BlogDUE

Energy and environmental State aid: the Court of Justice of the European Union interprets extensively the notion of "incentive effect" in the case *Veejaam and Espo*, C-470/20, of 15 December 2022

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SUMMARY: 1. Introduction. – 2. The incentive effect in Environmental and Energy Aid Guidelines (EEAG). – 3. The connection between the "start of works" and the "incentive effect". – 4. State aid and mandatory environmental standard. – 5. On existing aid, new aid, and the regime of unlawful aid compatible with internal market. – 6. Concluding remarks.

1. With the ruling in the case *Veejaam and Espo*, C-470/20, issued on December 15th, the European Court of Justice provided interpretive clarifications on the notion of the "incentive effect" in the context of the compatibility assessment of environmental State aid, in accordance with the 2014 Guidelines on State Aid for Environmental Protection and Energy (EEAG). The 2014 Guidelines require State aid for environmental and energy purposes to have an "incentive effect" for internal market compatibility. This implies that the aid should encourage beneficiaries to change their behaviour and improve environmental protection, instead of only reimbursing them for regular business expenses.

The judgment is noteworthy because the Court, balancing competition rules with environmental objectives, has provided a significantly broad interpretation of the concept of the "incentive effect". This interpretation may appear to diverge from the 2014 Guidelines; nevertheless, the Court has affirmed its consistency with the EU law.

Veejaam and Espo, two electricity producers in Estonia, were deemed ineligible for State aid by the competent Estonian authority, Elering, despite replacing their generating units with new turbine generators according to the Estonian Law on the electricity market (ELTS). Indeed, the generators could be eligible for subsidies under the ELTS, which provided a renewable energy support scheme that was declared compatible with the internal market by the Commission in its 2014 (SA.36023) and 2017 (SA.47354) decisions. However, Elering refused to grant aid to the companies as the scheme was

meant to "to promote the entry onto the market of new operators, and not to support electricity producers on a permanent basis" (C-470/20, paragraph 8).

The case was brought before the Supreme Court of Estonia, which expressed doubts regarding the compatibility of the authorised State aid scheme with the EEAG, and referred five questions for a preliminary ruling to the Court of Justice.

The first two questions concern the notion of the "incentive effect" required under paragraphs 49-52 of the 2014 Guidelines, which expressly state that "aid does not present an "incentive effect" for the beneficiary in all cases where work on the project had already started prior to the aid application by the beneficiary to the national authorities". The remaining questions regard, on the one hand, the distinction between existing aid and new aid, and, on the other, the regime of unnotified aid deemed compatible by the Commission.

2. Before analysing the judgement, this section will first elucidate the issue of the compatibility assessment of environmental aid with the internal market.

In general terms, State aid regulation has been influenced by soft law instruments such as guidelines, frameworks, notices, explanatory notes, communications, and opinions (M. CINI, *The Soft Law Approach: Commission Rule-making in the EU's State Aid Regime*, in *Journal of European Public Policy*, 2001, pp. 192-207). Although these documents are considered non-binding, many of them form the basis for decision-making by the European Commission when evaluating the compatibility of national measures with the internal market. Consequently, Member States must take into account these instruments when designing national measures to avoid "negative decisions" and orders to recover illegal State aid. This trend is especially evident in the strategic policy area of environmental protection, which has been regulated through Commission guidelines since 1994.

The aim of State aid control regarding environmental protection and energy is to guarantee that State aid measures produce a higher level of environmental protection than what would have been achieved without the aid, and that the aid's positive effects outweigh any negative impacts on competition. According to the 2014 Guidelines, State aid for environmental and energy purposes must have an "incentive effect" to be compatible with the internal market. This "incentive effect" means that the aid should motivate the beneficiaries to modify their behaviour in order to enhance environmental protection, rather than simply compensating them for regular business expenses, even if their business decisions already have positive environmental impacts. This includes costs related to complying with mandatory environmental protection legislation.

By implementing environmental protection standards and requirements in the compliance assessment procedure, even for non-environmental aid, the "incentive effect" can be used as a crucial tool to identify projects that are genuinely likely to bring about a higher level of environmental benefits, and are therefore classified as authentic environmental aid. Only State aids capable

of achieving a degree of environmental protection consistent with the high standards fixed by environmental objectives (currently part of the European Green Deal) are considered compatible with the internal market (S. VERSCHUUR, C. SBROLLI, *The European Green Deal and State Aid: the Guidelines on State Aid for Environmental Protection and Energy Towards the Future*, in *European State Aid Law Quarterly*, 2020, pp. 287-289). For individually notified aid, the EEAG require Member States to provide clear evidence of the aid's effective impact on investment decisions and a detailed description of the aided project and its profitability without the aid.

In relation to mandatory environmental protection requirements, the "incentive effect" plays a pivotal role for companies planning to exceed current environmental standards. Pursuant to the EEAG, such companies are eligible for aid in connection with investments that exceed EU standards, that facilitate early implementation of EU standards, or that comply with a national standard surpassing EU standards.

