

## Invitation to submit comments on State aid SA.35980 (2018/NN) - United Kingdom Electricity Market reform: Capacity Mechanism

### Observations from ClientEarth

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Dear Commissioner Vestager,  
Dear State Aid Greffe,

1. ClientEarth<sup>1</sup> hereby wishes to submit to the Commission its response to the invitation to submit comments in respect of the decision of 21 February 2019 to initiate a formal investigation on the capacity market in force in Great Britain (hereafter the "**Capacity Market**" or the "**scheme**"), (hereafter the "**Opening Decision**").<sup>2</sup>
2. We have been analysing the GB Capacity Market very closely since it was first examined by the Commission in 2014 and provided comments to the Commission and the UK authorities on the design and amendments to the scheme on several occasions (see Annexes 1 to 5). These comments remain valid subject to subsequent regulatory changes in the UK and shall be read in conjunction with the present observations.

### Executive summary and recommendations

3. Capacity mechanisms should only be introduced to the extent that there is an authentic and persisting resource adequacy problem, with a built-in mechanism for closing the scheme if this ceases to be the case. They should be designed in a way so as to make it possible for any capacity that can effectively contribute to addressing the resource adequacy problem to participate, while ensuring that the scheme does not have a negative impact on the objective of phasing out environmentally harmful subsidies. In particular, it should be open to substitutable technologies, such as demand side management, interconnectors and storage. Agreement lengths should be set at an appropriate level to incentivise behavioural shifts, enable investment decisions and promote the development of new business models. However, long-term agreements granted to conventional generation capacity providers can undermine the clean energy transition, have a negative impact on competition and should therefore be avoided. These principles guide our response to the invitation to submit comments on the scheme.

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<sup>1</sup> ClientEarth is a leading non-governmental public interest environmental law organisation based in London, with offices in a number of global cities including Brussels, Berlin, Madrid and Warsaw. Our work notably focuses on shaping energy market rules and a State aid legal framework that supports a flexible, efficient, competitive and sustainable energy market.

<sup>2</sup> Official Journal C 109, 22.3.2019, p. 3–45. Our observations are made on the basis of the Commission's decision of 21 February 2018 as published on the State Aid Register on 15 March 2019. Any corrections made by the corrigendum announced on 11 March 2019 on the State Aid Register, that is not published yet, could not have been taken into account. We reserve the right to amend the present observations should this corrigendum affect our analysis.

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4. The analysis of the Capacity Market by the Commission in 2014 was, as also confirmed by the General Court, unsatisfactory. Likewise, there are a number of flaws in the Opening Decision.
  - It is extremely questionable that a Capacity Mechanism is needed at all in the UK at present and for the future. The assessment of the necessity of the scheme shall be reviewed by the Commission.
  - The organisation of T-1 and T-3 auctions during the standstill obligation is concerning and the Commission must carefully control that all contracts are awarded under the condition that the Commission adopts a final positive decision on the scheme.
  - Due account must be taken of the amendments and public consultations launched by the UK authorities since the Opening Decision. In particular, the proposal to open the eligibility criteria to certain renewable technologies is an important development, assuming a Capacity Market is needed.
  - The absence of reference to the new rules on capacity mechanisms adopted within the Clean Energy For All Europeans Package creates a severe risk of inconsistency and incompatibility of the Capacity Mechanism with the new regulatory framework. The final decision must ensure a complete compliance of the scheme with these new rules.
  - The scheme still does not appear to be sufficiently technology neutral and it is essential that this is remedied for the future.
5. The Commission must ensure that the formal investigation is truly an in-depth investigation, taking into account all relevant information that is or could be available, publicly or not (and can be requested from the UK authorities or third parties), as well as all information provided by third parties and the reports expected to be produced by BEIS and Ofgem in summer 2019, and must also take due account of the evolution of the UK and EU regulatory frameworks.

## 1 General remarks

### 1.1 Description of the GB capacity Market and amendments to the Regulations and Rules

6. We do not have substantial comments to make on the accuracy of the description of the scheme in Section 2 of the Opening Decision.
7. The Capacity Market rules have been amended on several occasions since 2014.<sup>3</sup> Although many of these amendments have been taken into account in the Opening Decision, this is not the case of the most recent amendments or public consultations, as

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<sup>3</sup> The Electricity Capacity (Supplier Payment etc.) Regulations 2014 (2014 No. 3354); The Electricity Capacity (Amendment) Regulations 2015 (2015 No. 875); The Electricity Capacity (Amendment) (No. 2) Regulations 2015 (2015 No. 1974); The Electricity Capacity (Amendment) Regulations 2016 (2016 No. 742); The Electricity Capacity (Amendment) Regulations 2017 (2017 No. 1053) - all available at: <http://www.legislation.gov.uk/>; For other amendments, see <https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-market-reform/capacity-market-cm-rules>; For a consolidated version of the Rules up to 19 July 2018, see [https://www.ofgem.gov.uk/system/files/docs/2018/07/consolidated\\_capacity\\_market\\_rules.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/07/consolidated_capacity_market_rules.pdf)

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detailed further below under Section 2.1. These amend the Capacity Market legal framework with the intent, essentially, to (i) organise its implementation during the standstill period and (ii) address regulatory burdens and barriers faced by participants:

- **The Electricity Capacity (No. 1) Regulations 2019 (2019 No. 862) made on 9 April 2019<sup>4</sup>**, which essentially provide for rules relating to (i) the implementation of the capacity mechanism during the standstill period for agreements existing on 15th November 2018 and (ii) the organisation of T-1 "conditional agreement auctions" for delivery as from 1st October 2019, as well as (iii) various amendments regarding the possibility to certain capacity market units ("CMUs") to opt out or withdraw from the auctions and the rules for reconciliation of payments after the standstill period expires;
  - **The Capacity Market (Amendment) (No. 2) Rules 2019<sup>5</sup>** that supplements the Electricity Capacity (No 1) Regulations 2019 with dates of entry into force of the various amendments, coordination of texts and specific implementation rules;
  - **BEIS' public consultation on a T-3 auction for the 2022/23 delivery year**, to replace the T-4 auction which had been scheduled for January 2019<sup>6</sup>;
  - In the same BEIS public consultation, **the project to make certain renewable energy technologies (onshore and offshore wind and photovoltaic solar) eligible** to participate in the scheme as from delivery year 2022/2023 (in the replacement T-3 auction);
  - **Ofgem's public consultation launched on 16 April 2019 on the Five Year Review of the Capacity Market** and on "*changes that [Ofgem] are aiming to implement to simplify the CM in the short term*".<sup>7</sup> The responses to this consultation and the closing report from Ofgem that would be available in the summer may highlight some flaws of the current Capacity Market<sup>8</sup> and prospects for amendments.
8. BEIS and Ofgem reports proposing amendments to the scheme are expected to be published in the summer and in any case, within the 18 month period available to the Commission to conduct its formal investigation.<sup>9</sup> These reports are expected to contain a number of items that could be highly relevant to the compatibility assessment of the scheme. In accordance with its duty to take account of all relevant information that is or could be available at the time it takes a decision, it is essential that the Commission wait to undertake a full assessment of the content of these reports before taking a final decision.
9. Rushing the adoption of a final decision without taking these reports fully into account, when the Commission is aware that they will soon be published (or when it could request

