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Competition DG

Market and Cases I: Energy and Environment
The Director

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Permanent Representation of Croatia to the
European Union
Avenue des Arts 50
B-1000 Brussels

Subject: SA.42188 2014/PN – Plomin C Power Station

Dear Sir, Madam,

On 17 June 2015, your authorities pre-notified to the Commission a measure to support the construction of a new coal-fired power plant in Croatia. You sent further information on the case on 9 and 15 July 2015, and 5 and 28 August 2015. On 29 September 2015, the Commission services sent you a letter laying out their preliminary assessment of the pre-notified measure. You sent further information on the case on 28 October 2015, 25 November 2015, 18 January 2016, and 1 March 2016.

The measure includes a tender by the 100% state owned utility Hrvatska Elektroprivreda d.d. (HEP) for a sponsor to enter into a special purpose vehicle (SPV). The sponsor will provide 50% of the required equity (and take a 50% share) in the SPV. HEP will take the other 50% share and contribute the other 50% required equity. The SPV will design and construct a 515 MW coal-fired power station at the Plomin site (Plomin C) and maintain and operate the plant for 20 years. The SPV will also raise the debt financing required to undertake the project. Through a 20 year power purchase agreement (PPA) HEP will acquire 100% drawing rights over the plant (meaning HEP chooses when the plant runs and the SPV cannot independently choose to run the plant). In return, the SPV will be paid an availability credit (EUR/MW) by HEP sufficient to cover all financing and debt service costs related to the construction of the plant. For any hours in which HEP instructs the plant to run and generate electricity, the SPV will receive an energy payment (EUR/MWh) which covers the variable costs associated with running the plant.

The original proposal included, effectively, a State guarantee. In October 2015 this was removed and instead the parties proposed a change in control clause which would require HEP to buy 100% of Marubeni's shares in the SPV at a pre-agreed price if at any point HEP ceases to be majority state-owned.

On 18 July 2012 HEP published the tender notice in the Official Journal. On 2 September 2014 Marubeni Corporation was selected as the preferred applicant to be the project sponsor.

Your authorities submit that the measure does not constitute State aid because HEP, although publicly owned, is acting independently from the Government, and because HEP and

Marubeni Corporation are acting as market investors so there is no advantage to either party in the deal. Your authorities further state that even if the measure constituted State aid, it would be compatible with the Guidelines on State aid for environmental protection and energy 2014-2020 (EEAG).

On the basis of the information available, the Directorate General for Competition has come to the following preliminary assessment.

Existence of aid

Despite the changes to the project which removed the State guarantee, the Commission services still have several indications that the present measure might constitute State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU).

In terms of imputability, HEP's supervisory board represents the interests of the Croatian Government as shareholder. Six of the seven members of the supervisory board are appointed by the government. The supervisory board then appoints a management board to manage HEP's day to day business. You have explained that it was the management board, not the supervisory board, that took the decision to invest in Plomin C, and that under Croatian company law the management board has responsibility to act in the best interests of the company, and that this demonstrates that the Government was not involved in HEP's decision to invest in Plomin C.

However, although you have provided minutes that show that the management board agreed to the timing and content of the tender documents for the Plomin C project, no documents have been provided that show the basis on which a decision to invest in the project was taken, nor which individuals or which board took the investment decision.

In September 2012 the then Croatian Prime Minister was quoted in the press saying that the project was important for Croatia, including because it would reduce the need to rely on 'wasteful' electricity imports¹. The Croatian Government also recognised the Plomin C project as a 'strategic investment project' under the Act on the Strategic Investment Projects of the Republic of Croatia (the SIP Act) on 15 May 2014, and initially offered a State guarantee to support the project. This points to a degree of Government influence on the decision related to this project.

Finally, the potentially low or negative rate of returns to HEP associated with the project (see below) also raise doubts as to whether the project is actually in HEP's interest to pursue, and therefore whether its board would be considered to be acting in the best interests of the company in choosing to make the investment.

Taken together these indicators demonstrate that HEP's decision to invest in Plomin C was unlikely to have been taken independently from Government.

