



# Case study: The UK capacity mechanism

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# Agenda

1. Introduction to the UK Capacity Market
2. Tempus Energy and the CM suspension
3. Consequences of suspension
4. What does this mean for CM design?
5. Questions

# Origin of the Capacity Market - 1

- The Capacity Market ("**CM**") grew out of the Electricity Market Reform ("**EMR**")
  - Following a major review undertaken by Ofgem and the Department of Energy and Climate Change (DECC, now BEIS) into the fundamentals of market
  - Initially announced in December 2010
- Focus of EMR is to meet the long-term challenge of decarbonisation and deliver renewable energy targets, while maintaining secure and affordable electricity supplies
- EMR developed against a context of significant planned capacity closures during 2011 - 2021, concerns over limited flexibility of new low carbon generation, volatile oil and gas prices and a wide range of scenarios for future demand

# Origin of the Capacity Market - 2

- Key challenges EMR sought to address (as seen in 2010):
  - Potential for demand for electricity to double. Decarbonisation of the economy means electricity providing more of GB's heating and transport needs
  - Risks to security of supply arising from a need to replace a quarter of GB's then-existing capacity by 2020
  - Decarbonisation of economy needed to be led by the power sector, but the current market has a bias towards fossil fuels
  - Around 30% of GB's electricity needed to come from renewable sources by 2020
  - Gas-fired generation the lowest cost and lowest risk investment. Also seen and providing vital flexibility to support an increasing amount of low-carbon generation and to maintain security of supply

# Overview of the Capacity Market

## Key aims

- CM was one of the tools designed to address these challenges
- Provides a back-up electricity supply that can meet peak demand at times of system stress, which intermittent renewables cannot meet
  - e.g. when there is a winter cold snap with high pressure and little or no wind
- CM aims to:
  - Ensure sufficient investment in the overall level of reliable capacity needed to provide secure electricity supplies
  - Bring forward investment by allowing the market to set a price for capacity through competitive auctions
- Operates alongside other services contracted by National Grid to balance the system (Black Start, DSR, Frequency Response, Fast Reserve, STOR, etc.)

# Capacity Market – summary of operation - 1

- The Delivery Body (National Grid) forecasts future peak demand, based on analysis of the evidence gathered
- Applicants participate in a pre-qualification process run by the Delivery Body
- Most generation, including existing plant, eligible to participate (but not if supported through renewables obligation or in receipt of a FIT). Interconnectors and demand side response ("**DSR**") services can also participate
- Delivery Body runs auctions to contract capacity needed in future years. Auctions are held four years (T-4) and one year (T-1) before each delivery period
- Delivery Body awards capacity agreements to successful auction participants

## Capacity Market – summary of operation - 2

- Capacity provider must provide the capacity committed under its capacity agreement in the event of shortage of generation or increased demand in the delivery year or years
- Regular capacity payments made to capacity providers, with price determined by the auction (T-4 price is usually higher than T-1 price)
- Failure to meet delivery obligations trigger financial penalties



# Tempus Energy v European Commission

## Background

- The CM is a form of state aid and, as such, in the EU it is subject to state aid approval from the Commission
- A benchmark for the state aid approval are the EU Guidelines on State aid for environmental protection and energy 2014-2020
- The UK authorities notified the Commission in June 2014 of its intention to seek approval of the state aid, in accordance with Article 108(3) TFEU
- On 23 July 2014, the Commission issued Decision C(2014) 5083 final ("**2014 Decision**") not to raise objections on the grounds that the measure was justified by Article 107(3)(c) TFEU
- i.e. "*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*" is deemed compatible with the internal market



# Tempus Energy v European Commission

## Judgment

- In November 2018, the General Court ("**GC**") of the CJEU decided on the case of *Tempus Energy v European Commission* (case reference T-793/14)
- Tempus claimed that the European Commission did not launch a proper investigation to determine the compatibility of the CM with EU state aid rules
- Tempus's key argument was that the CM favoured generation over DSR in a discriminatory and disproportionate manner
- In its judgment, the GC confirmed that the CM was a state aid measure, and it held that the UK did not conduct a proper investigation (i.e. procedural issue)
- The judgment however did not take a position on whether the CM conforms with state aid rules (i.e. material issue)
- As a result, on 15 November 2018 the GC annulled the 2014 Decision
- The judgment is being appealed – in the meantime the UK suspended the CM

