly raise the need for specific supply-side or demand-side measures as a hedge against primary energy source curtailments in the form of low hydro reservoir levels.

Article 7(1), last sentence, of the Electricity Directive requires Member States, first, to substantiate that new investments are necessary in order to avoid electricity rationing and, second, that such investments will not be carried out solely on the basis of the authorisation procedure.

The public authorities' assessment of whether and to what extent new investments are necessary in order to avoid a potential supply shortage is in principle subject to review by the EFTA Surveillance Authority and, ultimately, the EFTA Court. Although this assessment will have to be carried out on the basis of the specific merits of each case at hand, it is likely that the review intensity in most cases in practice will be limited given the difficulties involved in providing a precise estimate of the risks of a disruption.

As a general point of departure, it is in our opinion unlikely that the EFTA institutions will refuse to acknowledge a security of supply concern which is based on credible estimates of worst case precipitation levels combined with maximum projected peak load. Moreover, the fact that Norwegian electricity supply is almost 100 % reliant on hydropower supports the view that some level of diversification of energy sources in electricity generation may be necessary in order to ensure supply security. Article 3(3)(a) of the Security of Electricity Supply Directive specifically permits Member States to take account of "*the degree of diversity in electricity*

generation at national or relevant regional level". This provides a strong case for arguing that supply-side investments in capacity reserves based on other available energy sources and/or demand-side investments may be necessary to ensure long-term security of supply. Provided it can be established that maximum projected peak load may outstrip supply in a year with low precipitation, taking into account possible electricity imports on existing grids from other electricity areas, the condition is consequently likely to be fulfilled.

The next question which arises is in what situations investments carried out on the basis of the authorisation procedure can be deemed "not sufficient" to alleviate the security of supply concern at hand. At the outset, this evaluation raises the question of whether the market participants can be expected to plan, apply for and carry out the necessary investments on the basis of electricity prices in energy-only markets, i.e. markets in which the price for electricity is the only source of revenue for recovering investments.

The EU Commission has in its State aid decision concerning *Irish CADA* in principle acknowledged that investments in so-called reserve capacity may not necessarily be carried out by market participants solely on the basis of electricity market prices.[32] The case arose prior to the entry into force of the prevailing Electricity Directive, and the EU Commission's assessment has its basis in the State aid provisions of the EC Treaty. Nevertheless, the Commission's assessment of reserve capacity measures in the form of public service obligations under the State aid provisions of the EC Treaty is of corresponding interest to the understanding of Article 7(1) of the Electricity Directive.

The Commission reasoned, *inter alia*, that

> *"meeting security of supply via the setting up of sufficient reserve capacity generation an be considered in itself as a service of general economic interest, to the extent that:*
>
> *"● A clear distinction is made between "normal" capacity and "reserve" capacity generation. The former being the capacity that the market would spontaneously provide to cover expected demand (or expected increases of demand) under normal market and regulatory conditions. Indeed, in a liberalised market, as with other products, private investors are expected to ensure that sufficient capacity is available to meet demand. In general terms, the price mechanism is the way that this is expected to be achieved in the competitive market. As prices rise investment will become viable and either more capacity will come on stream, or demand will be constrained. A transparent and reliable price mechanism*

[32] State aid N 475/2003 – Ireland, Public Service Obligations in respect of new electricity generation capacity for security of supply, 16.12.2003 ("*Irish CADA*").

for wholesale electricity is sufficient in this respect. The provision of (or the increase of) normal capacity generation cannot be considered a Service of General Economic Interest.

● *The "reserve" capacity is the additional capacity that would not be spontaneously provided by normal market forces but is considered necessary in order to meet peaks of demand. One may indeed wonder whether investors are prepared to invest in peaking capacity to cover the very highest periods of demand or incidents where a large proportion of other generation is not available. It is arguable that such investment might not occur because such events are infrequent and their occurrence is unpredictable. Accordingly there may be a case for governments to provide further measures, in addition to market mechanisms, to ensure adequate capacity is available."33*

Consequently, the Commission seeks to draw a distinction between investments in electricity generation which are commercially attractive on ordinary market terms and investments which are not deemed commercially viable. The fundamental difference between these categories of investments is that reserve capacity will only be put into operation seldom and irregularly in order to ensure supplies in periods when demand exceeds estimated peak-load. Investments in "ordinary" capacity, on the other hand, typically comprise investments in base-load facilities which operate during most operating conditions and which are therefore able to recover investment costs under most conditions. It is, however, difficult to provide precise criteria for drawing this distinction. These difficulties are also underscored by the fact that both the Electricity Directive and the Security of Electricity Supply Directive applies the reserve capacity term without defining the notion further.[34] Other attempts to define the term are also rather loosely formulated.[35]

Reserve capacity is also often referred to as capacity margins, which can be defined as the margins of installed capacity over the highest expected level of demand (peak load). Consequently, the (reserve) capacity margins constitute the extra supply capacity available to respond to unexpected events such as extreme weather conditions or unplanned curtailments on the supply-side. According to the Commission, capacity margins have generally been considered acceptable to ensure sufficient operating margins when ranging between 18 % and 25 % of the total generating capacity, while 15 % is accepted as a minimum.[36] There is, however, no legal harmonisation of reserve capacity margins at European level, which entails that

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33 *Irish CADA*, para. 35.

34 See Article 11(6) of the Electricity Directive and recital 10 of the preamble as well as Article 5(1)(b) of the Security of Electricity Supply Directive.

35 See for example Christopher W. Jones, EU Energy law. Volume 1: The internal Energy Market (2nd ed., 2006), note 39 at p. 31, where "reserve capacity" is defined as "[c[apacity, usually kept unused, which is brought on line only in the event of extraordinary demand levels".

36 Commission Staff Working Document accompanying the Second Strategic Energy Review, SEC(2008) 2871, 13.11.2008, p. 43.

the necessity of a given margin will have to be assessed on a case-by-case basis from Member State to Member State.

The reserve capacity question arises within a different context in the Norwegian hydro-based electricity systems than in most other European systems which are often more reliant on thermal power plants. In the Norwegian system, electricity production margins are primarily needed as a hedge against primary energy constraints and not against production capacity constraints. The need to ensure supply security through measures aimed at ensuring sufficient energy is, however, in principle no different from the provision of capacity-related measures. In our opinion, Article 7(1) of the Electricity Directive therefore clearly applies to energy-related measures as well as capacity-related measures provided that a security of supply concern can be established.[37]

4.4.4 The relationship to other less restrictive measures

Article 7(1) of the Electricity Directive only requires that measures taken by market participants "*on the basis of the authorisation procedure*" are insufficient to ensure security of supply. The provision does not, however, indicate whether Member States are required to supplement the authorisation procedure with other incentive schemes before recourse is had to a tendering procedure. Investments in new electricity production under an authorisation procedure may, for example, be promoted through the granting of direct investment aid or tax exemptions. Although such measures may possibly be less liable to distort the price signals in electricity markets than the launching of tenders, the wording in Article 7 does not indicate that Member States are required to have recourse to such other alternatives first. The provision only requires that an authorisation procedure as such is not a sufficient instrument to attract the necessary investments.

Some of the provisions of the Security of Electricity Supply Directive may be applied as an argument in favour of requiring Member States to seek recourse to more market-based incentive schemes in combination with an authorisation procedure before the tendering alternative is applied. For example, the Directive requires Member States to take account of the importance of a transparent and stable regulatory framework and of encouraging the establishment of liquid wholesale markets.[38] The relatively advanced market design applied in Norway is in our opinion already sufficient to fulfil these generally worded requirements. In principle, the reference in Article 3(3)(d) of the Directive to "the importance of removing administrative barriers to investments in infrastructure and generation capacity" could be of some relevance. It is, however, difficult to see that the latter provision

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[37] See also along these lines Christopher W. Jones, EU Energy law. Volume 1: The internal Energy Market (2nd ed., 2006), p .20, who more indirectly makes a similar assumption by emphasising that Article 7 may be applied to promote nuclear investments.