On the question of advantage and the market economy investor principle (MEIP), you have argued that HEP expects to achieve a reasonable rate of return on its investment in Plomin C,

¹ Poslovni dnevnik, 'Milanović: TPP Plomin C will work with cleaner technology', 14 September 2012, 16:20. <http://www.poslovni.hr/vijesti/milanovic-te-plomin-c-ce-raditi-s-ciscom-tehnologijom-215815>

and that although this rate of return is expected to be lower than Marubeni Corporation's this is justifiable because Marubeni Corporation takes on some risks that HEP does not bear, since it must design and build the plant, and must raise the debt financing for the project. You have also argued that it is 'normal financial logic for incumbent players to target lower returns for single investment projects in their geography, because they can optimise their geographic asset base and because they know the market, whilst new players who don't know the market, and have only a single project to implement (like Marubeni) will price the risk of entering a new market with no existing assets to leverage higher, and include such risk in their cost of equity'. Finally, you have argued that 'when the Plomin C transaction is analysed as part of HEP's overall business, the downside risks are mitigated by savings made from retiring less efficient plants'. You have not quantified these potential advantages to HEP, but have stated as a point of comparison that HEP's average return on equity for 2010-2014 has been 5.1%.

However, the business plans submitted as part of the draft notification show that HEP expects to make a pre-tax internal rate of return of between minus 3.6% and 12% depending on future coal, carbon and electricity prices. Marubeni Corporation will earn a pre-tax internal rate of return on its equity investment of 12.5% regardless of these future uncertain prices. To support an argument that HEP is acting as a market economy operator, there would need to be strong arguments to justify the lower rate of return to HEP, particularly since HEP faces the risk of marketing the electricity from the plant and there is inevitably high uncertainty about future commodity prices looking 25 years ahead.

Overall, the rate of return scenarios presented in the draft notification suggest that the deal is significantly more attractive for Marubeni Corporation than for HEP. You have suggested that of the rate of return scenarios presented, the (by far most optimistic) 12% rate of return scenario is the most likely. However, this is based on arguments that the International Energy Agency (IEA)'s estimates of future coal and carbon prices are a less reliable benchmark than estimates by HEP which take today's coal and carbon prices and inflate them by 2.4% a year. If the IEA's estimates for coal and carbon prices are used, the project is loss-making for HEP.

The fact that Marubeni benefits from a potentially much higher rate of return than HEP, combined with lower risks, indicates the possible existence of an advantage conferred directly on the SPV through the PPA, and indirectly on Marubeni Corporation.

As concluded in related case-practice² the electricity generation market in which HEP and Marubeni Corporation are active is open to competition throughout Europe. Any advantage from State resources to any undertaking in that sector has the potential to affect intra-Union trade and to distort competition.

The Commission services therefore consider that, based on the available information, the Plomin C project is likely to constitute State aid within the meaning of the TFEU.

² Cf. for instance case SA.35980 (2014/N-2) – United Kingdom Electricity market reform – Capacity market, recital 114

Compatibility

The measure allegedly targets a perceived generation adequacy issue. Section 3.9 of the Guidelines on State aid for environmental protection and energy 2014-2020 (EEAG) sets out specific conditions for aid for generation adequacy measures³.

As explained in our letter of September 2015, the Commission services have doubts that the measure will satisfy all of the relevant assessment criteria.

Necessity

In terms of necessity, there is a significant proportion of ageing capacity in the region, and 100% private projects from new market entrants do not seem to be forthcoming. However, HEP is also investing in a 450MW gas plant elsewhere in Croatia (at Osijek).

To justify State aid for generation adequacy, the EEAG (point 222) require the nature of a generation adequacy problem to be clearly identified and quantified. The draft notification does not indicate the level of reliability sought by Croatia, nor has a detailed generation adequacy assessment identifying an anticipated shortfall been provided. Hence the necessity of the measure has not been demonstrated.

Appropriateness of the aid

Based on the available information, the Commission services doubt that the envisaged measure is the most appropriate instrument to ensure generation adequacy in the medium to long term.

