IN THE MATTER OF THE ENERGY BILL

AND THE EC STATE AID RULES

ADVICE

INTRODUCTION

1. We have been asked to advise Greenpeace concerning the implications for the Energy Bill ("the Bill") of the European Community ("EC") State aid rules, with particular regard to issues arising from the proposed restructuring of British Energy ("BE"). We start by providing a brief explanation of those rules and, after summarising the current position concerning proposed aid to BE and the possible impact of that aid, we set out our views as to how the Bill engages EC law.

2. In summary, we conclude that:

   (i) It is strongly arguable that Part 2, Chapter 1 of the Bill involves the establishment of a state aid scheme which enables the proposed Nuclear Decommissioning Authority ("the NDA") to carry out decommissioning for private, as well as State, operators from public funds.

   (ii) Furthermore, it arguably provides the legislative infrastructure to enable further aid to be granted to BE over and above that proposed by the restructuring package.

   (iii) In so far as the relevant provisions of Part 2, Chapter 1 have not been notified to, and have not received approval from, the Commission prior to enactment, the aid scheme established by Chapter 1 would fall foul of the EC State aid rules.

INTRODUCTION TO THE EC STATE AID RULES

3. State aid can often be used as a form of protectionism to benefit a certain producer or certain producers by giving them competitive advantages or enabling them to avoid necessary structural adaptation. The principle underlying the EC State aid rules is that the establishment of a true single market and a system of undistorted competition requires that Member States be prohibited from granting to undertakings aids that distort, or threaten to distort, competition and trade between Member States. Only aid which can be considered to be, on balance, generally beneficial to the Community may be permitted. For example, aid may be permitted in certain circumstances and subject to certain conditions where it brings about the restructuring of a firm in difficulty so as to restore its long term viability.

4. The Commission of the European Communities ("the Commission") has principal responsibility for monitoring and approving State aid and enforcing the Community's state aid provisions. Member States are therefore required (pursuant to Article 88(3) of the EC Treaty) to notify any proposed aid measures before they are implemented (any aid that is not so notified is unlawful aid) and Member States may not implement aid measures before the Commission has approved them as being compatible with the common market. Accordingly, if the Commission does not approve a notified aid measure, the Member State is not permitted to implement it[1]. If the Member State does implement aid in the absence of notification or prior to Commission approval, it may be required to claw back the aid.

5. The Commission and the European Court of Justice ("the ECJ") have adopted a wide definition of "aid" which extends beyond mere subsidy and includes any advantage (that would not otherwise be available in the normal course of business) conferred on an undertaking or undertakings directly by the State or indirectly through State resources.

[1] Articles 87 and 88 of the EC Treaty.

6. The definition of aid is wide enough to embrace, *inter alia*, investment grants, subsidies to cover operating losses, loans at reduced rates of interest, loan guarantees, preferential energy tariffs, debt write-offs, and tax breaks and exemptions. Relieving an undertaking of a cost that it would have to bear in the normal course of events can also be a State aid, even if there is no direct payment to the undertaking concerned, because the State takes over the liability for the cost. Further, the concept of a State aid is not confined to individual measures but also covers schemes through which aid is granted. Both individual measures and schemes which make provision for future aid to be granted must be notified to the Commission for its approval.

7. In order to decide whether or not *the provision of public funds* to an undertaking, howsoever they are provided, constitutes an aid one has to examine whether or not the terms on which the funds are provided go beyond those that a private investor, operating under normal market economy conditions and having regard to the information available and foreseeable developments at that time, would find acceptable when providing funds to a comparable private undertaking (the "market economy investor principle"). The application of the principle requires an examination of whether or not there will be an acceptable return on the provision of funds within a reasonable period of time. In assessing what a comparable private investor would find acceptable, it is permissible to adopt the viewpoint of a private holding company or group of enterprises which pursues a structural, global or sectoral policy and which is guided by a longer term view of profitability. By parity of reasoning, where the State takes over a responsibility of a private sector undertaking, the State is effectively providing a service to that undertaking and, like any service provider operating under normal market conditions, would be expected to charge for the provision of the service. If the service is provided without charge, or is undercharged, a State aid has been provided.