<sup>4</sup> Available at: <http://www.legislation.gov.uk/ukxi/2019/862/made>

<sup>5</sup> Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/786989/capacity-market-amendment-no2-rules-2019.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786989/capacity-market-amendment-no2-rules-2019.pdf)

<sup>6</sup> BEIS, Consultation on "Proposals for Further Amendments to the Capacity Market", March 2019 - available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/784221/further-amendments-to-capacity-market-consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/784221/further-amendments-to-capacity-market-consultation.pdf)

<sup>7</sup> This consultation closes on 28 May 2019 - Available at: <https://www.ofgem.gov.uk/publications-and-updates/five-year-review-capacity-market-rules-first-policy-consultation>

<sup>8</sup> In its Five Year Review (p.6), Ofgem admits that: "*We believe that the Rules are meeting their first objective to deliver security of supply, but that in part they hinder their own ability to meet their second objective to ensure the efficient operation of the CM. The complexity of the Rules and the regulatory burden they place on participants may be a barrier to participation and certainly makes participation complicated, which may in turn lead to inefficient bidding in the Auction. We identified the regulatory burden and the complexity of the Rules as a priority area in our consultation.*"

<sup>9</sup> Procedural Regulation 2015/1589, Art. 9(6)

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them from the UK authorities), could result in the Commission adopting a decision that does not duly take account of all information that is or could be available, as required by the case law.<sup>10</sup> For example, this situation could arise if the Commission were to expedite its decision-making process for the purposes of ensuring approval in time for the T-1 “conditional agreement auctions” referred to above. Any such unlawful expedition could be susceptible to legal challenge.

## 1.2 Evolution of the GB electricity market and of the Capacity Market calls for a distinct assessment of the scheme for the past (2014 to present) and for the future

10. By contrast to the Commission's decision not to raise objections against the Capacity Market issued on 23 July 2014, the scope of the Opening Decision comprehends the entirety of the scheme as implemented since 16 December 2014<sup>11</sup>, i.e. amendments to the scheme, results of the auctions, the evolution of the GB electricity market and of the UK policy in this respect - subject to the new pieces of legislation mentioned in Section 1.1 above.
11. In this respect, in addition to market developments that have taken place since 2014, the Commission's investigation will need to take into account subsequent regulatory changes (for example, cash out reform and reforms mentioned under Section 1.1 above), as well as the increased contribution of interconnection and the growth of low-carbon capacity resources such as DSR, storage and renewable generation. These developments are covered in more detail in our Capacity Market Review Response to the UK (Annex 3).
12. In the Opening Decision, the Commission formally divides its reasoning between the past, unlawful aid and the aid potentially going forward only in respect of the preliminary assessment of the objective of common interest and necessity of the aid.<sup>12</sup> This division is relevant given the limited evidence that exists of a genuine resource adequacy concern in Great Britain. Even if it were the case that such concerns were valid in 2014, which ClientEarth does not necessarily accept, those concerns need to be reassessed in light of the market dynamics that exist in 2019 and going forwards (see Section 2.2.2 below).
13. This division shall also apply to the assessment of the other compatibility criteria.
14. Besides, the reasoning should not be divided around the date of the General Court's ruling but around the date on which the Commission will take a final decision. This requires that all developments concerning the design of the scheme, as well as

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<sup>10</sup> See e.g. judgment of 10 February 2009, *Deutsche Post and DHL International v Commission*, T-388/03, EU:T:2009:30, para. 109 and 110; judgment of 15 November 2018, *Tempus Energy Ltd and Tempus Energy Technology Ltd v Commission*, T-793/14, EU:T:2018:790, para. 69, 71 and 72; judgment of 3 April 2014, *France / Commission*, C-559/12 P, EU:C:2014:217, para. 63; judgment of 13 September 2010, *Hellenic Republic (T-415/05), Olympiakes Aerogrammes AE (T-416/05) and Olympiaki Aeroporia Ypiresies AE (T-423/05) v European Commission*, EU:T:2010:386, para. 249

<sup>11</sup> That is, according to rec. (203) of the Commission's decision to initiate formal investigations, the date of first implementation of the scheme, when the first auction under the capacity market took place.

<sup>12</sup> See rec. (137) to (144) for the period 2014-November 2018 and rec. (145) to (147) for the period after November 2018.

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developments in the market and the regulatory environment,<sup>13</sup> that arise until the Commission reaches a final decision, or are foreseen to arise<sup>14</sup> at that time, must be included in the definitive assessment of the compatibility of the aid for the future.<sup>15</sup>

### 1.3 Ensuring alignment of the scheme with the recast Regulation on the internal market for electricity

15. Whilst the decision not to raise objections of 23 July 2014 was grounded on the EEAG alone, the legal framework relating to capacity mechanisms has evolved with the adoption of the recast Regulation on the internal market for electricity (hereafter the "**recast Regulation**").<sup>16</sup> It is expected that the recast Regulation will apply as of 1 January 2020.<sup>17</sup>
16. The Opening Decision does not refer to this new legal framework at all, which is open to criticism given the imminence (or precedence) of the entry into force of the recast Regulation with the Commission's final decision on this matter. This flaw is even less understandable given that some of the decisions of 7 February 2018 authorising capacity mechanisms in other Member States contain a revision clause that specifically refers to the recast Regulation.<sup>18</sup>
17. It is imperative that the Capacity Market operates in the context of a coherent policy and legal framework. As a matter of good practice (if the final decision is adopted before 1 January 2020) and as a matter of law (if it is adopted after that date), the Commission should ensure that the Capacity Market is approved only to the extent that the requirements set out in the recast Regulation are complied with.
18. In this respect, it should be noted that the text of the recast Regulation was substantively agreed by the end of 2018, based largely on the Commission proposal of 30 November 2016. Both the European Parliament and the Council of the European Union had indicated their approval by early 2019.<sup>19</sup> Consequently, both the UK Government and the European Commission have been well aware of the principles and rules that have been agreed in the recast Regulation for an extended period, and certainly since prior to the date of the Opening Decision.
19. Given that the formal investigation currently being undertaken could run for a period of up to 18 months (and that this is only a best endeavours date), it is possible that it could

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<sup>13</sup> This includes notably the reforms of the Capacity Market rules, adopted, planned or proposed; and the recast Regulation on the internal market for electricity.

<sup>14</sup> These shall include both reforms that the UK or the EU have already projected, but also forward analysis of the energy markets and of UK and EU policies in respect of the development of the energy sector.

<sup>15</sup> cf. C-49/05 P *Ferriere Nord SpA v Commission* EU:C:2008:259, paragraphs 70-71.