Rather than identifying a capacity need and then establishing a process for the identification of the required capacity that can best meet this need, as required by EEAG point 226, the measure selectively supports only HEP and its strategic partner in a contract to build and operate a coal-fired plant at a specific site.

Your authorities have provided arguments to explain that coal is preferred for security of supply reasons because of the dependence of Croatia on Russian pipeline gas. However, it has not been demonstrated convincingly that the chosen measure – a coal plant at one particular site – is the most appropriate measure to ensure security of electricity supply in Croatia. In particular, it has not been shown that other companies than the incumbent could not have built and operated the plant or that other projects at different sites or different technologies including demand response would not have been suitable and eligible for the same support to offer all or some of the required capacity. The progress of the Osijek CCGT project suggests there are alternatives to address a future security of supply problem in Croatia or the South East Europe region.

The Commission services also note that the notified measure is not open to existing generation as required by point 226 EEAG. The Commission services have concerns that the present measure could be ineffective because it risks accelerating the closure of existing plants which are not financially supported in the same way as the new plant, since it will be more efficient than existing plants, and these existing plants would therefore run less often

³ OJ, 28.06.2014, C 200/39

once Plomin C was built. The potential increase in generation capacity by means of the present measure may therefore be quickly offset by the exit of other generation capacity which as a result may become less profitable.

Your authorities identify as the main market failure the lack of liquidity in the Croatian power market which means investors do not feel the market is investible without the kind of guarantee provided by the 100% PPA offered by HEP. Although the measure includes a commitment for 50% of the output of Plomin C to be sold on the new Croatian power exchange (once it is established) the measure does not directly seem to target the identified market failure. A wider and more competitive process for supporting new capacity would have the potential to identify new market entrants and do more to develop investor confidence in the Croatian market.

These concerns cast doubt on the effectiveness of the measure, which seems unlikely to solve Croatia's security of electricity supply problems in a systemic and sustainable way. In fact there may soon be a need for additional tenders or other measures to ensure continuous generation adequacy.

Proportionality

The payments due to Marubeni were established on the basis of a tender. However, proportionality cannot be assumed because the scope of eligible projects was limited to a coal plant at a specific site, and involving a specific contract structure with HEP, and therefore may have excluded better-value alternatives.

Avoidance of negative effects on competition and trade

The Commission services are concerned that the impacts on competition and trade would be highly problematic, given the project will require the SPV to sell the energy generated by Plomin C only to HEP, strengthening the incumbent's already dominant position in the market (HEP already generates almost 100% of electricity generated in Croatia), and the potential for a tender for new capacity to reduce incentives for future independent market entry in Croatia. Given that Marubeni is an established investor in the European energy market more broadly, the aid in this case could attract investment to the Croatian market that might otherwise have been made by Marubeni into other Member States.

According to the draft notification, limiting the tender to coal-fired power plants may be justified because of the need to limit exposure to Russian pipeline gas imports. However, no detailed information was provided in the draft notification to quantify the reliability concerns about Russian pipeline gas. Moreover, new gas infrastructure is likely to diversify gas supply in the future, namely a new LNG terminal is envisaged on the Croatian island of Krk which may provide another source of natural gas. The Commission services have doubts that the exclusion of all other generation technologies than coal (e.g. gas, biomass, refurbished hydro power etc.) and of other generation adequacy measures relating for example to demand response, storage and interconnection can be justified.

According to the draft notification, Plomin C is a suitable site for a new coal-fired plant because there is existing infrastructure at the site that can be recycled and because the site is on a coast providing excellent access for coal imports. However, a wider competitive process to select a project may have resulted in the identification of alternative sites.

Conclusion

Based on the above considerations, the Commission services consider that the measure is likely to constitute State aid within the meaning of the TFEU and have doubts that the measure in its current form is compatible with the internal market.

Should your authorities decide to pursue the present measure, the Commission services may decide to examine the above mentioned issues in more detail and give interested third parties the opportunity to provide observations in the context of a formal investigation procedure.

This position is not a definitive position of the Commission, but only a preliminary view of the services of DG Competition, based on the information available at this stage.



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