[38] Article 3(2)(b) and (g), respectively, of the Security of Electricity Supply Directive.

places any substantive obligations on Member States by merely setting forth that States "may also take account" of such measures.

Furthermore, Article 7 of the Electricity Directive does not require Member States to prioritise between measures on the supply-side or the demand-side. Consequently, the provision does not, for example, require that a tender for energy option contracts (interruptible contracts) on the demand-side is arranged before recourse may be had to tenders for the building of new electricity production. Article 7(4) does, however, require Member States also to consider electricity supply offers from existing generation facilities in its assessment of tenders, provided that the capacity needs can be met in this way.

4.4.5 Requirements for the carrying out of the tendering process

Article 7 of the Electricity Directive also raises a number of requirements relating to how a tendering procedure should be structured. These requirements are to a large extent parallel to the fundamental principles governing public tendering procedures more generally, such as for example Section 5 of the Norwegian Public Procurement Act. The requirements will therefore only be briefly mentioned in the following.

Transparency and non-discrimination requirements form important aspects of any tendering procedure. This is also confirmed in Article 7(1), which in addition to tendering procedures opens up for other procedures *equivalent* in terms of transparency and non-discrimination. Article 7(3) last subparagraph elaborates further on these requirements by providing that:

> *"With a view to ensuring transparency and non-discrimination the tender specifications shall contain a detailed description of the contract specifications and of the procedure to be followed by all tenderers and an exhaustive list of criteria governing the selection of tenderers and the award of the contract, including incentives, such as subsidies, which are covered by the tender. These specifications may also relate to the fields referred to in Article 6(2)." (emphasis added)*

These conditions entail that Member State are required to clarify all details and requirements concerning the tendering procedure in advance in order to minimise the tendering authority's margin of discretion in its subsequent selection of the successful bidder.[39] It is also worth noting that the provision requires that possible incentives and subsidies (which are also subject to scrutiny under the State aid provisions of the EEA Agreement, as further outlined below) are also specified in the invitation to tender.

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[39] See also as an illustration the similar reasoning of the Court of Justice with respect to requirements concerning authorisation procedures in case C-205/99, *Analir*, [2001] ECR I-1271, paras 37-38.

Article 7(1) also underscores that the procedures are to be based on published criteria. The latter publication requirements are further outlined in Article 7(3), which requires that the tendering specifications shall be published in Official Journal at least six months prior to the closing date of the tender. Moreover, Article 7(3) second subparagraph also imposes an obligation on Member States to make the tendering specifications available to "any interested undertaking" established within the EEA area "*so that it has sufficient time in which to submit a tender*".

In our opinion, the requirements for the launching of tenders also entail that a cost-based compensation awarded to certain electricity producers in absence of a competitive tendering procedure, as discussed in section 3.3 of the economic report, is unlikely to qualify under Article 7 of the Electricity Directive.

4.5 The choice of tendering authority

Article 7(5) of the Electricity Directive provides that:

> *"Member States shall designate an authority or a public body or a private body independent from electricity generation, transmission, distribution and supply activities, which may be a regulatory authority referred to in Article 23(1), to be responsible for the organisation, monitoring and control of the tendering procedure referred to in paragraphs 1 to 4. Where a transmission system operator is fully independent from other activities not relating to the transmission system in ownership terms, the transmission system operator may be designated as the body responsible for organising, monitoring and controlling the tendering procedure."*

At the outset, this provision opens up for the designation of the MPE, the Norwegian Water Resources and Energy Directorate ("NVE"), Statnett or other public or private bodies which satisfy the independency requirements as tendering authorities.

The question may be raised whether the Ministry in assuming responsibility for a tender process would satisfy the requirement that it should be independent from, *inter alia*, transmission activities, given its ownership responsibility on behalf of the State in Statnett. In our opinion, the Ministry fulfils this independency requirement. First, the provision does not specify how the term "independent" should be interpreted. Second, Article 7(5) also explicitly opens up for the designation of ownership unbundled transmission system operators as tendering authorities. Provided that an independent transmission system operator such as Statnett may be designated as tendering authority, it is difficult to see any reasons why the public body exercising ownership in Statnett should be prevented from carrying out the same task. Moreover, it is difficult to envisage that an interest in transmission activities as such compromises neutrality with respect to tender decisions concerning electricity production and supply. The right to designate ownership unbundled transmission system operators as tendering authorities appears to be based on a similar reasoning.

The question of sufficient level of independency also arises with respect to Statnett's potential responsibility for carrying out tendering procedures. The company is at the outset clearly "fully independent from other activities not relating to the transmission system in ownership terms" as required by Article 7(5). Statnett has, however, acquired mobile gas power plant units at Tjellbergodden and Kollsnes as a reserve in order to ensure its responsibility for maintaining balance between electricity production and supply under exceptional operating conditions pursuant to the Energy Act Section 5A-1 and Section 22a of Regulation 7 May 2002 No. 448. The acquisition of these units raises the question of whether Statnett qualifies as being "fully independent" from electricity production and supply activities.

On the one hand, the operation of the reserve power plants amounts to a generation activity and entails that Statnett acts as a producer within the meaning of the definitions in the Electricity Directive.[40] On the other hand, Statnett's operation of the reserve plants are subject to strict conditions, and can only be operated when necessary to avoid demand-side rationing and pursuant to specific authorisation from NVE. Statnett's involvement in potential reserve electricity production therefore by no means amount to an ordinary electricity production activity. Moreover, Article 5(1)(b) of the Security of Electricity Supply Directive imposes an obligation on Member States to require transmission system operators to ensure that an appropriate level of generation reserve capacity is available. Correspondingly, Article 11(6) of the Electricity Directive is based on an assumption that such tasks may be imposed on transmission system operators. Although none of these provisions sets forth that transmission system operators are permitted to act as producers of reserve electricity generation, they do establish that these actors should have a responsibility for ensuring sufficient capacity reserves.

In our opinion, the Norwegian approach where Statnett has acquired reserve capacity to be utilised as a very last resort is most likely not liable to disqualify the company from assuming responsibility for tendering procedures. The conclusion at this point is, however, not evident and therefore subject to uncertainty.

4.6 Concluding remarks

Our main conclusions in this chapter can be summarised as follows:

- Article 7 of the Electricity Directive in part requires Member States to make preparations for the potential launching of tenders in the security of supply interest, and in part restricts the Member States' rights to launch such tenders to situations where it is necessary in order to ensure security of supply.

[40] See the definitions of "generation" and "producer" in Articles 2(1) and (2), respectively, of the Electricity Directive.

- Article 7 does not specifically require that an authorisation to build and operate new electricity production facilities is awarded as a part of a tendering procedure, but the authorisation requirements must not be detrimental to the transparency, objectivity and non-discriminatory application of the tendering alternative. Consequently, an authorisation procedure cannot be designed in such as way that it restricts the number of interested bidders ex ante or results in a renewed evaluation of the successful bidder ex post in a discriminatory manner.

- Article 7 leaves the tendering authority a wide margin of discretion in determining the object of a tender. The tendering procedure may for example relate to the tendering of public support to new construction or capacity expansions as proposed in the economic report. The provision also opens up for the application of equivalent procedures in terms of transparency and non-discrimination, such as capacity payments. Moreover, the provision opens up for both capacity related and energy related measures, and for supply-side measures as well as demand-side measures such as energy options.

- A security of supply concern within the meaning of Article 7 can in our opinion be defined as a concern that future demand is likely to outstrip supply with the effect that demand-side rationing must be imposed unless specific measures are introduced.

- Article 7 requires Member States to substantiate that new investment is necessary in order to avoid electricity rationing and that such investments will not be carried out solely on the basis of the ordinary authorisation procedure. New investment is likely to be considered necessary if it can be established that projected peak load may outstrip supply in a given region in a year with low precipitation, taking into account the potential for electricity imports to the region on existing transmission lines. Tenders may be launched if such investment is not carried out by market participants in absence of specific public incentive schemes.