<sup>16</sup> At the date of the present observations, the last version of the recast Regulation for the internal market for electricity is the one adopted by legislative resolution of the European Parliament on 26 March 2019 (P8\_TA-PROV(2019)0227).

<sup>17</sup> Recast Regulation on the internal market for electricity, Art. 71(2)

<sup>18</sup> See the clause included in the decisions adopted on capacity mechanisms on 7 February 2018, on SA.48490 (footnote 26); SA.45852 (footnote 14 resulting from the corrigendum of 28 November 2018); SA.42011 (footnote 50); SA.46100 (footnote 32).

<sup>19</sup> Interinstitutional negotiations were commenced in February 2018, with trilogies held on 18 December 2018, and the Council of the European Union confirming on 18 January 2019 that it would approve the text once it had been approved by the European Parliament. The text was formally approved by Parliament on 26 March 2019. See further the legislative file:

[https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2016/0380\(COD\)&l=en](https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2016/0380(COD)&l=en)

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conclude following entry into force of the recast Regulation. However, it is also possible that it could conclude prior to that date (although that would represent an exceptionally and unprecedented short investigation for such a complex measure). It would be extremely unfortunate, and logically incoherent, if the date at which the Commission chooses to issue its final decision were to determine the manner in which it assesses compatibility of the Capacity Market with the internal market.

20. Given that it is uncertain on which date the final decision will be issued, it would be logical to assess it having regard to the principles set out in the recast Regulation, regardless of the timing of that final decision. The alternative, that the Commission sets out, from the outset, to assess the Capacity Mechanism without regard to the recast Regulation, could give rise to the impression that the Commission is intentionally expediting its assessment in order to avoid the UK having to apply the rules in the recast Regulation. Clearly any such expedition – for this or any other reason unrelated to ensuring full assessment of the compatibility of the measure with the internal market – is impermissible.<sup>20</sup>
21. For this reason, in assessing the compatibility of the Capacity Market, the Commission should have regard to the principles set out in the recast Regulation. Evidently this applies only to the forward looking assessment – given that the recast Regulation had not been drafted at the time of the 2014 approval decision, nor for most of the period from 2014 to 2018 when aid was (unlawfully) granted, it may not strictly be necessary to assess this existing aid on the basis of the new legislation.
22. To the extent that the Commission decides not to take the approach of assessing compliance of the Capacity Market on the basis of the principles set out in the recast Regulation – which we maintain would not be the correct approach – it should at the very least ensure that one or both of the following actions is undertaken<sup>21</sup>:
  - The UK commit to amend the Capacity Market pursuant to the new rules, in particular Articles 20 to 26, as soon as they will enter into force; and / or
  - The final decision, if positive, be conditional on amendments to the scheme that will bring it in compliance with the new rules as soon as they will enter into force.
23. Consequently, whilst the Commission should in principle have regard to the principles underlying the recast Regulation in assessing the compliance of the Capacity Market, it must at the very least ensure that compliance with the recast Regulation is ensured upon its entry into force.

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<sup>20</sup> This is demonstrated by the case law of the European Courts. For example, in Case T-793/14 – Tempus Energy Ltd et al v European Commission, the General Court held that: “the Commission may not decline to initiate the formal investigation procedure in reliance on other circumstances, such as third-party interests, considerations of economy of procedure or any other ground of administrative or political convenience.” (para 63). The same principle must apply, by extension, to the conduct of the in-depth investigation – third party interests must not dictate the manner or timing of the Commission’s assessment, as this could affect the Commission’s ability to fully assess compatibility of the measure with the internal market.

<sup>21</sup> Procedural Regulation 2015/1589, Art. 9(3) (“...where appropriate following modification by the Member State concerned...”) and Art. 9(4)

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## 1.4 Inconsistency of the scheme with the recast Regulation on the internal market for electricity

24. In substantive terms, the Capacity Market as designed is inconsistent with the recast Regulation. Some examples of this inconsistency are set out in the following paragraphs.
25. The Commission's acceptance of National Grid's assertion that sufficient investment in new capacity to satisfy the Reliability Standard will not take place unless the capacity market as reinstated is at odds with the thrust of the recast Regulation.
26. Without sight of National Grid's counterfactual studies - they have not been made publicly available by National Grid or BEIS, and (at the time of this response) have not been provided in response to information requests - it is difficult to provide a detailed rebuttal to this assertion. However, it is clear that Great Britain currently has a capacity surplus of more than 11%<sup>22</sup> and has introduced virtually all of the energy market reforms required by the recast Regulation – reforms that are designed to avoid the need for a capacity market. The Opening Decision therefore appears in conflict with the theme running through the recast Regulation that properly designed energy markets can ensure that security of supply is maintained.
27. Moreover, this capacity surplus provides a strong indication that the aid is incompatible with the internal market, given that a market failure is not evidenced, as required by the EEAG. This point is further developed in section 2.2.2 below.
28. It is also worth noting that the Capacity Market in Great Britain, and market-wide capacity markets in general, will undermine the market reforms set out in the recast Regulation. Whereas those market reforms aim to restore the “missing money” to the energy market through the removal of price caps and the introduction of scarcity pricing, market-wide capacity markets drain revenues from the energy market and reduce the infra-marginal rents available to energy market participants. This particularly damages the economics of those technologies such as demand response and storage that depend on a degree of price volatility. The tendency for capacity markets to depress peak energy prices and drain revenues from the energy market was evidenced by the increase in forward peak energy prices that occurred on the suspension of the Capacity Market in November 2018.<sup>23</sup>
29. It is also worth noting that the recast Regulation specifies that, where residual capacity concerns remain following the introduction of necessary energy market reforms, Member States should consider the introduction of a “strategic reserve”.<sup>24</sup> Unlike the market-wide

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<sup>22</sup> On the capacity surplus (for winter 2018/19), see National Grid's Winter Outlook Report and the debates at the House of Commons on 2nd and 3rd April 2019 on the Draft Electricity Capacity (No. 1) Regulations 2019, mentioning that Great Britain has a capacity margin of 11% and “It is unlikely that there will be any capacity problems over the winter.”. The 2018 National Grid Winter Outlook Report gives a de-rated margin of 11.7% or 7.1 GW and LoLE at 0.001. Our analysis shows that the capacity market needs just less than a 4% de-rated margin to satisfy the reliability standard, say 2.5 GW. So, by removing Cottam and Fiddler's Ferry (2.2 GW de-rated) from the capacity stack and adding Nemo and ElecLink (1.45 GW de-rated using PTE recommendations), we should have a de-rated margin of around 6.3 GW in Winter 2019/20 – well above that needed to meet the reliability standard.

The other approach is to look at the aborted T-1 auction for winter 2019/20. 4.6 GW of de-rated capacity was to be procured and about 14 GW pre-qualified. This suggests a margin of around 7 GW – again more than enough to meet the reliability standard.

