

Latvia has prepared additional information regarding the state aid case SA.43140 (2015/NN) and submits it as the reply to the European Commission letter of the 14 June 2016 No B.2/AV/nz D\*2016/056592 and in addition to the Latvian reply to the European Commission letter of the 14 December 2015 No B.2/AC/DB D\*2015/138244.

### **1. The solution of the overcompensation issue**

Latvia on July 5 has adopted changes in the regulations of Cabinet of ministers to develop further the conditions that the European Union (hereinafter referred to as the EU) Member States must comply with regarding the compliance with the EU's single market principles, including when developing support mechanisms for promotion of renewable energy and high efficiency cogeneration. Thus ensuring the compliance of the State Aid Scheme SA.43140 (2015/NN) – Aid to Electricity Producers –with the conditions of the EU internal market and State-aid rules.

The adopted regulations (see in attachment) shall take effect on the first day of the following full calendar month after the European Commission has adopted a decision on compliance of the state aid conditions with the European Union's internal market conditions within the framework of the State Aid Scheme SA.43140 (2015/NN) "Aid to Electricity Producers".

The adopted regulations prescribe the procedures that tackle the overcompensation risk. It is done through setting a ceiling of 9% for the total capital investment internal rate of return (hereinafter referred to as IRR) for merchants producing electricity from renewable energy sources.

The assessment of IRR of the projects will be calculated using fixed benchmarks, e.g., investment costs, workload, operation and maintenance costs, therefore ensuring an equal approach to all merchant projects. The regulations foresee a procedure according to which an assessment shall be carried out after the first five full calendar years of operations, namely, from the moment when the merchant receives the mandatory procurement or guaranteed payment for the installed electrical capacity. After the submission of the annual report for the fifth calendar year, the Ministry of Economics within a time limit of two month shall calculate the IRR for the entire period when the merchant has been and is eligible in the future to receive aid.

If the merchant has already submitted the annual report for the fifth calendar year before the adopted regulations take effect, the IRR shall be calculated within two month from the day when the adopted regulations take effect.

In case the IRR exceeds 9%, a price differentiation coefficient is applied, notifying the merchant, public trader and system operator about the calculations. The price differentiation coefficient will be set at a level that ensures that the IRR of the merchant's project in the final year of the project is not higher than 9%. At the same time, if the project's IRR does not exceed 9%, no price differentiation coefficient will be applied to the project.

Regulations also enable the merchant to ask the Ministry of Economics to perform IRR calculation before the power plant or cogeneration unit has been operating for a period of five full calendar years. In addition, it is foreseen that in case where the circumstances affecting the IRR of the power plant have changed, the Ministry of Economics, on its own initiative or at the request of the merchant, may recalculate the IRR of the power plant and the price differentiation coefficient.

The values of benchmarks and calculation methods of the IRR and price differentiation coefficient for preventing overcompensation are established in the conclusions of the study “Development of Proposals for Methodological Guidelines for Calculation of the Internal Rate of Return to Eliminate Overcompensation for Merchants that have been Granted the Right to Sell Electricity Under the Mandatory Procurement or the Guaranteed Payment” procured by the Ministry of Economics.

The benchmarks are set for certain variables according to studies<sup>1</sup> conducted in the EU member states on establishing the reference costs for production of electricity from renewable energy sources and the research<sup>2</sup> conducted in Latvia. Thus, eliminating the possibility that the IRR could significantly vary for power plants with the same technologies at similar situations. In addition, the use of benchmarks in the IRR calculation will ensure that merchants, who plan the operations of their power plant efficiently, integrating them into a complete operating cycle (for example, a biomass cogeneration unit that is located next to a pellet manufacturing company that consumes the heat produced in the unit and provides it with biomass left over from the production of pellets) are not in a worse legal position than merchants, who runs their power plant with less efficiency.

Some benchmark values have been changed in the regulations compared to the information obtained from the study “Development of Proposals for Methodological Guidelines for Calculation of the Internal Rate of Return to Eliminate Overcompensation for Merchants that have been Granted the Right to Sell Electricity Under the Mandatory Procurement or the Guaranteed Payment”, taking into account the additional information obtained in the coordination process from the Ministry of Agriculture and industry representatives regarding the constant own consumption for biogas production (to 8000h), a larger amount of manure in the volume of biogas raw materials (the price of biogas has been changed), including net heat capacity calculation (according to the average ratio of gross and net heat energy produced by cogeneration units, which, according to the statistics, was 97% in the period from 2007 to 2014). In addition, taking into account the objection of the Public Utilities Commission, the annual number of working hours of natural gas cogeneration units was changed to average working hours according to the statistics (average working hours of supported natural gas cogeneration units in the period from 2013 to 2015).