# Rationale of Tempus judgement -1

## Tempus' Arguments

### 1. *Agreement Length:*

- New build/refurbished generation = 3 or 15 year terms, depending on capex
- DSR providers = 1 year term
- The difference in treatment based upon detailed examination of the expenditure and financing needs of generation, but no similar scrutiny was applied to DSR

2. *Cost recovery method:* Cost recovery based on consumption between 16:00 and 19:00 each winter weekday, not during the triad (highest three half-hour demand periods on transmission networks between Nov and Feb). Failed to incentivise consumers to reduce their consumption during demand peaks and thus does not limit the aid to the minimum amount necessary

3. *Participation condition:* DSR must procure a bid bond at the same level as generation, i.e. a barrier to entry to DSR, a sector still in its infancy

# Rationale of Tempus judgement -2

## GC's findings

- Commission should have looked beyond UK submissions in its notification, i.e. it should have performed a full investigation to determine compatibility with state aid rules
- Commission did not fully recognise the potential role for DSR services
- If Commission had been satisfied that the CM intends to allow DSR to participate alongside generation (i.e. both can provide an equivalent solution), the aid measure should be open and provide adequate incentives to the relevant operators
- Based on the evidence, the GC found that the Commission should have had doubts about the compatibility of the CM with state aid rules

# Commission's response

- Annulment of the 2014 Decision does not necessarily mean the CM measures are incompatible with state aid
- The general working assumption is that the Commission needs to open an in-depth investigation and determine whether the UK CM complies with the EU state aid rules
- The process likely to take some time, with a result expected in mid-2020. In the meantime payments under CM "suspended". The expectation is that, if aid is approved, payments will be released later
- In January 2019, the Commission filed an appeal against the GC's November 2018 judgment. This however does not suspend the effects of the judgment
- The Commission opened an in-depth investigation in February 2019

# UK Government's response -1

- The UK Government is looking to reopen the CM as soon as the state aid issue is resolved
- To create stability during the "standstill period" starting on 15 November 2018, the Capacity Market rules were amended in March 2019, and the Electricity Capacity (No. 1) Regulations 2019 entered into force on 10 April 2019
- The 2019 Regulations provide for a replacement T-1 auction to be held on 11-12 June 2019 in order to secure capacity for the delivery year 2019-20
- The 2019 Regulations will expire on one of two triggers:
  - The deferred capacity payment trigger event – should the Commission decide the CM regime still confirms with state aid rules, or
  - The agreement termination trigger event – should the Commission decide it to be incompatible with state aid
- In the first case, the 2019 Regulations provide for the collection of charges that were payable by electricity suppliers during the standstill period to be resumed

# UK Government's response -2

- In March 2019 Tempus Energy applied for judicial review of UK Government's decision to continue operating the CM
  - Tempus argues that GC's judgment made because CM breaches state aid
  - Government argues GC's judgment made because of procedural failings
- The judicial review is a purely national based process and will not have an outcome on the Commission's investigation of the CM
- If successful, the judicial review could result in the closure of the CM, recovery of previous payments made to capacity providers and reimbursement of supplier charge paid by electricity suppliers
- The Commission's appeal against the judgment and/or full investigation of the compatibility of the CM with state aid rules will however be decisive

# What does this mean for designing a CM?

- CM is a recognised form of state aid under EU state aid rules, which are part of the Energy Community *acquis*
- Any CM scheme must be notified to the responsible body – in the case of the Energy Community, the designated national authority
- If the scheme is deemed incompatible with state aid rules, it is possible that infringement proceedings may be commenced
- *Tempus Energy* may be considered persuasive authority of compliance with procedural aspects, i.e. a proper investigation must be conducted
- As seen with the UK CM, if the scheme is improperly implemented, there is the risk of uncertainty for market participants and additional costs to contest any disputes



# *Any questions?*



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