<sup>23</sup> See e.g. <http://watt-logic.com/2018/11/19/capacity-market-ruling/>

<sup>24</sup> Recast Regulation on the internal market for electricity, Art. 21(3)

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capacity market design introduced by Great Britain, a strategic reserve would allow energy prices to reflect the value of continued supply and would not drain revenues from the energy market. If Great Britain still has concerns that its energy market reforms are unlikely to bring forward sufficient investment to ensure compliance with its reliability standard going forward, consistency with the recast Regulation would require the consideration of a targeted strategic reserve, not the reinstatement of a market-wide capacity market.

30. We believe it is crucial that the Commission takes account of the consistency between the recast Regulation and the design of the Capacity Market for the future. As compliance with the new capacity mechanism design rules are intrinsically linked to the assessment of the compatibility of the scheme with State aid rules including the EEAG that are currently in force.

## 2 Assessment of the scheme

### 2.1 Existence and lawfulness of aid - standstill period

31. First of all, we support the Commission in its preliminary findings that the scheme is a State aid measure and that its compatibility with the internal market shall be assessed under the EEAG.<sup>25</sup>
32. Secondly, we also support the Commission's preliminary findings that the current scheme is unlawful given that the General Court (T-793/14) annulled the Commission's decision of 23 July 2014 not to raise objections to the scheme.<sup>26</sup> Consequently, any payments made in the past and currently under the scheme are exposed to recovery orders by national courts.
33. Likewise in light of the standstill obligation, the award of capacity agreements pursuant to any auctions (not only the capacity payments) shall not proceed pending a Commission's final positive decision, as they would confer new<sup>27</sup> aid to the capacity providers.<sup>28</sup> We refer in particular to our recommendations of January 2019 to the UK in this respect (Annex 5).

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<sup>25</sup> Commission's decision to initiate formal investigations, rec. (131) and (133)

<sup>26</sup> Commission's decision to initiate formal investigations, rec. (132)

<sup>27</sup> These individual acts have lost the protection of their underlying (approved) scheme with the annulment of the 2014 decision, thus can no longer be considered "existing aid" and are subject to EU State aid control. Without going into the distinction between capacity contract awards and payments based on them, recitals 5 et seq. Opening Decision also make it clear that the GB Capacity Market scheme as such is to be considered new aid, not existing aid. The Judgment did not leave the Commission any other possibility; as long as the Commission opens a formal investigation procedure considering a measure new aid, the suspension obligation under Article 108(3) TFEU remains fully applicable (Case C-400/99 Italy v Commission ('Tirrenia' – admissibility) EU:C:2001:528, para 45-65; Case C-367/95 P Commission v Sytraval and Brink's France EU:C:1998:154, para 37) This means that the entire scheme, including the contract awards, are currently unlawful – that the Commission is ambiguous about this in recital 10 does not change this.

<sup>28</sup> The award of contracts constitute an economic advantage: running auctions under a scheme and awarding agreements for future payment confers an economic advantage (See Case C-279/08 P European Commission v Kingdom of the Netherlands [EU:C: 2011:551], the CJEU held at para 88 that "by making [NOx emission] allowances tradable, the Kingdom of the Netherlands confers on them a market value") The EU Commission itself considers even Government assurances to a possible beneficiary about the possibility of future payments (i.e. even short of a "binding" contract award) without notification in the meaning of Article 108(3) TFEU as a possible violation of EU State aid rules (See e.g. the press reports about Commission questions regarding rumours that the UK Government had, a few months after the Brexit referendum in 2016, given assurances to Nissan in an effort to convince it not to transfer employment outside the UK (<https://www.reuters.com/article/us-britain-eu-nissan-commission-idUSKBN1321CN>), dated 7 November 2016 (last visited on 16 April 2019). Also the other elements of the notion of State aid are present as regards the Capacity Market contract awards.



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34. Nevertheless, recital 10 of the Opening Decision is somewhat misleading as to the actual suspension of the scheme and of grant of aid by the UK authorities since 15 November 2018. ClientEarth welcomes the UK authorities' decisions to (i) halt the T-4 auction scheduled for 2018 for delivery of capacity in 2022<sup>29</sup>; (ii) defer and condition payments under capacity agreements existing on 15th November 2018 upon the Commission approving the scheme<sup>30</sup>; and (iii) hold supplier charge payments received from electricity suppliers until the Commission approves the scheme.<sup>31</sup> Nevertheless, the decision (ii) also involves that the contracted CMUs are due to keep on providing capacity anyway<sup>32</sup>, and the decision (iii) involves that the Settlement Body will keep on collecting charges from electricity suppliers, hence from consumers, during the standstill period. The scheme is therefore not entirely suspended and necessarily involves unlawful aid. The Commission should issue a suspension injunction against those acts of the UK which are perpetuating the advantages of the scheme which should have all ceased and been recovered pursuant to the standstill obligation.
35. Moreover, it is concerning that the UK plans on organising the following auctions despite its standstill obligation:
- A T-3 auction securing capacity for delivery in 2022/2023, to be held in early 2020.<sup>33</sup> It would replace the T-4 auctions that were meant to be organised in January 2019 but that did not take place due to the General Court's ruling. BEIS' intentions are, subject to technical adaptations, that the auction structure "*would be as similar as possible to the previously planned T-4 auction*" but would include certain renewable technologies (if this proposal is adopted).<sup>34</sup> The opening of eligibility conditions to renewable technologies was not taken into account in the Opening Decision and shall be assessed *per se* (see Section 2.2.3 below).
  - A "conditional agreement auction" that is a T-1 auction that would be organised on 11-12 June 2019 for the delivery year commencing on 1st October 2019.<sup>35</sup> This conditional agreement auction was not mentioned in the Opening Decision but shall be taken into account by the Commission too. The conditional capacity agreements secured through the 2019 T-1 auction would convert into regular capacity agreements for the same delivery year, capacity obligation, and capacity cleared price, pursuant to the Commission approving the scheme.<sup>36</sup>

<sup>29</sup> Commission's decision to initiate formal investigations, rec. (53); See the Electricity Capacity Regulations 2014 [2014 No. 2043], reg. 26(3)(a)

<sup>30</sup> Electricity Capacity (No. 1) Regulations 2019, reg. 4(2) and 6(1). More precisely, the "*deferred capacity payment trigger event*" is the notification by the Secretary of State to the Settlement Body that the state aid approval has been obtained from the relevant authority i.e. a positive decision of the Commission on that aspect.

<sup>31</sup> Electricity Capacity (No. 1) Regulations 2019, reg. 7(1)(a) and 8

<sup>32</sup> The capacity providers may elect to terminate their contracts or not deliver capacity but will be subject to the regular termination or non-completion fees if the Commission issues a positive decision and the scheme is fully reinstated.