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<sup>1</sup> For example, Methodology for Determining Reference Costs of Electricity Generated from Renewable Resources, Slovenia, 2009

<sup>2</sup> For example, Evaluation of the Support to Electricity Produced from Renewable Energy Sources and in Cogeneration and Proposals for Improvement of the Support. The second deliverable, Riga, 2013 (the study is available on the website of the Ministry of Economics: [https://www.em.gov.lv/files/energetika/SIA\\_Ekodoma\\_atskaite.pdf](https://www.em.gov.lv/files/energetika/SIA_Ekodoma_atskaite.pdf) ).

Should the merchant disagree with the IRR calculated by the Ministry of Economics, it may submit an alternative calculation approved by a sworn auditor and supplemented with complete set of supporting documentation. This provision provides the merchants an opportunity to use the actual, proved values of revenues and expenditures. After assessing the information provided, the Ministry of Economics corrects the IRR set for the production site.

Taking into account the wide differences in the costs of large power plants receiving aid in form of the guaranteed payment for the installed electric capacity, the IRR will be calculated on the basis of actual and prospective operating costs and be approved by a sworn auditor.

In determining the IRR rate applicable to merchants, the existing rate of return of the Latvian energy sector was evaluated. According to the cogeneration tariff calculation methodology<sup>3</sup> developed by the Public Utilities Commission (hereinafter referred to as the Regulator) a 9% rate was established. The same profitability index was mentioned in study of February 2016 conducted by the Fraunhofer-Institut<sup>4</sup>. After assessing this information, the maximum IRR rate applicable to merchants is set at 9%.

Given that the a part of the heat produced in the cogeneration process is sold to ensure district heating in Latvian municipalities, the condition of the IRR calculation does not apply to the merchants for whom the price of heat energy produced is established or approved by the Regulator in accordance with the Regulator's methodology as the methodology already provides a reasonable return of 9%.

The mechanism established for preventing overcompensation will not be applied to power plants to whom the aid will cease in 2017. These are 22 cogeneration units providing public service of district heating in municipalities. There is no risk of overcompensation as the revenues of these units from selling electricity under the mandatory procurement are taken into account upon determining tariff for district heating in respective municipalities.

In addition the changes in the regulation have fixed the maximal level of the natural gas price component included in the formula of mandatory procurement prices of electricity for the power plants using renewable energy sources. The mandatory procurement price of electricity is based on a price formula. One of the elements of the price formula is a tariff for trade of natural gas approved by the Regulator without value added tax, which changes on a monthly basis and depends on the level of natural gas sales price.

The fixed natural gas price was established according to a study "Evaluation of the Support to Electricity Produced from Renewable Energy Sources and in Cogeneration and Proposals for Improvement of the Support"<sup>5</sup> conducted by limited liability company "Ekodoma" in 2013. This study evaluated the validity of the formula

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<sup>3</sup> <http://likumi.lv/doc.php?id=208283>

<sup>4</sup> <http://diacore.eu/images/files2/WP3-Final%20Report/diacore-2016-impact-of-risk-in-res-investments.pdf>

<sup>5</sup> Page 118 of the study "Evaluation of the Support to Electricity Produced from Renewable Energy Sources and in Cogeneration and Proposals for Improvement of the Support".

of mandatory procurement prices of electricity, and it concluded that tying the existing aid to a fluctuating natural gas price for the power plants using renewable energy sources and biomass and biogas cogeneration units does not reflect real production costs of these units and there is need to fix this component in the formulas.

These conclusions are also supported by the fact that as of February 2013, a fall in the sales price of natural gas is observed. In case of a further fall of gas prices, the mandatory procurement price of electricity will not cover the actual operating costs of power plants, including fixed costs. In order to ensure the mandatory procurement prices would not fall below the level necessary to ensure the operation of the supported power plants using renewable energy sources as a result of a decrease in the natural gas sales tariff, the changes in the regulation fix the natural gas price component included in the formula at the level of 234.77 euro/thousand n.m<sup>3</sup>, which was the average natural gas sales price for the period from August 2007, when Cabinet Regulation No. 503 “Regulations Regarding the Production of Electricity Using Renewable Energy Resources” of 24 July 2007 entered into force, until September 2012, when merchants were no longer eligible to qualify for the acquisition of the right to sell electricity produced within the framework of the mandatory procurement and acquisition of the right to receive a guaranteed payment for the electric capacity installed at the cogeneration power plant (as of 10 September 2012) pursuant to Cabinet Regulation No. 221.