- Article 7 leaves the choice of whether to launch tenders for supply-side or demand-side investment to the discretion of Member States.

- The provision imposes strict requirements on Member States concerning the clarification and advance publication of the tendering specifications in a potential tendering procedure.

- Aid or subsidies provided as a part of the tendering scheme is also subject to scrutiny under the State aid provisions of the EEA Agreement, as further discussed below in chapter 6.

- The MPE, the NVE as well as other public or private bodies independent of the interests of the electricity sector may at the outset act as tendering authorities. In our opinion, Statnett may also most likely act as tendering authority, although this latter conclusion is subject to uncertainty given Statnett's involvement in reserve electricity production.

5 SERVICES OF GENERAL ECONOMIC INTEREST: ARTICLE 3 OF THE ELECTRICITY DIRECTIVE

5.1 Introduction

Article 3(2) of the Electricity Directive sets forth that:

> *"Having full regard to the relevant provisions of the EEA Agreement and in particular Article 59 thereof, Member States may impose on undertakings operating in the electricity sector, in the general economic interest, public service obligations which may relate to security, including security of supply, regularity, quality and price of supplies and environmental protection, including energy efficiency and climate protection. [...]"*

Article 3(8) provides that:

> *"Member States may decide not to apply the provisions of Articles 6, 7, 20 and 22 insofar as their application would obstruct the performance, in law or in fact, of the obligations imposed on electricity undertakings in the general economic interest and insofar as the development of trade would not be affected to such an extent as would be contrary to the interests of the Community. The interests of the Contracting Parties include, amongst others, competition with regard to eligible customers in accordance with this Directive and Article 59 of the EEA Agreement. "*

Read in conjunction, these provisions provide a sector-specific application of Article 59(2) EEA, which includes a corresponding derogation from the main provisions of the EEA Agreement.

Article 3(8) of the Directive explicitly opens up for exemptions from Articles 6, 7, 20 and 22 only. The reference to Article 6 is of most interest to investments in new production capacity, entailing that Article 3 may be applied as an alternative exemption ground to the tendering procedure in Article 7 in order to promote new investments. The reference to exemptions from Article 7 at the outset seems curious, since the latter provision in itself amounts to an exemption ground. Nevertheless, this reference at the very least supports the view that Member States are free to choose whether to rely on the derogation in Article 7 or in Article 3 as exemptions from the authorisation procedure in Article 6. As we will revert to below, however, there are

in practice few practical differences between the assessments to be made under Article 3 and Article 7 with respect to new investments in the security of supply interest.

The possibility in Article 3(8) to derogate from Article 20 of the Directive may also be of some relevance to investment incentives, since a feed-in scheme designed to attract investments in certain geographical areas may, depending on its shaping, potentially be in breach of Article 20. Since feed-in schemes have not been recommended as one of the preferred incentive schemes in the economic report we will not pursue the relationship to exemptions from Article 20 further in the following.

In the following we will first briefly comment upon the relationship between the Directive based exemption ground in Article 3 and the more general exemption ground in Article 59(2) EEA. We will then, in section 5.3, discuss whether an obligation to invest imposed on certain market participants in the security of supply interest amounts to a service of general economic interest within the meaning of the Directive. The procedure for the selection of public service providers is discussed in section 5.4, while scope for exemptions under Article 3(8) is further outlined in section 5.5. Section 5.6 concludes.

5.2 The relationship between Article 3 of the Directive and Article 59(2) EEA

The wording of Articles 3(2) and 3(8) of the Electricity Directive open up for derogations from certain provisions of the Directive, but not from the provisions of the main part of the EEA Agreement. This entails that, formally speaking, exemptions for the performance of a service of general economic interest which requires derogations from both the Directive provisions and the EEA Agreement is subject to scrutiny under both Article 3 of the Electricity Directive and Article 59(2) EEA. In practice, however, these assessments will be similar and consequently *de facto* amount to one single test.

One may also question whether the more general derogation in Article 59(2) EEA opens up for exemptions from provisions of the Electricity Directive. It is in principle possible to envisage the application of Article 59(2) EEA as an exemption ground from Directive provisions.[41] However, within an area where a sector-specific regulation of public service obligations exists and where a Directive explicitly mentions which provisions Member States may derogate from, Article 59(2) EEA cannot in our opinion be applied as an alternative derogation ground from other Directive provisions.[42]

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[41] See similarly the reasoning of the Court of First Instance in case T-260/94, *Air Inter SA v Commission*, [1997] ECR II-997, paras 134-138.

[42] The Court of Justice seems to apply a similar approach in case C-439/06, *Citiworks*, NYR, paras 55-65. See also along these lines Leigh Hancher, case note to case C-17/03, VEMW, CMLR (2006), pp. 1125-1144, at p. 1141 and Christopher W. Jones, EU Energy Law. Volume 1: The Internal Energy Market (2006), p. 231.

Consequently, any exemption from the provisions of the Electricity Directive based on the need to carry out public service obligations must be based on Article 3(8) of the Directive, which only opens up for exemptions from Articles 6, 7, 20 and 22.

5.3 Article 3(2) of the Electricity Directive: new investment as a public service obligation in the general economic interest

5.3.1 Ensuring security of supply as a public service obligation

Article 3(2) of the Directive explicitly provides that Member States may impose public service obligations in the general economic interest "which may relate to security, including security of supply, regularity, quality and price of supplies". The need to establish public service requirements in the security of supply interest is also emphasised in the preamble to the Directive.[43] The Commission has also on several occasions underscored that security of supply is a legitimate, and perhaps even the most important, public security objective within the electricity sector.[44]

A more difficult question concerns what tasks that qualify as a public service obligation in the security of supply interest. More specifically, the question arises whether an obligation to invest in new electricity generation or to invest in demand-side measures in the security of supply interest qualifies as a public service obligation.

Member States have traditionally enjoyed a wide margin of discretion in defining their public service obligations under Article 86(2) EC, which corresponds to Article 59(2) EEA, in the absence of harmonised Community measures within the field.[45] Neither the Electricity Directive nor the Security of Electricity Supply Directive appears at the outset to restrict this margin of discretion with respect to investment tasks. On the contrary, the preamble to the latter Directive indirectly supports the view that investment tasks may qualify as public service obligations in the security of supply interest by setting forth that the Electricity Directive

"gives the Member States the possibility of imposing public service obligations on electricity undertakings, inter alia, in relation to security of supply. Those public service obligations should be defined as precisely and strictly as possible, and should not result in the creation of generation capacity that goes beyond what is

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[43] Recital 26 of the preamble to the Electricity Directive.

[44] Proposal for a Directive amending Directives 96/92/EC and 98/30/EC concerning common rules for the internal market in electricity and natural gas, COM(2001) 125 final, 13.03.2001, p. 21 and *Irish CADA*, para. 29.

[45] See, *inter alia*, Commission Communication concerning Services of general interest in Europe, OJ C 17/4, 19.01.2001, para. 22 and the view of the Court of First Instance in case T-442/03, *SIC v Commission*, NYR, para. 195. See also Article 1 of the Protocol on services of general interest to the yet non-ratified Lisbon Treaty, OJ C 306/158, 17.12.2007.

necessary to prevent undue interruption of distribution of electricity to final customers."[46]

Moreover, the preamble to the Electricity Directive underscores that Member States still retain a margin of discretion by setting forth that "[i]t is important that the public service requirements can be interpreted on a national basis, taking into account national circumstances and subject to the respect of Community law".[47]

The Commission has also in several cases in principle acknowledged that investment tasks may qualify as public service obligations in the security of supply interest. With respect to reserve capacity measures, this view was acknowledged in both *Irish CADA* and in a related case concerning Irish reserve capacity measures.[48] Although none of these cases were decided on the basis of the provisions of the now prevailing Electricity Directive, the reasoning of the Commission in our opinion applies correspondingly to the understanding of Article 3(2) of the Directive.