THE AID GRANTED TO BRITISH ENERGY

8. On 9 September 2002 the Government put in place a rescue aid package for BE. It consisted of £1175 million worth of credit facilities. It was not notified until 10 December 2002. The Commission found that the aid was unlawful as not having been notified prior to its implementation but took a decision not to raise objection to the aid on the basis that it considered it to be compatible with the common market (in other words, the aid was illegal but, in the exercise of its administrative discretion, the Commission decided not to require its repayment). Under that decision, the UK authorities had until 9 September 2003 to submit a restructuring or liquidation plan for BE, or to demonstrate that the aid had been repaid. On 7 March 2003 the UK authorities notified a restructuring plan to the Commission. On 11 July 2003, the UK authorities informed the Commission that they would implement the measures unless the Commission took a decision whether or not to initiate formal proceedings within a period of 15 working days. The Commission did so and, by a decision of 23 July 2003, it decided to initiate a formal investigation procedure and provided its preliminary views as to the lawfulness and compatibility of the measures.

9. The full detail of that package is not in the public domain but it is known to consist of the following elements:

   A. The undertaking by the UK Government to assume the funding of historic nuclear liabilities, in particular with respect to the management of fuel loaded prior to the restructuring and to the decommissioning of BE's nuclear plants. The value of this measure for BE is estimated to be £3,298 million.

   B. The renegotiation of fuel supply and spent fuel management contracts with British Nuclear Fuel Limited (BNFL), leading to a decrease of prices charged by BNFL to BE for these services. The value of this measure is estimated to be up to £1 billion.

C. The achievement of a standstill on BE's debts towards its major creditors, including BNFL, plus the possibility that part of those debts be finally waived. The cash saved by BE through the standstill is estimated to be £642 million.

D. A number of financial restructuring arrangements with major creditors.

E. The introduction of a new trading strategy for BE, aimed at improving its hedging against wholesale electricity price fluctuations.

F. The disposal of assets in North America to generate cash.

G. A 3 months' deferral of about £4 million business rates by local authorities.

10. The Commission analysed the aid in the light of the "Community Guidelines on State aid for rescuing and restructuring firms in difficulty". Its preliminary view of the restructuring package was that measures A, B, C and G involved State aid. The Commission also had doubts over the compatibility of the aid with the common market, *inter alia*, for the following reasons:

    (i) The Commission doubted that the aid would restore the long-term viability of BE within a reasonable time frame and doubted that the aid brought about physical internal restructuring;

    (ii) It considered that the renegotiation of BNFL contracts, to the extent that it did constitute aid, would constitute long term operating aid and would be incompatible both with the requirement that BE faces the market with its own forces alone after the restructuring is over, and with the polluter pays principle;

    (iii) The Commission also doubted that the aid was restricted to the minimum necessary largely because of the considerable uncertainties as to the amount of aid to be granted over time. In part, this is because the restructuring package permits BE to pay 65% of its net profits

towards historic liabilities but if that is not sufficient to cover the full extent of the liabilities, the government has undertaken to meet the shortfall (which is therefore at present an unknown amount).

11. As at the date of this Advice, the Commission had not yet completed the formal investigation procedure and had not therefore arrived at a final decision as to the compatibility of the aid.

12. The question arises, however, whether or not those proceedings impact upon the Bill and whether the Bill gives rise to further aid to BE over and above that envisaged by the restructuring package (as to which see below).

THE ELECTRICITY MARKET AND THE IMPACT OF THE AID

13. The United Kingdom electricity network is geographically segmented by regions corresponding to England and Wales, Scotland and Northern Ireland and there is little interconnection between those subnetworks. Save in relation to Northern Ireland, the introduction of NETA has substantially increased competition among suppliers of electricity, especially in England and Wales, leading to price reductions. The UK electricity market is not, however, isolated from competition from other Member States. There is trade or the possibility of trade in electricity between France and the UK over an interconnector. There is also some balance of trade between Northern Ireland and Eire. There is no question therefore but that the EC State aid rules apply in principle to aid granted to electricity producers and the Commission has expressly proceeded to apply those rules on that basis.