## **2. The compliance with the Articles 30 and 110 TFEU**

Referring to the decisions of the European Commission of 23 July 2014 No C(2014) 5081 on the State Aid SA.38632 (2014/N) – Germany and of 28 April 2016 No C(2016) 2726 on the State Aid SA.43756 (2015/N) – Italy, Latvia considers that the financing mechanism of the notified aid measure does not infringe Article 30 or Article 110 TFEU. In addition to explanation given in Latvian reply to the letter No B2/AC/DB/D\*2015/138244 regarding the state aid case SA.43140 (2015/NN) we would like to give additional clarifications on this issue.

Latvia considers that there is no issue under Article 30 or 110 TFEU because the mandatory procurement component (hereinafter referred to as the MPC) does not constitute a charge unilaterally imposed by a Member State within the meaning of those articles as the support is financed through a surcharge imposed on electricity consumed in Latvia; the charge is calculated on the amount of electricity consumed, i.e. it is imposed on the product itself; the obligation to pay that surcharge results from the law, i.e. it is a unilaterally imposed charge and the charge does not correspond to the price paid for a good.

Latvia operates in Nord Pool power market exchange where it has a separate trading area. According the Nord Pool rules, all market participants’ transactions that exceed the borders of the trade area and involve physical electricity transmission, have to be done only through the Nord Pool exchange. Transactions within the trade area related to the physical transmission of electricity can be done through the market or on the basis of the bilateral agreement. So, it means that the direct supply of electricity is possible only in the territory of the country.

Electricity traders buy and sell electrical energy in the exchange. It is not possible to determine whether the electricity is local or imported, whether it is produced from renewable or fossil energy sources, as all electricity sold and bought in the market becomes equal. All electricity sold under the mandatory procurement is sold in Latvian trade area, so we infer that all electricity sold under mandatory procurement is a part of all electricity bought in Latvian trade area. Thus all electricity bought in Latvian trade area proportionally contains a part of electricity sold under mandatory procurement and it is not possible to divide the consumers in those who receive imported and those who receive local electricity and thus apply different MPC.

Moreover if the imported electricity was released from the MPC it would contribute to the distortion of competition. In such case electricity traders would be interested to import electricity to avoid MPC payments for their consumers, so it would be discrimination of other electricity producers in Latvia as the additional amount of the expenses of the mandatory procurement would be spread on their electricity production.

A decision is made that new permits are not and will not be issued under the existing scheme neither for local nor the foreign producers. Therefore Latvia is not able to take additional steps to adjust previous decisions. When developing the framework for the new aid scheme for new installations to promote renewable energy, Latvia will take into account all requirements on non-discrimination relating to imported electricity produced using renewable energy resources from other EU member states and will ensure that the installations from other member states could qualify for support if there will be technical transmission capacity for cross-border electricity flow. Latvia would like to ask for confirmation that the information submitted is sufficient to evaluate the compliance of the support.

Please find attached these documents:

1. Amendments to Cabinet Regulation of 10 March 2009 No. 221 “Regulations Regarding Electricity Production and Price Determination upon Production of Electricity in Cogeneration” adopted on 5 July 2016 (Annex\_1);
2. Ex-ante impact assessment report (abstract) of the Cabinet regulation “Amendments to Cabinet Regulation of 10 March 2009 No. 221 “Regulations Regarding Electricity Production and Price Determination upon Production of Electricity in Cogeneration”” (Annex\_2);
3. Assessment of the conformity of the Cabinet regulation “Amendments to Cabinet Regulation of 10 March 2009 No. 221 “Regulations Regarding Electricity Production and Price Determination upon Production of Electricity in Cogeneration”” with the EC communication “Guidelines on State aid for environmental protection” (Annex\_3);
4. Amendments to Cabinet Regulation of 16 March 2010 No. 262 “Regulations Regarding the Production of Electricity Using Renewable Energy Resources and the Procedures for the Determination of the Price” adopted on 5 July 2016 (Annex\_4);

5. Ex-ante impact assessment report (abstract) of the Cabinet regulation “Amendments to Cabinet Regulation of 16 March 2010 No. 262 “Regulations Regarding the Production of Electricity Using Renewable Energy Resources and the Procedures for the Determination of the Price”” (Annex\_5);
6. Assessment of the conformity of the Cabinet regulation “Amendments to Cabinet Regulation of 16 March 2010 No. 262 “Regulations Regarding the Production of Electricity Using Renewable Energy Resources and the Procedures for the Determination of the Price”” with the EC communication “Guidelines on State aid for environmental protection” (Annex\_6).