Furthermore, the Commission has also acknowledged that ensuring electricity production from indigenous energy sources may qualify as a public service obligation with explicit reference to Article 3(2) of the Directive.[49] In the latter cases, the Commission has applied Article 3(2) in combination with Article 11(4), which sets forth that:

> *"A Member State may, for reasons of security of supply, direct that priority be given to the dispatch of generating installations using indigenous primary energy fuel sources, to an extent not exceeding in any calendar year 15 % of the overall primary energy necessary to produce the electricity consumed in the Member State concerned."*

According to its wording, this provision only concerns priority dispatching to the benefit of electricity produced from indigenous energy sources. By analogy, the Commission has, however, also applied this provision as a presumption in favour of allowing other incentive schemes to the benefit of indigenous energy provided that the 15 % limit is respected.

In conclusion, there is in our opinion little doubt that an obligation to invest in or to ensure production from certain electricity generation facilities in order to guarantee security of supply in principle may qualify as a public service obligation in the

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46 The first recital to the Security of Electricity Supply Directive.

47 Recital 26, last sentence, to the Electricity Directive.

48 State aid N 143/2004 – Ireland Public Service Obligation – Electricity Supply Board (ESP), 14.07.2004, in particular at section 3.3 of the decision.

49 Commission decision of 24 April 2007 on the State aid scheme implemented by Slovenia in the framework of its legislation on qualified energy producers – Case No C 7/2005, OJ L 219/9, 24.08.2007, para. 103 with references to further Commission State aid cases.

general economic interest. This conclusion also applies correspondingly to demand-side investments aimed at safeguarding similar interests.

The conclusion above does not mean that investment obligations always qualify *per se* as public service obligations. The internal electricity market legislation builds on the point of departure that both supply-side and demand-side investments are ordinary market activities to be executed by market participants on the basis of functioning electricity markets.

Although Member States enjoy a wide margin of discretion in defining their services of general economic interest, Community law requires that for an undertaking to be considered entrusted with services of general economic interest, the operation of those services must be necessary for reasons of general interest.[50] For example, the Court of Justice held in *Porto di Genova* that dock work consisting of loading, unloading, transhipment, storage and general movement of goods or materials did not appear to be "of a general economic interest *exhibiting special characteristics as compared with the general economic interest of other economic activities*".[51]

The commission has explained this distinction between ordinary services and services of general economic interest as follows:

> *"Services of general economic interest are different from ordinary services in that public authorities consider that they need to be provided even where the market may not have sufficient incentives to do so. This is not to deny that in many cases the market will be the best mechanism for providing such services. […] However, if the public authorities consider that certain services are in the general interest and market forces may not result in a satisfactory provision, they can lay down a number of specific service provisions to meet these needs in the form of service of general interest obligations."52*

On the other hand, as emphasised by the Court of First Instance, "it does not follow from Community law that, in order to be capable of being characterised as an SGEI, the service in question must constitute a universal service in the strict sense, such as the public social security scheme."[53]

Based on the above, the question essentially arises whether supply-side or demand-side investments are activities that exhibit the characteristics of a public service. This, in turn, raises the question of whether the investments deemed necessary in

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[50] Case 66/86, *Ahmed Saeed Flugreisen.*, [1989] ECR 803, para. 55.

[51] Case C-179/90, *Merci convenzionali porto di Genova*, [1991] ECR I-5889, para. 27 (emphasis added). A similar view is also expressed in case C-242/95, *GT-Link*, [1997] ECR I-4449, para. 53.

[52] Commission Communication concerning Services of general interest in Europe, OJ C 17/4, 19.01.2001, para. 14.

[53] Case T-289/03, *BUPA v Commission*, NYT, para. 186.

order to safeguard security of supply will be carried out by market participants in absence of specific incentive schemes. This assessment is parallel to the question concerning the necessity of launching a tendering procedure under Article 7 of the Electricity Directive. The questions discussed above in section 4.4.3 therefore apply correspondingly to the evaluation of public service obligations under Article 3(2) of the Directive.

5.3.2 The Commission's reasoning in *Irish CADA*

The reasoning of the Commission in its *Irish CADA* decision is of some concern to the view that Member States enjoy a wide margin of discretion in defining their services of general economic interest.

The *Irish CADA* decision concerned a notified Irish aid scheme aimed at ensuring investments in reserve generation capacity in the security of supply interest. In order to counter an estimated future capacity deficit, the Irish energy regulator offered to award so-called Capacity and Differences Agreements (CADAs) lasting up to 10 years to electricity generators who undertook the construction of new generation capacity. The CADAs introduced period-weighted capacity payments to producers based on generator availability coupled with an obligation for the producers to reimburse the price differences between the electricity prices obtained at the mandatory Pool market and a predefined strike price. The scheme consequently introduced a kind of reliability contract based on capacity payments. The CADAs were entered into by, on the one hand, the public electricity supply branch of the Irish Electricity Supply Board and on the other the electricity producers which offered the cheapest conditions for capacity payments.

The Commission scrutinised the CADA scheme under the State aid provisions of the EC Treaty, finding that no aid was involved on the basis of the four conditions set forth by the Court of Justice in *Altmark*.[54] The first *Altmark* condition was at the centre of the Commission's attention. This condition requires that in order for public payment for the performance of services of general economic interest to escape classification as State aid, clearly defined public service obligations must be imposed on the service providers in question.[55]

The Commission's assessment of whether investments in reserve generation capacity qualifies as a public service obligation under the *Altmark* conditions is of equal relevance to the corresponding assessment under Article 3(2) of the Electricity Directive.

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[54] Case C-280/00, *Altmark*, [2003] ECR I-7747. The *Altmark* conditions are discussed further below in section 6.3.2.

[55] Case C-280/00, *Altmark*, [2003] ECR I-7747, para. 89.

In *Irish CADA*, the Commission established, first, that ensuring security of supply could be considered as a legitimate objective of general economic interest.[56] It then went on to emphasise that this objective could "be achieved by different means, whose impact on competition and trade between Member States may be very different".[57] On this basis, the Commission emphasised that the first priority in ensuring supply security should normally be to control demand and, furthermore, that such concerns often can be remedied by developing new or increasing capacity in existing interconnectors.[58] The Commission did, however, recognise that interconnector construction may not be an economically rational alternative for Ireland given the country's geographical location.[59]

In sum, and although the Irish scheme was eventually approved, the Commission's reasoning seems to imply that the public service obligations chosen by Member States must not only be suitable to ensure security of supply. In order to qualify as public service obligations, they must also apply the means which entails the least impact on trade, competition and the interests of the Community. In our opinion, this approach lacks sufficient basis in EU law. Neither *Altmark* nor subsequent State aid case law suggests such an extensive interpretation of the public service obligation requirement. Correspondingly, the wording of the prevailing internal electricity market legislation does not indicate that the Member States' margin of discretion in defining their public service obligations is restricted to this effect. Consequently, the qualification of a public service obligation within the meaning of Article 3(2) of the Electricity Directive only requires the tasks in question to pursue security of supply interests which would not be pursued by ordinary market participants on ordinary market terms.

Two reservations should be made to the conclusion above. First, the available capacity in interconnectors connected to other surplus areas must be utilised before recourse is made to new supply-side investments. If such available capacity exists, imposing investment tasks on certain market participants is in principle not necessary to promote a general economic interest at all. Second, the general economic interest in question, i.e. the security of supply interest, must not already be protected by other Community measures. In the latter case, imposing a separate investment obligation to pursue the interests which are already safeguarded by specific internal electricity market legislation would be superfluous. In our opinion, however, no Community measures presently exist which may be deemed to ensure sufficient investments to guarantee a reasonable balance between electricity production and demand.

5.3.3 Public service obligations, universal service and reasonable prices

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[56] *Irish CADA*, para. 29.
[57] *Irish CADA*, para. 30.
[58] *Irish CADA*, paras 31-32.
[59] *Irish CADA*, para. 34.