<sup>33</sup> Commission's decision to initiate formal investigations, rec. (53) and (156). It appears that BEIS is now contemplating to hold these auction in early 2020, rather than in 2019 as mentioned in the Opening Decision - see: BEIS, Consultation on " Proposals for further amendments to the capacity market", March 2019, pp.4 and 6

<sup>34</sup> BEIS, Consultation on " Proposals for further amendments to the capacity market", March 2019, pp.6 and 8

<sup>35</sup> Electricity Capacity (No. 1) Regulations 2019, Part 5, reg. 28 *et seq.* That T-1 auction is actually the postponement of the T-1 auctions that were planned in January 2019, until the Commission's decision was annulled by the General Court on 15 November 2018. For details of schedule and modalities of these auctions, see See Letter from BIS to National grid of 10 April 2019 (available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/794942/20190410\\_SoS\\_to\\_Duncan\\_Burt\\_RE\\_Capacity\\_Market-A.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/794942/20190410_SoS_to_Duncan_Burt_RE_Capacity_Market-A.pdf)); and the Auction Guidelines 2019 v.3.0, the Pre-Auction Activity Guidance and the Auction Withdrawal Notice v.1.0, all published on 11 April 2019 and available at: <https://www.emrdeliverybody.com/CM/Guidance.aspx>

<sup>36</sup> Electricity Capacity (No. 1) Regulations 2019, reg. 31(c)

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36. Despite the fact that *"the Government do not consider that holding this T-1 auction, or awarding additional capacity agreements in that auction, amounts to state aid [on the ground that] conditional capacity agreements convert into capacity agreements only if there is state aid approval to make payments, meaning that any aid under the agreement awarded is entirely conditional on state aid"*<sup>37</sup>, the Commission shall include these auctions in its analysis of compliance with the standstill obligation and assessment of compatibility.

## 2.2 Compatibility with the internal market

### 2.2.1 Preliminary remark: Information available to assess the compatibility of the scheme

37. The following analysis has been made on the basis of the documentation publicly available. On 12 April 2019<sup>38</sup>, ClientEarth requested from BEIS some information necessary in particular for assessing the objective of common interest, the need for a capacity mechanism and the organisation of transitional auctions. To date, these documents have not been provided<sup>39</sup> and we reserve the right to supplement the present observations with an analysis of this relevant information upon receipt.
38. Pursuant to its duty to assess the compatibility of the scheme in light of all information available, the Commission must ensure that it collects and analyses all of this information even if the UK Government chooses not to disclose it to the public, if necessary by using its investigations powers under Article 7 of the Procedural Regulation 2015/1589.
39. Furthermore, there are no time-related boundaries as regards the facts that the Commission has to take into account in reaching its final decision pursuant to Articles 108(2) TFEU and Article 9(1)-(5) of the Procedural Regulation. The Commission shall use all relevant information made available since it adopted the decision not to raise objections in 2014, including, but not limited to, any information that the UK Government provided to it on 20 December 2018 (which is not publicly available), as well as all information provided to the Commission by third parties.

### 2.2.2 Objective of common interest and necessity of the aid

40. The following observations relate to Section 3.3.1 of the Opening Decision.
41. Security of electricity supply is of course an essential part of safeguarding the economic and wider public interest. However, whether a capacity mechanism, i.e. a State aid measure, is necessary to ensure security of supply shall be assessed strictly under the applicable legal framework described in the EEAG.

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<sup>37</sup> House of Commons, Draft Electricity Capacity (No. 1) Regulations 2019, 2 April 2019, intervention by Chris Skidmore, at 2:59pm - [https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity\(No1\)Regulations2019](https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity(No1)Regulations2019)

<sup>38</sup> Annex 6 - ClientEarth' request for information to BEIS dated 12 April 2019

<sup>39</sup> See Annex 7 - BEIS' reply to ClientEarth' request for information, dated 12 April 2019

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42. Paragraphs 220 and 221 impose two main criteria for assessing whether an aid measure can be deemed to meet the objective of common interest consisting in ensuring security of supply. At paragraph 220, that *"the Member States should [...] primarily consider alternative ways of achieving generation adequacy that does not have a negative impact on the objective to phasing-out environmentally and economically harmful subsidies..."*; at paragraph 221, that the generation adequacy problem be clearly identified and consistent with ENTSO-E's analysis.
43. **The requirement in paragraph 220 was not met back in 2014 and is still not met at present.** Some UK policies such as the introduction of an emission intensity limit and the reforms of the Capacity Market rules enabling certain renewable technologies to participate, or facilitate the participation of demand side management, are however going in the right direction.
44. In more detail, recital 150 of the Opening Decision insufficiently takes into account the reality of the continuous subsidies to fossil fuel generation that are granted through capacity agreements, in particular open cycle gas plants and diesel generators<sup>40</sup>, or old nuclear producers.<sup>41</sup> This is to the detriment of more responsible and sustainable resources such as demand side management (demand side response, energy efficiency storage, in particular) that actually have the potential to reduce energy consumption and thus the need for additional capacity - in line with the proportionality principle.
45. Also at recital 150, the Commission states that the UK "has passed stringent emission performance standards to prevent commissioning high carbon intensive generation".<sup>42</sup> Evidence that even the UK considers this is not strict enough to meet the objective of phasing out environmentally harmful subsidies (paragraph 220 EEAG), is the intention to introduce an "emission intensity limit"<sup>43</sup> of 450gCO<sub>2</sub>/KWh for solid fossil fuel generation CMUs that would apply to auctions for delivery in 2025/2026.<sup>44</sup> ClientEarth already alerted the UK authorities on the necessity for such emission intensity limit to meet the objective to phase out fossil fuel subsidies provided in paragraph 220 EEAG.<sup>45</sup> This emission intensity limit is still to be passed into law (indeed, no formal legislative proposal

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<sup>40</sup> House of Commons, Draft Electricity Capacity (No. 1) Regulations 2019, 2 April 2019, intervention by Dr. Whitehead, at 2:59pm (column 11) - Available at: [https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity\(No1\)Regulations2019](https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity(No1)Regulations2019): "On the particular point of the capacity market providing new build, will the Minister agree that the only combined cycle gas plant supported by the capacity market is one 400MW plant during the entire period of the auctions? The capacity that has been procured more recently has either been open cycle gas plants, which are more polluting than combined cycle gas plants, or diesel set generators, which are more polluting than coal. Does the Minister consider that that is a good method of procuring capacity for the future through the capacity market arrangements?"

<sup>41</sup> House of Commons, Draft Electricity Capacity (No. 1) Regulations 2019, 2 April 2019, intervention by Dr. Alan Whitehead, at 2:37pm - Available at: [https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity\(No1\)Regulations2019](https://hansard.parliament.uk/Commons/2019-04-02/debates/3b82c91d-7577-471a-83ff-da3beb5221d4/DraftElectricityCapacity(No1)Regulations2019) : "A capacity market which did that 15-year job of bringing long-term capacity into the frame might make some long-term sense. The problem with the capacity market as it stands is that it has signally failed to do that job. Instead, almost all the contracts are one-year contracts for immediate capacity for companies not to produce, but to stand by to produce, if required, in the event of a capacity shortfall in a particular period, in this case, next winter. That is a very long way from the original intention of the capacity market. Not only are contracts being given out to coal-fired generators, which increases the amount of energy they produce when they are supposed to be reducing it until their disappearance in 2025, but capacity payments are being given to old nuclear power producers in order for them to stand by and produce power when, in fact, a nuclear power station cannot be turned off. It is therefore quite impossible for that nuclear power station not to provide power and yet capacity payments are going to those organisations. It is not a good system as it stands."