The EEAG also cover cases where a company adapts to future EU standards that have been adopted but are not yet in force. In such cases, aid can still be granted if the investment is implemented and finalized at least one year before the standard enters into force, as this is considered to have an "incentive effect". The rationale behind the "incentive effect" is to encourage companies to engage in additional activities that they would not have carried out otherwise or to a lesser extent. Compliance with future environmental standards ahead of time has a positive impact on the environment, which is why such investments are eligible for aid.

The EEAG consider supporting investments going beyond the applicable EU standards to be a positive contribution to the relevant environmental or energy objective, regardless of the existence of more stringent mandatory national standards. In these cases, the Commission will assess whether the aid recipient would have faced significant cost increases that they could not have absorbed. This is based on the basic idea that businesses should typically bear the costs of complying with environmental regulations, but Member States have some leeway to provide compensation to affected businesses when they impose ambitious environmental standards that exceed EU requirements.

3. The ruling of the Court of Justice in the case *Veejaam and Espo* should be read in light of the aforementioned backdrop.

The Estonian Supreme Court's first question queried whether an aid scheme that enables energy producers to apply for subsidies after commencing works on a project is compatible with the internal market, under the EU legal framework on State aid, including the EEAG.

Both the referring court and the ECJ recognised that "according to paragraph 50 of those Guidelines, the Commission considers that aid does not present an "incentive effect" for the beneficiary in all cases where work on the project concerned had already started prior to the submission of the aid application by the beneficiary to the national authorities" (C-470/20, paragraph 28). Nonetheless, the ECJ went beyond the potential conflict

between the authorised aid scheme and the EEAG, by affirming that Commission soft law instruments are not binding for Member States.

The Court quoted the well-known case *Kotnik* - C-526/14 (A. ANTONUCCI, *Gli "aiuti di Stato" al settore bancario: le regole d'azione della regia della Commissione*, in *Studi sull'integrazione europea*, 2018, pp. 593-597; G. LO SCHIAVO, *Burden Sharing Arrangements vs. Shareholders and Creditors: Kotnik, Dowling and the Current State Aid Policy in the Banking Sector*, in *European Business Organization Law Review*, 2018, pp. 588-591) to emphasize that the EEAG are binding on the Commission, which limits its discretion when Member States notify aids that meet the requirements provided in the Guidelines. However, Member States have the right to notify aids that do not meet these criteria and the Commission shall assess the compatibility of this measure in exceptional circumstances. Indeed, the Court concurred with the Opinion of AG Rantos that the "incentive effect" requirement can be satisfied even if the aid application is submitted after work has commenced.

It is noteworthy that soft law instruments in State aid law have several positive effects on Member States. The guidelines offer certainty and ensure that by meeting the specific requirements State aid is compatible with the internal market. Otherwise, in the ordinary compatibility assessment, the Member State shall demonstrate that State aid "promote the execution of an important project of common European interest".

The Commission, which has full discretion in the assessment under Article 108(3), stated that "anyone who has started work on a project is clearly prepared to implement the project even if no aid is granted" (C-470/20, Summary of the request for a preliminary ruling pursuant to Article 98(1) of the Rules of Procedure of the Court of Justice, paragraph 19), thus the aid could not have an "incentive effect".

On the contrary, the Court and the AG Rantos did not provide further clarification on the exceptional circumstances that might justify environmental aid, nor did they elaborate on how the State could demonstrate the "incentive effect" on the beneficiary when the application was submitted after the start of works.

4. In the reply to the second interpretative question, the ECJ analysed the connection between the "incentive effect" and mandatory environmental standards.

The second question pertained only to Veejaam, which replaced its turbines in 2015 due to changes in environmental approval. As the replacement was mandatory under Estonian law, it raised doubts about the existence of the "incentive effect" and the need for subsidy to adhere to mandatory laws.

The referring court observed that in the absence of the aid, the energy producer would have been forced to stop electricity production. In the same line of reasoning the Estonian Supreme Court recognised that replacing the generating unit was mandatory to obtain the environmental approval

necessary to produce electricity in Estonia. Thus, one may wonder whether the "incentive effect" – that is the enhancement of the environment – is caused by the environmental standard improvement, or by State aid.

The Court stated that State aid that supports investments necessary to obtain environmental approval could have an "incentive effect". In this context, national judges shall verify the so-called "alternative scenario", i.e., whether the aid enhances the environment or whether the same environmental situation would exist without the aid.

The argument put forth by the Court of Justice in paragraphs 38-39 is difficult to reconcile with State aid case law and EC's praxis. It appears that the ECJ stated that if in the "alternative scenario" the electricity producer cannot bear the cost necessary to reach environmental standards, thus without the aid the operator would have to stop its activity, then the State aid would have an "incentive effect". It is questionable that the mere fact that the enterprise would have stopped the electricity production without the aid implies an environmental "incentive effect"; otherwise, it seems that the Court is overlapping individual advantage with "incentive effect".