In section 4.4.2 above we concluded that the security of supply notion as applied within the meaning of Article 7 of the Electricity Directive entails safeguarding the balance between production and demand in order to avoid demand-side rationing. The concept of reasonable or affordable electricity prices, on the other hand, is not as such a relevant aspect of this security of supply definition.

Article 3(2) of the Electricity Directive appears to take a different approach to the issue of electricity prices by providing that public service obligations "may relate to security, including security of supply, regularity, quality *and price of supplies* [...]" (emphasis added). Consequently, the wording of the provision clearly underscores that electricity prices amount to a general economic interest which possibly may be subject to public intervention through the imposition of public service obligations.

The reference to electricity prices must also be seen in relation to the universal service provision in Article 3(3) of the Directive, which requires Member States to ensure that at least all household customers enjoy "the right to be supplied with electricity of a specified quality within their territory at reasonable, easily and clearly comparable and transparent prices".

The recognition of electricity prices as a legitimate public service concern partly appears to derive from the Court of Justice's earlier case-law concerning services of general economic interest in pre-liberalised energy markets.[60] Moreover, the issue of affordable or reasonable prices is more generally regarded by the Commission as an important aspect of the universal service concept, which is regarded as one of the common elements of the services of general economic interest notion.[61]

Within an investment perspective, however, the concept of reasonable prices does not correspond well to the idea of facilitating market-based investments within a competitive regime. A legal regime where Member States are permitted to impose obligations to invest in facilities which under normal circumstances would be uneconomical in order to bring down end user prices would contradict the underlying regulatory point of departure of a competitive market. The latter view is also reflected in the first recital to the Security of Electricity Supply Directive, which underscores that the imposition of public service obligations "should not result in the creation of generation capacity that goes beyond what is necessary to prevent undue interruption of distribution of electricity to final customers."

In our opinion, Articles 3(2) and 3(3) cannot be interpreted as allowing Member States to impose supply-side or demand-side investment obligations in order to bring down electricity market price levels. The provisions does, however, provide a basis for requiring Member States to ensure supply at reasonable prices to household

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[60] See in particular case C-393/92, *Almelo*, [1994] ECR I-1477, paras 47-48 and case C-157/94, *Commission v Netherlands*, [1997] ECR I-5699, paras 34-43.

[61] Commission Green Paper on Services of general interest, COM(2003) 270 final, 21.05.2003, pp. 16-18 and 35-39.

customers in extraordinary situations, for example by ways of suppliers of last resort, as specifically mentioned in Article 3(3). Such instruments are not of direct relevance to the promotion of new investments, and will therefore not be discussed further in the following.

5.4 Requirements for the selection of public service providers

Article 3(2) of the Electricity Directive requires that public service obligations shall be "clearly defined, transparent, non discriminatory, verifiable and shall guarantee equality of access for EU electricity companies to national consumers." These requirements are further explained by the Commission in an interpretative note to the Electricity Directive and will therefore not be elaborated further on here.[62]

Moreover, Article 3(4) provides that when "financial compensation, other forms of compensation and exclusive rights which a Member State grants for the fulfilment of the obligations set out in paragraphs 2 and 3 are provided, this shall be done in a non-discriminatory and transparent way".

Since public service obligations concerning new investments are likely to be accompanied by some sort of incentive scheme to compensate the extra costs involved in performing the task, Article 3(4) will in practice require that the public service obligation (and the compensation) is imposed in a non-discriminatory manner. For obligations which can be performed by other undertakings than those in a natural monopoly position, in practice the TSOs and DSOs, the most practical way to ensure such non-discrimination is to put the public service obligation on tender. Consequently, public service obligations and compensation awarded pursuant to a tendering procedure which fulfils the requirements in Article 7 of the Electricity Directive will clearly also fulfil the non-discrimination requirement in Article 3(4) of the Directive.

On the other hand, Article 3(4) does not specifically require that public service compensation is awarded pursuant to a tendering procedure. This raises the question whether public authorities as a last resort may impose investment obligations and provide compensation to certain electricity producers without launching a tender in situations where only a limited number of market participants may perform the obligations in practice. This approach is further outlined in section 3.3 of the economic report.

The Commission has advocated the view that except for obligations which can only be imposed on TSOs, the only way to effectively guarantee non-discrimination is to appoint the public service providers pursuant to a tendering process.[63] Consequently,

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[62] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas: Public service obligations, 16.01.2004, pp. 2-7.

[63] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas: Public service obligations, 16.01.2004, p. 6.

it is likely that the EFTA Surveillance Authority will impose a very strict burden of proof on Member States for the fulfilment of the non-discrimination requirement in those cases where public service obligations and compensation have been awarded in absence of a tendering process. In principle, however, Article 3 of the Directive does not require that public service obligations and compensation is awarded pursuant to a tendering procedure. Awarding such obligations and compensation in absence of a tendering procedure is therefore not contrary to Article 3 provided that the public authorities can document clearly that the non-discrimination requirement is fulfilled by other means.

5.5 Article 3(8) of the Electricity Directive: exemptions from the Directive in the general economic interest

5.5.1 The necessity requirement

Article 3(8) of the Electricity Directive provides that Member States may decide not to apply, *inter alia*, Article 6 of the Directive "insofar as their application would obstruct the performance, in law or in fact, of the obligations imposed on electricity undertakings in the general economic interest and insofar as the development of trade would not be affected to such an extent as would be contrary to the interests of the Community."

The wording includes two conditions: (1) the application of the provisions subject to exemption must obstruct the performance of the public service obligations imposed, i.e. an exemption must be necessary in order to perform the tasks in question, and (2) such exemption must not affect the development of trade contrary to Community interests. The first condition is discussed here, while the second is dealt with in section 5.5.2 below.

The imposition by a Member State of an obligation to invest in new electricity generation on certain market participants will in itself require an exemption from the authorisation procedure in situations where the authorisation to construct is awarded as a part of the tendering procedure. An exemption from Article 6 of the Directive should therefore be granted provided that the investment in question promotes security of supply and that the Member State can substantiate that the investment will not be carried out solely on the basis of the authorisation procedure. Consequently, the assessment under Article 3(8) corresponds to the similar assessment of the necessity of granting an exemption from the authorisation procedure under Article 7, discussed above in section 4.4.3.

The imposition of demand-side investment obligations does not necessarily raise the need for an exemption from Article 6 or any of the other provisions mentioned in Article 3(8), and the need for an evaluation under the latter provision may not arise at all. If an exemption from a Directive provision is called for, the evaluation of necessity referred to above applies correspondingly. It should be noted that even in situations where an exemption from Article 6 is not necessary, public authorities are

nevertheless under an obligation to notify the public service obligation to the EFTA Surveillance Authority in accordance with Article 3(9) of the Directive.

5.5.2 Development of trade and the interests of the Community

The second condition under Article 3(8) reflects the corresponding condition under the second sentence in Article 59(2) EEA and, similarly, Article 86(2) EC. The condition as enshrined in the latter provision "seeks to reconcile the Member States' interest in using certain undertakings, in particular in the public sector, as an instrument of economic or fiscal policy with the Community's interest in ensuring compliance with the rules on competition and the preservation of the unity of the Common Market".[64] The relevance of this criterion as a supplement to the necessity criterion discussed above is, however, not clear from the case-law of the Court of Justice.

The threshold in Community law for finding that a measure has an effect on trade is generally modest.[65] The crucial question is therefore whether a Directive exemption is liable to affect trade to an extent contrary to the interests of the Community. Article 3(8) last sentence specifically provides that the interests of the Community "include, amongst others, competition with regard to eligible customers", i.e. all customers with effect from 1 July 2007.[66] Whether the interests of the Community notion as applied within the meaning of Article 3(8) also include other Community energy policy interests such as environmental and security of supply interests is an open question. In any case, the condition is in our opinion not likely to restrict the application of transparent and non-discriminatory procedures such as tendering procedures given their, most likely, modest effects on trade. It cannot, however, be ruled out that the EFTA Surveillance Authority, and ultimately the EFTA Court, will apply a slightly more stringent approach to this criterion in situations where Member States have awarded public service compensation to certain predefined market participants in absence of a tendering procedure. This evaluation will have to be carried out on a case by case basis.