<sup>42</sup> See Energy Act 2013 (2013 Chapter 32), sect. 57, available at: <http://www.legislation.gov.uk/ukpga/2013/32>

<sup>43</sup> That is said to be an instantaneous limit that contrasts with the existing Emissions Performance Standard, which sets an annual limit on CO<sub>2</sub> emissions from fossil fuel generators. See BEIS, "[Implementing the end of unabated coal - Government response to unabated coal closure consultation](#)", January 2018, footnote 6

<sup>44</sup> BEIS, "[Implementing the end of unabated coal - Government response to unabated coal closure consultation](#)", January 2018, para. 18 and 27.

<sup>45</sup> See Annex 3, para. 3 to 6

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has been published) and is promised "in good time before" the auctions organised in 2020/2021.<sup>46</sup> We recommend that the final decision taken by the Commission, if positive, contain a commitment by the UK authorities to comply with their own policy of unabated coal closure by 2025 and introduce the necessary legislation to achieve this.

46. In accordance with paragraph 221, it could be argued that the UK identified a generation adequacy problem that is consistent with ENTSO-E's analysis. However, this statement is **not sufficient to establish that there was, is and will be for some more years a genuine need for a Capacity Market in Great Britain.**
47. First, at recital 146, the Commission states that "*The identification of a persistent need for a capacity mechanism for the future has to be based on counterfactual scenarios, assuming that no capacity mechanism exists in the UK.*" Our enquiry for the counterfactual scenario made to National Grid was rejected on the ground that this document could not be disclosed pursuant to a BEIS' request to National Grid. We are therefore unable to assess in any detail the conclusion drawn by the Commission in recital 147 that the requirement of paragraph 221 EEAG is met.
48. Nevertheless, the immediate conclusion at recital 147 that National Grid' analysis is consistent with the generation adequacy analysis carried out by ENTSO-E (the MAF), as both are based on the same input data (National Grid's FES base case), is biased: the fact that both use the same data rather undermines the usefulness of the ENTSO-E analysis as a sanity check.
49. Furthermore, contrary to the Commission's preliminary finding at recital 151, on the evidence available there is no need for the Capacity Market as designed.

### ***The UK's conservative approach***

50. The following comments are based on the UK's original submissions to the Commission. National Grid are not prepared to release the studies submitted to the Commission in December 2018 as BEIS has requested that they remain confidential.
51. In its original submission, the UK Government's own evidence (recital 92, fig 4 of the Opening Decision) only shows LoLE rising above the reliability standard prior to winter 2018/19 under the "low supply" and "high demand" scenarios. In the reference scenario, LoLE remains at low levels other than in year 2015/16, when it approaches the reliability standard. This is despite extremely conservative assumptions about peak demand, plant availability and interconnection contribution.

### ***Interconnection***

52. In their longer-term estimates of de-rated capacity margin (recital 93, fig 5 of the Opening Decision), again in their original submission, the UK Government do show de-rated

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<sup>46</sup> See BEIS, "[Implementing the end of unabated coal - Government response to unabated coal closure consultation](#)", para. 40: "As the introduction of the emissions intensity limit will prevent unabated coal units entering into the Capacity Market auctions held in late 2021/early 2022 for the 2025/26 delivery year, and subsequent auctions for delivery years beyond that, the government will prepare the required legislation in good time before these 2021/22 auctions."

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margins falling below that necessary to meet the reliability standard.<sup>47</sup> However, this is again influenced by the very conservative estimates made, e.g. that the total interconnector capacity makes a zero-net contribution. This assumption is at odds with the capacity agreements allocated to individual interconnectors in recent auctions and the fact that total interconnector capacity is expected to rise to around 11.5 GW by 2022<sup>48</sup> – the first year that the UK Government (recital 95, fig 5 of the Opening Decision) expected de-rated margins to fall below that necessary to meet the reliability standard

53. Just what capacity contribution interconnectors can be expected to make when total interconnection capacity rises to these levels is unclear as saturation effects may arise. However, using the contribution assumptions recommended by the UK Government’s own Panel of Technical Experts and including contributions only from continental Europe, interconnection alone would have contributed more than enough de-rated capacity to ensure the reliability standard was met in all years.
54. National Grid’s methodology for calculating assumed interconnection contribution in recent auctions has improved considerably from the extremely conservative assumptions used in the UK Government’s original submission and the early auctions. However, without sight of National Grid’s recent analysis it is impossible to comment on validity of the assumptions used.

*Plant availability*

55. Although it is not clear what assumptions were made about plant availability in the UK Government’s submission to the Commission, National Grid takes a conservative approach when recommending capacity to be auctioned to the Secretary of State. The assumptions made about existing generator availability over peak are a significant factor in estimating de-rated capacity margins and how much capacity needs to be contracted at auction. As with interconnector contribution assumptions, National Grid’s conservative approach (see table below) adds to capacity requirements at auction. As an example, using availability assumptions for CCGT plant that more accurately reflected recent outturn would reduce the amount of capacity needed to be contracted by over 1 GW.

	2016/17 Actual	2017/18 Actual	Capacity market Assumption
<b>Nuclear</b>	6	5	18
<b>Coal</b>	15*	5	12
<b>OCGT</b>	3	3	5
<b>CCGT</b>	7	6	11-13

Assumed generator non-availability and outturn (%)

Source National Grid publications

\* High unavailability thought to be due to commercial decisions reflecting a low probability of running.

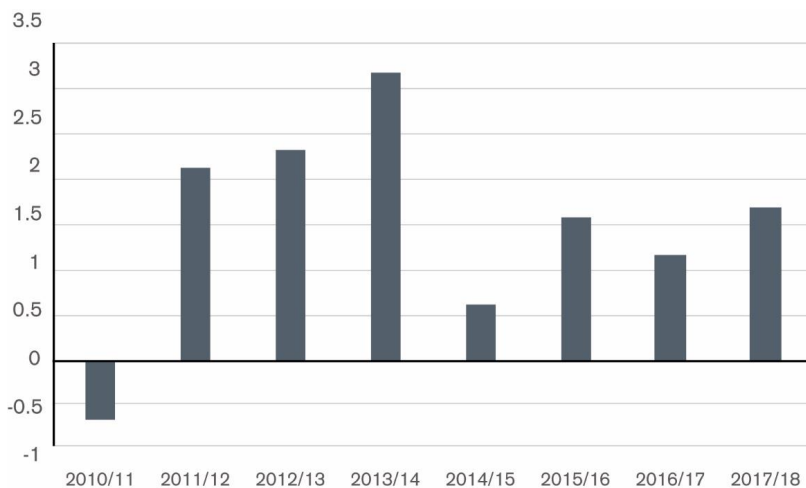
<sup>47</sup> A de-rated capacity margin of just under 4% is necessary to meet the reliability standard of 3 hours p.a.