14. As a result of both generation overcapacity and the introduction of NETA, the electricity market is both highly competitive and price sensitive. The degree of current overcapacity in the electricity market has been variously stated at figures between 20% and 30%. According to OFGEM, there is a currently a margin of

between 22 and 25+ per cent of present spare capacity over present maximum demand[2].

15. In the normal course of events, competitors can assume that, where there is vigorous competition, an excess of supply over demand, and prices reach low levels, the more efficient competitors will survive and the less efficient competitors will not. As the competitive process brings supply back into balance with demand, competitive prices will be restored.

16. However, there is a forceful argument that the grant of the aid to BE is enabling it to displace other, more efficient, generators, in the wholesale electricity market and is artificially depressing wholesale prices to the detriment of other generators and the future of other kinds of power generation.

THE BILL AND ITS STATE AID IMPLICATIONS

17. The keystone of Part 2, Chapter 1 of the Bill is the establishment of the NDA. Clauses 6 to 11 set out its main functions, the primary aspect of which is the decommissioning and cleaning up of designated nuclear installations and designated nuclear sites and the treatment, storage, transportation and disposal of nuclear matter and waste in "designated circumstances".

18. Of the clauses setting out the functions of the NDA, clauses 6, 8 and 10 are of particular importance with regard to State aid (clause 10 in particular makes provision for the NDA to be the conduit through which the decommissioning aspects of BE's restructuring package can be delivered). Clause 24, relating to the financial responsibility of the NDA is also relevant.

19. Clause 6 makes provision for directions to be given by the Secretary of State to the NDA in relation to sites and circumstances. Those directions trigger the NDA's responsibilities in relation to the relevant site or circumstance. Directions

[2] According to OFGEM "Review of the First Year of NETA" and OFGEM fact sheet of 14 October 2002.

may be issued both to the State sector (including BNFL) and, subject to the consent of the person in control, to private sector companies. The intention therefore is for the NDA to be responsible or potentially responsible for all decommissioning in the UK. That is not to say, however, that the NDA necessarily has financial responsibility in respect of all such decommissioning.

20. Clause 24 makes provision for those sites and circumstances where the NDA must (subject to certain narrow exceptions) take financial responsibility. It does not extend to private sector companies but does of course cover BNFL and the public sector. So, in order to determine whether or not the NDA has or is capable of having financial responsibilities in relation to the private sector, one has to revert to clause 8 of the Bill.

21. Clause 8 makes supplemental provisions for designating directions and provides for a power (and not a duty), on the part of the Secretary of State, to direct that the person in control of the site makes payment to the Secretary of State in respect of the work carried out under the direction. It also enables the direction to impose requirements "with respect to the charges which…are to be imposed by the NDA" (which appears to be an allusion to the discretionary charges that the NDA is empowered, but not obliged, to impose under clauses 10(7) and 13(3)).

22. Thus, there is no requirement, only a discretion, in the Secretary of State to require in a direction that a private operator make payment to him and/or the NDA in respect of the works. Further, there is no requirement that payment reflect the actual costs incurred by NDA in carrying out those works. It would appear therefore that the NDA can become financially responsible for private sector decommissioning by default where no provision, or no adequate provision, for recovering costs is made.

23. That raises two issues for the private sector.

24. First, it would appear to enable the provision of State aid to any company in the private sector in any circumstances. In itself, the Bill does not preclude the

possibility that the decommissioning and other clean-up works may be carried out by the NDA in accordance with "the market economy investor principle" and will not constitute aid. However, the Bill contains no requirement to that effect and has built in considerable constraints upon the NDA acting in that manner. Whether or not aid to BE and other private undertakings will in fact result from the Bill remains uncertain but it is strongly arguable that the Bill renders the granting of aid more likely and indeed facilitates it: it facilitates the removal of decommissioning and clean-up responsibilities from the private sector, there is no requirement that costs be recouped and no requirement that costs reflect the actual cost of provision of the service[3].