5.6 Concluding remarks

Our main conclusions in this chapter can be summarised as follows:

- Article 3(2) read in conjunction with Article 3(8) provides a sector-specific application of the exemption ground in Article 59(2) EEA. Provided that the

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64 Case C-202/88, *France v Commission*, [1991] ECR I-1223, para. 12.

65 See for example Malcolm Ross, State Aid and National Courts: Definitions and Other Problems – A Case of Premature Emancipation?, CMLR (2000), pp. 401-423, at p. 416 for an overview of the case-law relating to the similar condition under the State aid prohibition in Article 87(1) EC (corresponding to Article 61(1) EEA).

66 Se Articles 21(1)(c) and 2(12) of the Directive.

conditions in Article 3 are fulfilled, Member States may derogate from, *inter alia*, the authorisation procedure in Article 6 of the Directive.

- Investment obligations aimed at ensuring security of supply, whether related to supply-side or demand-side investments, are likely to qualify as public service obligations in the general economic interest under Article 3(2) of the Directive provided that the necessary investments are not carried out by market participants on the basis of ordinary market terms.

- Despite the reference to electricity price levels in Articles 3(2) and 3(3) of the Directive, these provisions cannot in our opinion be interpreted as allowing Member States to impose supply-side or demand-side investment obligations solely in the interest of reducing electricity market price levels.

- Article 3(4) of the Directive requires that any public service compensation shall be granted in a non-discriminatory and transparent way. The provision does not explicitly require that public service compensation is awarded pursuant to a tendering procedure. Nevertheless, it is likely that Member States who award compensation to certain market participants in absence of such tender will be faced with a very strict burden of proof for substantiating that the award procedure has been carried out in a non-discriminatory and transparent manner.

6 STATE AID TO NEW INVESTMENTS

6.1 Introduction

EEA State aid control derives from the need to maintain a level playing field for all undertakings active within the area covered by the EEA Agreement, regardless of their country of establishment. More specifically, the aim of Article 61 of the EEA Agreement "is to prevent trade between Member States from being affected by benefits granted by the public authorities which in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of certain goods".[67]

In addition to the assessment under the internal electricity market legislation as incorporated into the EEA Agreement, the incentive mechanisms to promote new supply-side or demand-side investments are moreover subject to state aid control under the provisions of the EEA Agreement in order to prevent undue distortion of competition in the relevant markets. Consequently, internal electricity market provisions do not preclude the application of the EEA state aid regime. However, as will be demonstrated the legal instruments are closely interlinked.

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[67] Case 173/73, *Italy v Commission*, [1974] ECR 709, para. 13, and joined cases C-393/04 and C-41/05, *Air Liquide Industries*, [2006] ECR I-5293, para. 27.

In the following we will provide a short overview on the EEA state aid regime, cf. section 6.2. In section 6.3 we will provide an analysis of the application of Article 61(1) EEA. In section 6.4 the grounds for justification under Articles 61(3) and 59(2) EEA are analysed.

As a general comment to the report, it should be emphasised that since the national aid measure has not been designed in detail but merely identified in general, it is not feasible to provide an in-depth analysis of the application of the EEA state aid regime. Thus, as mandated this report puts emphasis on the options the Norwegian authorities are provided with under the state aid provisions of the EEA Agreement to design national aid measures.

6.2 EEA State aid regime - overview

The basic substantive provisions on state aid are found in Article 61 of the EEA Agreement. The primary procedural rules are set out in Article 1 of Protocol 3 to the Surveillance and Court Agreement. (Protocol 3 SCA) These provisions are comparable to Articles 87 and 88 EC. Their aim is to ensure a level playing field and that conditions of competition are not undue distorted by State measures.

The main rule in Article 61(1) EEA is that aid granted through State resources which distorts or threatens to distort competition and affects trade between the EEA Contracting Parties is incompatible with the EEA Agreement. The second and third paragraphs of Article 61 add certain exception clauses to this main rule.

The analysis of Article 61 EEA is a two step procedure. First, it is necessary to determine whether a national measure constitutes state aid within the meaning of Article 61(1) EEA. Second, in the affirmative, the question arises whether the aid "shall be compatible" or "may be considered to be compatible" with the common market in accordance with Articles 61(2) or 61(3), respectively, or in the case of a public service compensation, is compatible with the functioning of the EEA Agreement based on Article 59(2) thereof.

Originating in administrative practice from the Commission and case law from the Community Courts (European Court of Justice, Court of First Instance and the EFTA Court), the Authority following the Commission adopts guidelines for the application of the state aid policy within the area covered by the EEA Agreement.

Importantly, with the objective to secure supply of energy, the Authority has not yet adopted such guidelines. However, that does not preclude that national security of supply measures can be declared compatible with the functioning of the EEA Agreement based on Article 61(3) directly. Moreover, as regards compensation for discharging public service obligations, the Authority has adopted guidelines for both the aid assessment under Article 61 (1) EEA and the compatibility assessment under Article 59 (2) EEA.

The Norwegian authorities are obliged not to put into effect a new aid measure before the Authority has approved the national measure. State aid measures which fall within the ambit of Article 61(1) EEA must, therefore, be notified to the Authority prior to its implementation. The Authority must then assess whether the notified measure constitutes state aid and, if it does, examine whether the notified measure is eligible for exemption.

Apart from deciding on all national plans to grant or alter aid, the Authority is also obliged, under Article 1(1) of Protocol 3 SCA, to keep all systems of existing aid in the EFTA States under constant review.

Protocol 26 to the EEA Agreement stipulates that the Authority is entrusted with equivalent powers and similar functions to those of the Commission in the field of state aid. Provisions to that effect are contained in Articles 5 and 24 of Protocol 3 SCA. Furthermore, Protocol 27 to the EEA Agreement lays down the principles according to which the Authority and the Commission shall co-operate in order to ensure a uniform application of the state aid rules.

6.3 The application of Article 61(1) EEA

6.3.1 State aid within the meaning of Article 61(1) EEA - introduction

Article 61(1) EEA reads:

> *"Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States 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 Contracting Parties, be incompatible with the functioning of this Agreement".*

To be termed State aid within the meaning of Article 61(1) EEA, a measure must meet the following four cumulative criteria: The measure must;

(i) confer on recipients an economic advantage which is not received in the normal course of business;

(ii) the advantage must be granted by the State or through State resources and must

(iii) be selective by favouring certain undertakings or the production of certain goods; and

(iv) distort competition and affect trade between Contracting Parties.

It is against these four cumulative criteria the national aid measure shall be assessed. With the purpose to provide the full picture of the prohibition in Article 61(1) EEA, we will first introduce the criteria, which in our opinion will be easily fulfilled in the case at hand.

First, Article 61(1) EEA covers only measures involving a transfer of state resources. Compensation from the state, including state owned enterprises for discharging public service obligations in order to pursue a security of supply objective in the general interest is considered as state resources within the meaning of Article 61(1) EEA. Moreover, the transfer of state resources criterion will be fulfilled in the other aid measures identified in the economic report in that all are presumably funded by direct grants or parafiscal charges such as the Energy Fund.

Second, Article 61(1) EEA covers only selective measures, as opposed to general measures. A public procurement procedure (market based) or a cost based methodology (cost based which aims at selecting one or a limited number of service providers will in general be considered a selective measure within the meaning of Article 61(1) EEA. Likewise the other aid measures identified in the economic report will likely all be selective.