<sup>48</sup> Ofgem’s “Electricity Interconnectors” page. See <https://www.ofgem.gov.uk/electricity/transmission-networks/electricity-interconnectors>

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### *Demand estimates*

56. As with interconnector contribution and plant availability, peak demand estimates play a major role in estimating de-rated capacity margins. Again, without sight of the assumptions made by National Grid in support of the UK Government's recent submission to the Commission, it is impossible to comment on their veracity. However, on the basis of National Grid's demand forecasting performance generally, the suspicion is that peak demand estimates will be overly conservative. As shown below, an analysis of National Grid's performance in forecasting peak demand over an eight-year period to 2017/18 shows a conservative bias, with demand being over-estimated in seven of those years with an average over-estimation error of 1.5 GW.



Peak Demand Forecast error - source, Ofgem's 2018 State of the Market report <sup>49</sup>

57. The suspicion that National Grid's demand forecasting remains overly-conservative is reinforced by the fact that, despite a steady decrease in recent years, the 2018 Electricity Capacity Review ("**ECR**") forecasts peak demand to rise to 60.3 GW by 2022/23. This prompted the Government's Panel of Technical Experts<sup>50</sup> to express concern at a lack of transparency behind National Grid's demand forecasting methodology and also the

<sup>49</sup> 2018 State of the Market Report, Ofgem. See [https://www.ofgem.gov.uk/system/files/docs/2018/10/state\\_of\\_the\\_energy\\_market\\_report\\_2018.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/10/state_of_the_energy_market_report_2018.pdf)  
<sup>50</sup> Panel of Technical Experts independent report of National Grid's Electricity Capacity Report 2018. BEIS, <https://assets.publishing.service.gov.uk/government/uploads>

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failure to adequately take price sensitivity into account, given that energy prices are likely to be high when capacity is scarce.

### ***Risk of further capacity closures in the permanent absence of a capacity mechanism***

58. Without sight of National Grid's counter-factual analysis it is difficult to comment of the assertion that 8GW of coal and gas plant would close by winter 2019/20 (recital 101), however it seems highly unlikely. What is known is that 2.5GW of coal capacity will close in 2019 and, as all other transmission-connected generation will by now have committed to paying Transmission Network User of Service ("**TNUoS**") charges for 2019/20, no further closures seem likely prior to winter 2019/20. It is possible however that some of the small gas/diesel plants that have been awarded capacity market agreements but have been hit by Ofgem's embedded benefit changes may decide to terminate their contracts or not deliver.
59. What might happen post winter 2019/20 is unclear. The 8.5GW of remaining coal plant is expected to close prior to 2025 and closure could be advanced in the event of a permanent annulment. Aurora research has estimated that, if 15GW of coal and gas capacity failed to deliver, winter peak prices could double.<sup>51</sup> Losing 15GW would certainly result in a negative de-rated margin even with increased interconnection contribution etc. However, price increases of this magnitude would almost certainly encourage plants to remain operational, mitigating the overall loss of capacity.

### ***Market failures***

60. As in its original submission, the UK contends that the reason behind its perceived generation adequacy problem is two-fold (recital 149 Opening Decision). Firstly, the "public good" argument, which revolves around the fact that, absent half-hourly metering, domestic demand is not sufficiently price-sensitive and, secondly, there is an energy market "missing money" problem.
61. Dealing with the first issue, it is true that domestic and small commercial demand is generally metered on a summation basis, with wholesale market settlement relying on assumed consumption profiles. This will change with the ongoing deployment of smart meters. However, the contention that the current lack of half-hourly metering renders the energy market insufficiently price-sensitive, is flawed. Currently, it is estimated that 38% of peak demand is metered on a half-hourly basis, more than enough to allow scarcity pricing to be effective as a means of balancing supply and demand when capacity is scarce. Not all demand needs to be price-sensitive for an energy-only market to work effectively.
62. Furthermore, as any perceived security of supply concerns must relate to future decommissioning (Great Britain currently has a significant plant surplus), the focus should be on the price sensitivity of demand in the future, not as it is now. It is therefore pertinent to note that the Government's intention of having a smart meter in every home

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<sup>51</sup> See <http://watt-logic.com/2018/11/19/capacity-market-ruling/>

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by 2020 will significantly increase the potential for demand to become more price sensitive, just at the time when it might be required

63. Turning to the second issue, the Commission contends that the Capacity Market addresses the missing money problem. In fact, the opposite is true. Great Britain has introduced market reforms that should address the missing money problem, e.g. a scarcity pricing function, marginal imbalance prices etc. However, the presence of a capacity market undermines the usefulness of these measures and drains revenues from the energy market. The Capacity Market does not address the energy market missing money problem, it makes it worse – as evidenced by the increase in forward peak energy prices that occurred when the capacity market was annulled.<sup>52</sup>
64. **This analysis shows, contrary to the Commission' preliminary finding at recital 151, that it is seriously questionable whether the Capacity Market fully meets an objective of common interest - that is not only ensuring security of supply, but also doing it without having an impact on the objective to phase-out environmentally and economically harmful subsidies - and that the scheme is necessary, in particular going forward.** The analysis set out in the Opening Decision is therefore insufficient for concluding that the scheme is compatible with these criteria of the EEAG and this shall be assessed more in depth in the course of the formal investigation.
65. Nevertheless, should the Commission consider that the scheme meets an objective of common interest and is necessary, *quod non*, each of the other compatibility criteria shall be assessed.

### 2.2.3 Appropriateness of the aid

66. We do not challenge the fact that the scheme remunerates the service of pure availability of the CMUs only and meets paragraph 225 EEAG. However, **the appropriateness of the scheme in compliance with paragraph 226 EEAG is seriously questionable due to the lack, still, of technology neutrality of the Capacity Market.**
67. For the scheme to be effectively technology-neutral as required by paragraph 226 EEAG, it is essential that all resource providers are treated equally and that none face barriers to entry. **Equal, effective and hence competitive participation of all relevant resource providers shall be ensured by the combination of (i) eligibility criteria to bid in the auctions, (ii) the conditions of participation to the scheme, e.g. participation thresholds or guarantees to be provided and (iii) the conditions of the capacity agreements awarded pursuant to the auctions, including the length of those agreements.**
68. ClientEarth already extensively provided comments to the UK Government on the lack of proper consideration given to resource providers alternative to generation; demand side response in particular (see Annexes 1, 2, 3 and 5). Those views are supported by the

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<sup>52</sup> See <http://watt-logic.com/2018/11/19/capacity-market-ruling/>



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judgement of the General Court of 15 November 2018 and have lead to the present opening of a formal investigation by the Commission on this matter.