25. Secondly, as regards BE, to the extent that the restructuring package does not cover BE's contracted or uncontracted nuclear liabilities, clauses 6 and 8 of the Bill certainly appear to provide ample scope for those liabilities to become the responsibility (including the financial responsibility) of the NDA. Any absence of recoupment of costs through a direction made under clause 8 could conceivably be used to provide BE with aid to the extent that it is not already covered by the aid package. However, clause 10 of the Bill could also be a means of providing additional aid to BE.

26. Clause 10 of the Bill provides that the NDA may have the function of acting on behalf of the Secretary of State in relation to agreements to which he is party and that relate to expenditure incurred or to be incurred by him or others on decommissioning, clean up and treatment. Clause 10(3) provides that the NDA may be required to meet, in whole or in part, the cost of discharging the Secretary of State's liabilities under the agreement.

[3] In that connexion, it should be noted that the ECJ has previously held that, where domestic legislation creates a discretionary system that, due to the breadth of the discretion conferred on an administrative body, is capable of placing certain undertakings in a more favourable situation than others, *the system itself* meets the conditions for classification as a State aid: *e.g.* Case C-241/94 *France v Commission* [1996] ECR I-4551, paragraphs 23-24 of the judgment (page 4576).

27. Clause 10(2) is clearly directed to the BE restructuring package and enables the NDA to become the conduit through which the decommissioning aspects of BE's restructuring package are to be carried out. It also enables the Secretary of State to channel any future aid packages, whether to BE or other private sector operators, through the NDA.

28. In so far as concerns BE, that provision is somewhat premature and presupposes that the aid package will be approved by the Commission. It is to be noted that the European Commission is of the view that, for the purposes of Article 88(3) and the obligation upon Member States to refrain from putting aid into effect before it is authorised, aid is put into effect when the legislative measures which enable the aid to be granted without further formality have been adopted.

29. Clause 10(3) is curious in that it refers to a potential requirement on the NDA to meet the cost of discharging liabilities in whole or in part. As regards BE, clearly, if the Secretary of State channels aid through the NDA in the amount approved under any aid package, the fact that the NDA meets the cost of discharging liabilities does not involve any further aid to BE. If the cost of discharging liabilities under the agreement exceeds the amount of aid approved, however, there would appear to be scope for the NDA to become responsible for the shortfall. This could conceivably result in additional aid being granted to BE.

DOES THE BILL REQUIRE NOTIFICATION?

30. In its present form Part 2, Chapter 1 of the Bill arguably makes provision for the means by which additional aid may be granted to BE over and above the proposed restructuring package and provides the infrastructure for aid to be granted to cover future private sector decommissioning liabilities without the necessity of further implementing measures. The question arises whether such provision constitutes an aid scheme which must be notified.

31. Article 1(d) of Regulation 659/99, the procedural regulation in the field of state aid, provides that an aid scheme

"shall mean any act on the basis of which, without further implementing measures being required, individual aid awards may be made to undertakings defined within the act in a general and abstract manner and any act on the basis of which aid which is not linked to a specific project may be awarded to one or several undertakings for an indefinite period of time and/or for an indefinite amount".

32. It is strongly arguable that Part 2, Chapter 1 of the Bill does indeed constitute an act which will enable aid to be granted without any further implementing measures (since the aid can be furnished simply through administrative decisions of the Secretary of State and through the NDA) and it, or the Act, must therefore be notified.

33. Since the legislation itself constitutes the aid scheme, Part 2, Chapter 1 of the Bill ought not, pursuant to Article 88(3) of the EC Treaty, to be enacted unless and until it has been authorised by the Commission since its enactment would constitute putting the aid scheme into effect.

34. It is understood that the Energy Bill may have been notified to the European Commission but the details of that notification are not known. To the extent however that the notification did not cover the aid scheme envisaged by Part 2, Chapter 1 and in particular clauses 6, 8, 10 and 24 of the Bill, and to the extent that the government does not otherwise notify those provisions, those aspects of the Bill would arguably constitute unlawful aid if the provisions were to be enacted. It would also be unlawful to enact those provisions in the absence of any approval of the scheme on the part of the Commission.

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