Third, to be classified as aid within the meaning of Article 61(1) EEA, the measures must distort or threaten to distort competition and affect trade between the Contracting Parties. Applicable to all aid measures identified in the economic report, the Authority adopted decision 125/07/COL in which it accepted the financing of the Norwegian Energy Fund (Energifondet). On page 24, the Authority states regarding the criteria distortion of competition and effect on trade:

> *"In the present case, the measures are strengthening the competitive situation of the supported enterprises within the energy and electricity markets in the European Economic Area, where they actually or potentially compete with other energy producers. As the electricity market is largely liberalised and there is trade flow in energy products and electricity between the EEA States (e.g. Norway imports and exports a certain percentage of its electricity), the described (potential) distortion of competition takes place in relation to other EEA undertakings. This is further demonstrated by the fact that various types of electricity are traded in Nordpool, a common framework between the Nordic countries. The Energy Fund system is, therefore, distorting or threatening to distort competition and affect trade between the Contracting Parties."*

In our view there are no reasons to deviate from this approach in the present case. Thus, the conditions relating to distortion or threatening to distort competition and affect trade between the Contracting Parties within the meaning of Article 61(1) of the EEA Agreement will be fulfilled.

Accordingly, the remaining question is whether this national aid measure constitutes an economic advantage within the meaning of Article 61(1) of the EEA Agreement.

6.3.2 Economic advantage within the meaning of Article 61(1) of the EEA Agreement

Except for compensation for discharging public service obligations, we are of the opinion that the remaining aid measures as identified in the economic report constitutes an economic advantage within the meaning of Article 61(1) EEA. Thus, for those aid measures all conditions in the state aid prohibition are fulfilled, and to the extent the Norwegian authorities decides to implement one of these measures, the measure must be notified to the Authority, cf. section 6.2 above.

However, compensation for the costs of discharging a service of general economic interest may benefit from an exception to the principle of the prohibition of state aid. In certain cases, such compensation may not even be classified as state aid within the meaning of Article 61(1) of the EEA Agreement. According to the *Altmark* judgment, state measures compensating the net additional costs of providing a service of general economic interest do not qualify as state aid within the meaning of Article 61(1) EEA if the compensation is determined in such a way that it prevents a real economic advantage in favour of the undertaking. The ECJ has indicated that four conditions have to be fulfilled:

First, the recipient undertaking is actually required to discharge public service obligations and those obligations have been clearly defined;

Second, the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner;

Third, the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations;

Fourth, where the undertaking which is to discharge public service obligations is not chosen in a public procurement procedure, the level of compensation needed has been determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

The Commission has applied the *Altmark* doctrine in a number of cases, but has accepted that no aid has been involved in only two of them. Those cases are *Irish CADA* and C-7/2005 – Slovenia, both related to compensation for costs for providing public service obligations in relation to a security of supply objective.

The first *Altmark* condition requires the recipient undertaking actually to have clearly defined public service obligations to discharge. In accordance with consistent case law on the application of Article 86(2) of the EC Treaty and the Commission guidelines on state aid in the form of public service obligation (section 8), the first *Altmark* condition shall be understood as leaving the Norwegian authorities a wide margin of discretion regarding the nature of services that could be classified as being

services of general economic interest. Thus, the Authority's task is to ensure that this margin of discretion is applied without manifest error as regards the definition of services of general economic interest.

Therefore, a public service obligation that is in the general economic interest pursuant to Article 3(2) of the Electricity Directive will clearly also amount to a public service obligation within the meaning of the first *Altmark* criterion.[68]

The second condition, that compensation must be based on parameters established in advance in an objective and transparent manner, corresponds to Article 7 of the Electricity Directive, which requires tenders to be based on pre-published criteria which also contain a detailed description of any incentive measures.[69] A more detailed description of the criteria can be found in the guidelines, in which the Commission /the Authority in section 11 states that the entrustment document shall among others include the precise nature and the duration of the public service obligations, the undertakings and territory concerned, the nature of any exclusive or special rights assigned to the undertaking, the parameters for calculating, controlling and reviewing the compensation and the arrangements for avoiding and repaying any overcompensation.

The third *Altmark* condition establishes that compensation must not exceed what is necessary to cover the costs incurred in carrying out public service obligations (including a reasonable profit). In our view it may be argued that the third *Altmark* condition is likely to be fulfilled provided that the compensation is granted through a public procurement procedure where the selection of the successful aid recipient is objective, transparent and non-discriminatory as required by the Directive. Hence, it could be argued that the compensation provided to the best bidder will be presumed not to exceed the costs necessary to carry out the tasks in question. Recent Commission practice, however, seems to underscore that the launching of a tendering procedure on its own right is not necessarily sufficient to fulfil the *Altmark* conditions.[70] This evaluation will necessarily have to be carried out on a case by case basis.

The final *Altmark* condition provides that in cases where the recipient is not chosen pursuant to a public procurement procedure, the level of compensation must be fixed at a benchmark arrived at through an analysis of the costs a typical, well run undertaking would have incurred in discharging the same obligations. This condition, and in particular its application in situations where the recipient is not chosen pursuant to a public procurement procedure, raises uncertainties, which in our view is not advisable to explore further. Since the provisions of the Electricity Directive establish a clear preference for the award of public service obligations on the basis of

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[68] See further section 5.3 above.
[69] See in particular Article 7(3) third subparagraph of the Electricity Directive.
[70] See further Leigh Hancher in Christopher W. Jones (ed.), EU Energy Law Volume II: EU Competition Law and Energy Markets (2nd ed., 2007), p. 672.

tendering procedures, the condition is likely to be fulfilled in most cases, provided the conditions of the Electricity Directive are met.

On this basis, it is possible to conclude that, although the object of the assessment entails differences between the procedures, the application of the conditions set forth in the Electricity Directive and under the *Altmark* test essentially raises many of the same questions. The most important difference between the Electricity Directive conditions and the *Altmark* conditions is that the former criteria focus on in which situations a Contracting Party is entitled to launch a tendering procedure, while the latter criteria focus on the level of compensation awarded to the successful bidder. In the latter respect, it is important to emphasise that the *Altmark* conditions provide for a narrow exception from the State aid prohibition in Article 61(1) EEA, and that the Commission has interpreted these conditions very restrictively under the corresponding provision in Article 87(1) EC. Given the uncertainties involved in complying with the four *Altmark* conditions, a national scheme which seeks to rely on these criteria, and consequently escape classification as state aid, should in our opinion be notified in advance to the Authority in order to prevent a situation where non-notified compensation is considered as unlawful aid subject to recovery.

In conclusion, the national aid measure may be organised in conformity with the Electricity Directive and the *Altmark* doctrine in order to escape the state aid prohibition in Article 61(1) of the EEA Agreement. Any incentive scheme structures in accordance with the *Altmark* criteria in order to escape classification as State aid is, however, likely to be subject to intense scrutiny by the Authority, where the strict interpretations adopted by the Commission will be applied correspondingly by the Authority. Consequently, we strongly recommend that such measures are notified in advance to the Authority.

6.4 Grounds for justification

6.4.1 Introduction

To the extent that a national aid measure constitutes state aid within the meaning of Article 61(1) EEA, the Norwegian authorities may apply for an exemption to the state aid prohibition to the Authority. The Authority may grant such an exemption based on either Article 59(2) or 61(3) c of the EEA Agreement. In order to apply both grounds for justification, the Norwegian authorities are required to demonstrate the existence of a marked failure to which the aid measure shall be targeted. The market failures in question are discussed in the economic report.

In the following we will in section 6.4.2 provide an overview of Article 59(2) EEA. In section 6.4.3 we provide an overview of Article 61(3) c as the alternative for justification under the EEA state aid regime.

6.4.2 Application of Article 59 (2) of the EEA Agreement

To the extent the *Altmark* criteria as described above are not fulfilled, the Authority may declare the compensation for discharging public service obligations compatible with the functioning with the EEA Agreement based on Article 59(2) thereof.

This provision may be applied only on public service obligations: (1) To the extent the Norwegian authorities decide to undertake a public procurement procedure, which results in a limited number of bidders or there are other uncertainties as regard whether the public procurement procedure does not reflect the real market price. (2) In the alternative, if the Norwegian authorities decides not to undertake a public procurement procedure, but merely decide to entrust one or more undertakings with a public service obligation.