Under this perspective, a producer capable of complying with the more stringent conditions would be ineligible for the aid because, in the "alternative scenario", it could make the investment without State aid. Conversely, a less efficient producer that lacks the financial resources to meet the environmental standards would be eligible for the aid.

An attempt to reconcile the argument advanced by the ECJ with State aid law could be developed taking into account the reflections put forth in section 2 of this paper.

State aid may have an "incentive effect" where an economic operator made investments in order to comply with environmental standards that exceed EU ones. The "incentive effect" is not contingent on the economic condition of the undertakings, but rather on the degree to which it contributes to enhancing environmental protection in line with EU objectives.

5. Questions 3 to 5 pertained to a general issue of EU State aid governance. Specifically, the referring court asked whether an existing aid scheme should be considered "new aid" within the meaning of Article 1(c) of Regulation 2015/1589 if the scheme is applied beyond the end date indicated in the Commission's authorisation decision. The referring court also sought guidance on how to handle State aid applications submitted by companies in connection with unnotified State aid.

The case has some problematic aspects. Indeed, before Estonia's accession to the EU, the national Law on the electricity market provided subsidies for renewable energy, that could be deemed as existing aid according to article 1(b)(i), since it is an aid scheme "which [was] put into effect before, and are still applicable after, the entry into force of the [FEU Treaty] in the respective Member States". Between 2005 and 2007, after Estonian's accession to the EU, that scheme was amended and implemented in breach of the stand-still obligation set out in Article 108(3) TFEU. In 2014, the EC

authorised the aid scheme until 31 December 2014, nonetheless, Estonia maintained that scheme in force during 2015 and 2016. Eventually, in 2017 the EC found that "the scheme was compatible with the internal market, including after its period of validity had been extended" (C-470/20, paragraph 47).

It is rather clear in Regulation 2015/1589 that any alteration of an existing aid determines a new aid (case *Azienda Sanitaria Provinciale di Catania v Assessorato della Salute dellaRegione Siciliana*, C-128/19, 20 May 2021). Nonetheless, the ECJ provided further clarifications, corroborating existing case law, stating that "the period of validity of existing aid is a factor likely to influence the evaluation, by the Commission, of the compatibility of that aid with the internal market" (paragraph 43), "thus, extension of the duration of existing aid must be considered to be an alteration of existing aid and therefore, in accordance with Article 1(c) of Regulation No 2015/1589, constitutes new aid" (paragraph 44).

The Estonian scheme was lawful until 31 December 2014, then it was unlawful between 2015 and 2016, being eventually compatible with the internal market after the 2017 Decision.

The Court held that a national judge is not bound to order recovery of unlawful State aid if that aid has been declared compatible with the internal market by a subsequent decision of the Commission.

However, EU law requires national courts to order measures that are appropriate to remedy the consequences of unlawfulness. Thus, "the national courts are bound, under EU law, to order the aid recipient to pay interest in respect of the period of unlawfulness of that aid".

With respect to the specific case in Estonia, in which the applicant Veejaam made an investment in 2014, during the period when the aid scheme was considered lawful, and requested the subsidy in 2015, during the period of unlawfulness, the Court interestingly held that Article 108(3) TFEU does not preclude the operator from being eligible for the aid. Indeed, since "it cannot be precluded that an economic operator may benefit from the premature payment of the aid implemented in breach of the obligation to notify laid down in Article 108(3) TFEU, where the Commission adopts a final decision finding that that aid is compatible with the internal market, that provision also does not preclude that operator from obtaining that aid in respect of the period prior to such a Commission decision, as from that point at which the operator applied for the aid".

6. The "incentive effect" is a crucial element in State aid for climate, energy, and the environment. It ensures that Member States do not waste money helping inefficient operators but instead use taxpayers' funds for a European common interest, such as a greener transition.

From the first part of the judgment, it appears that an "incentive effect" could be demonstrated outside the scope of the EEAG in light of the primary rule provided by Article 107(3)(b) TFEU. However, the Court does not explain how Member States can demonstrate that aid "promotes the execution

of an important project of common European interest".

While at first glance, the judgement suggests that subsidies have an "incentive effect" when economic operators cannot bear the cost of environmental standards, it is argued in this paper that a coherent interpretation of State aid law should take into consideration principally the enhancement of environmental protection. Eventually, State aid for investments in environmental standards that exceed EU requirements has an "incentive effect", irrespective of the financial condition of the beneficiary, even if the standards are mandated by national environmental law.

The preliminary ruling in the case *Veejaam and Espo* has underlined that the promotion of renewable energy development is an objective of common interest under EU law, and may outweigh the potential distortion of competition. The EU State aid plays a pivotal role in achieving the objectives of the European Green Deal through the dialogue between Member States and the European Commission. The future development of case law will contribute to clarifying the appropriate balance between competition and environmental objectives.