Due to the high risk of overcompensation, the Norwegian authorities will be required to notify the Authority, and await an approval before the service provider is entrusted.

As the aid instrument as such is not yet designed, we do not have the factual information to provide an in-depth analysis on the application of Article 59(2) EEA. Consequently, in the following we provide a general description of the application of Article 59(2) EEA, and indicate which requirements that needs to be fulfilled in order to qualify for exemption under Article 59(2).

Article 59(2) EEA reads;

> *"Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Agreement, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Contracting Parties."*

According to consistent case law from the Community Courts under Article 86(2) EC the analysis shall be carried out in three steps as follows;

- the service must be a service of general economic interest, clearly defined as such by the EFTA State (definition);

- the undertaking has been explicitly entrusted by the authorities with the provision of the service (entrustment);

- the application of the competition rules of the EEA Agreement must obstruct the performance of the tasks assigned to the undertaking and the exemption from

such rules must not affect the development of trade to an extent that would be contrary to the interests of the EEA Agreement (proportionality test).

The first criterion, definition, corresponds to the first *Altmark* criterion. Thus reference is made to above in which the criterion is explained in further detail.

As regards the second criterion, entrustment, it follows from section 11 of the guidelines that the Norwegian authorities are required to demonstrate that the service provider is entrusted the obligation in an official act. Moreover, that act need to specify among others the precise nature and the duration of the public service obligations, the undertakings and territory concerned, the nature of any exclusive or special rights assigned to the undertaking, the parameters for calculating, controlling and reviewing the compensation and the arrangements for avoiding and repaying any overcompensation.

As regards the third criterion, proportionality, it is merely a question of compensation for discharging the public service obligation, including a reasonable profit. Thus, pursuant to section 13 of the guidelines the amount of compensation may not exceed what is necessary to cover the costs incurred in discharging the public service obligations, taking into account the relevant receipts and reasonable profit for discharging those obligations. Consequently, whereas the compensation under the *Altmark* doctrine is market based, the compensation under Article 59(2) of the EEA Agreement is cost based.

In conclusion, in general to the extent the aid measure is designed in such a way that the aid recipient only is granted a reasonable profit on its investment the Authority may declare an aid instrument in the form of a public service obligation compatible with the functioning of the EEA Agreement based on Article 59(2) thereof.

6.4.3 Application of Article 61(3) c of the EEA Agreement

National aid measures which constitute state aid within the notion of Article 61(1) EEA may be compatible with the functioning of the EEA Agreement based on Articles 61(2) and (3) thereof of which 61(3) c is of relevance in this particular case.

Contrary to Article 59(2) EEA there is no requirement that the aid instrument is compensation for discharging a public service obligation. Consequently, the Norwegian authorities may in any event apply for derogation from the state aid prohibition under Article 61 3(c). This article will be applicable for all aid measures which are identified as alternative in the economic report. In other words, aid measures which objective is to increase supply, reduce consumption or both may be eligible for exemption under Article 61(3) c EEA.

Please note that as the aid instrument(s) as such is not yet designed, it is not feasible to provide an in-depth analysis of the application of Article 61(3) c EEA. Consequently, in the following a general description of Article 61(3) c EEA is

provided in combination with an identification of the requirements the Norwegian authorities are obliged to fulfil.

Article 61(3)c reads:

> *"The following may be considered to be compatible with the functioning of this Agreement:*
> *(...) 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; (...)"*

In its analysis of the compatibility with the functioning of the EEA Agreement, and in the absence of adopted guidelines with the purpose to address security of supply objectives, the Authority applies its standard methodology. The understanding of this methodology is essential in order to identify relevant factual information which needs to be submitted to the Authority to obtain a swift approval of the planned aid measure.

In short; compatibility with the functioning of the EEA Agreement is essentially balancing of the positive effects of aid (in terms of contributing to the achievement of a well-defined objective of common interest) and its negative effects (namely the resulting distortion of competition and trade) (the "balancing test"). In order to be declared compatible with the functioning of the EEA Agreement, aid must be necessary and proportionate to achieve a particular objective of common interest.

The balancing test sets forth the following elements of analysis:

Well-defined objective of the common interest

The aid measure should be aimed at a well-defined objective of a common interest. Security of supply is in our view a legitimate objective of common interest. The market failure must be clearly defined and demonstrated as identified above.

Well-designed instrument

The basic issue is to ascertain whether the aid instrument is well designed to deliver the objective of common interest as identified above. In order to do so, the answers to the following three questions are of importance.

- Is the aid an appropriate policy instrument? State aid should be used where the advantages of using a selective instrument (such as state aid) are established and demonstrated.

Accordingly, the Norwegian authorities must demonstrate that the market failure cannot be corrected by regulatory measures. This is identified in the economic report.

- Is there an incentive effect? Does the aid change the behaviour of the beneficiary? The beneficiary should, as a result of the aid, engage in activities that it would (i) not carry out without the aid at all or (ii) carry out only in a restricted or different manner. The aim is to avoid state aid for an activity which the company would undertake in any case, even without the aid, to the same extent.

Consequently, the Norwegian authorities are required to demonstrate that the incentive for the current market is not profitable to trigger new investments in the region. This is further identified in the economic report.

- Is the aid measure proportionate to the problem tackled? This question addresses whether the same change in behaviour could have been achieved with less aid. The amount and intensity of the aid must be limited to the minimum necessary for the activity to take place.

Consequently, the Norwegian authorities are required to demonstrate that the objective could not have been achieved with less aid. A tendering procedure will in our view be considered as a positive element in order to limit the aid to the minimum necessary.

In order to perform the analysis, the Norwegian authorities are required to identify a counterfactual scenario as identified in the economic report. The methodology is namely to compare the aided project with a hypothetical situation that no aid was given. Only in such way can some of the objectives of the common interest (e.g. a market failure) and the incentive effect (did the behaviour of the beneficiary change?) be analysed.

Balancing of the positive and the negative effects/overall balance positive

The final exercise addresses the possible and negative effects of the aid and their magnitude against which its positive effects are balanced. The negative effects are primarily distortive effects on competition and trade. In order for the aid to be found compatible, a high magnitude of negative effects needs to be sufficiently offset by a corresponding high level of positive effects of the aid. The overall outcome will depend on a series of features of the proposed aid measure and will be assessed on a case by case basis for measures subject to a detailed assessment.

In conclusion, in general it is our understanding that Article 61(3)c EEA allows the Authority a wide margin of discretion to assess the compatibility with the EEA Agreement of security of supply measures on the specific merits of each separate case. However, note that in the absence of specific guidelines, the Commission has in practice chosen to identify electricity production from indigenous energy sources as a service of general economic interest which, by analogy, may be supported up to the

15 per cent threshold established in Article 11(4) of the Electricity Directive. The Commission has more recently applied the same practice in other state aid cases under the present Electricity Directive. Consequently, it is unlikely that the Commission and the Authority will accept State aid to mitigate energy-related security of supply problems for investments in electricity generation from indigenous energy sources where these sources exceed 15 per cent of the primary energy necessary to produce the electricity consumed domestically.

6.5 Concluding remarks

- State aid falling within the notion of Article 61(1) EEA, is subject to notification to and approval from the Authority prior to implementation of the aid measure.

- State aid in the form of compensation from discharging public service obligations may escape the prohibition of state in accordance with the Altmark doctrine. Given the legal uncertainties involved in applying the Altmark doctrine, any incentive scheme designed on the basis of these criteria should be notified in advance to the Authority. The other aid measures indentified in the economic report will likely fall within the notion of Article 61(1) EEA, and must also be notified to the Authority.

- In any event, the national aid measures as identified in the economic report may be found compatible with the functioning of the EEA Agreement based on Articles 61(3)c or 59(2) thereof.

- However, as the aid measures are not designed in detail yet, it is not feasible to provide an in-depth state aid analysis on the individual measures and its compatibility with the functioning of the EEA Agreement.