69. Besides, paragraphs 232(b) and 233(a) EEAG prescribe that a capacity mechanism measure shall be designed in a way so as to ensure the participation of foreign operators “where such participation is physically possible”. ClientEarth welcomes the opening of the scheme to interconnections since 2015. However, we support the Commission's views at recitals 172 and 191 of the Opening Decision that the scheme should also be open to direct foreign participation<sup>53</sup>.

70. In its consultation of March 2019, BEIS proposed that “certain renewable technologies” become eligible to participate in the Capacity Market as from delivery year 2022/2023.<sup>54</sup> This would encompass offshore wind, onshore wind and photovoltaic solar. BEIS admits that renewables technologies such as wind and solar can contribute meaningfully to security of supply.<sup>55</sup> Unfortunately, the Opening Decision neither refers to this proposal from the UK authorities<sup>56</sup>, nor does it preliminarily assess, nor call for comments on, the current exclusion of renewable energy sources from the scheme - which is not justifiable in view of the potential contribution of these technologies to the level of security of supply.

**71. We encourage the Commission to request more information from the UK authorities on their proposal, the responses to the consultation and require confirmation that renewable technologies would be able to bid in the replacement T-3 auction.** As mentioned above under Sections 1.1 and 2.2.1, it is essential that all the relevant information, including the responses to the consultation, be assessed in detail by the Commission to substantiate its assessment of the compatibility of the Capacity Market with paragraph 226 EEAG. As part of its assessment, the Commission shall analyse in particular:

(i) whether limiting eligibility to offshore wind, onshore wind and photovoltaic solar amongst renewable energy sources that are defined in paragraph 19(5) EEAG, ensures that the scheme effectively meets the requirements of paragraphs 220, 226 and 232(a) and (c) EEAG;

(ii) why these renewable technologies were not included in the Capacity Market in the first place in 2014 and whether the UK Government's explanations for this exclusion were well-grounded at the time, against the justifications brought now for the inclusion of these renewable technologies for the future.

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<sup>53</sup> In its Interim Report of the Sector Inquiry on Capacity Mechanisms (p.14), the Commission expressed the view that “it is technically challenging to include foreign capacity in capacity mechanisms”.

<sup>54</sup> BEIS, Consultation on “Proposals for further amendments to the capacity market”, March 2019, p.8. These renewable technologies could become eligible to the replacement T-3 auctions to be held in early 2020 for delivery year 2022/2023. They would be eligible subject to the rules on cumulation of State aid.

<sup>55</sup> BEIS, Consultation on “Proposals for further amendments to the capacity market”, March 2019, pp.13-14

<sup>56</sup> It may be so because BEIS consulted on the expansion of eligibility criteria in March 2019, after the Commission issued the Opening Decision.

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#### 2.2.4 Incentive effect (recitals 177-181 Opening Decision)

72. Assessment of the incentive effect of the aid requires the Commission to assess the counterfactual situation of absence of aid (paragraphs 277, 49 and 52 EEAG). As mentioned above, it is difficult to fully assess the incentive effect of the scheme without having any views on National Grid's counterfactual scenario. We nonetheless refer to our assessment of the reliability standard and the UK's conservative approach developed under Section 2.2.2 above, disagreeing with the UK's stance that the generation adequacy problem remains (recital 179 of the Opening Decision).

#### 2.2.5 Proportionality of the aid (recitals 182-188 Opening Decision)

73. The Commission (para 80) contends that recovering the costs of capacity agreements by charging suppliers based on their consumption across the entire Winter between 4-7 pm on working days will reduce the amount of capacity to be procured. However, this dilutes any cost-reflectiveness, because costs, instead of being directly causally linked to the TRIAD peak demand periods during which the CM will be needed, are basically "smeared" across the entire Winter period. Charging suppliers on this basis essentially eliminates demand response as a means of reducing chargeable demand as few providers could countenance reducing demand on every winter weekday. So, rather than reducing the amount of capacity to be procured as the Commission claims, the cost recovery methodology actually increases capacity requirements.
74. A better approach would be to recover the cost of capacity agreements over the triad periods, i.e. using the same methodology as applies to the recovery of network costs (and the methodology originally proposed by the UK Government itself). Although triad demand periods are identified ex-post and cannot be predicted with absolute certainty, in practice the methodology reduces the number of demand periods over which demand response needs to be applied. This would increase the effectiveness of demand response in reducing the amount of capacity to be procured.
75. Unfortunately however, Ofgem have signalled the end of the triad methodology without at this stage identifying how it will be replaced.<sup>57</sup> If the Capacity Mechanism is to be reinstated, some means of cost recovery that incentivises suppliers to reduce demand during periods when capacity is likely to be scarce needs to be found. Simply reverting to the original cost recovery methodology will discourage the use of demand flexibility and thereby increase both the capacity to be procured and cost to consumers. This would be squarely at odds with the proportionality principle, contrary in particular to paragraphs 230 and 231 EEAG (requiring the scheme to "*have built-in mechanisms to ensure that windfall profits cannot arise*" and "*to ensure that the price paid for availability automatically tends to zero when the level of capacity supplied is expected to be adequate to meet the level of capacity demanded*"), as more State aid than necessary would be paid out.

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<sup>57</sup> See <https://www.ofgem.gov.uk/ofgem-publications/143400>

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### **2.2.6 Avoidance of negative effects on competition and trade (recitals 189-197 Opening Decision)**

76. As mentioned above, ClientEarth is of the opinion that the requirements of paragraphs 232 and 233 EEAG are not currently met by the Capacity Market due, in particular, to (i) the discriminatory conditions preventing some operators from efficiently participating and contributing to the Capacity market, be it for the different contract length, participation thresholds and bid bond required; and (ii) the lack of direct foreign participation.

### **2.2.7 Compliance with Articles 30 and 110 TFEU (recitals 198-202 Opening Decision)**

77. We do not have any comments in this respect and welcome the inclusion of interconnectors in the scheme since 2015.

### **2.2.8 Duration (recital 203 Opening Decision)**

78. We are of the opinion that the scheme should not be approved at all, or at the very least not going forward. The market, the policy and legal frameworks have already significantly evolved since 2014. With a complete in depth compatibility assessment, the Commission should reach the conclusion that these evolutions highly contributed to the security of supply in the country and that the alleged resource adequacy problem does not persist (if there ever was one) (see Section 2.2.2 above).

79. Regardless, a potential approval of the scheme until 2024, as envisaged in recital 203 of the Opening Decision, does nothing to the obligation of the UK to comply with the recast Regulation as from 1 January 2020 and adapt the scheme in consequence; nor shall it be an excuse for the UK to unduly delay any reforms (of the energy market or the Capacity Market) after December 2024.

## **3 Conclusions and recommendations**

80. The analysis of the Capacity Market by the Commission in 2014 was, as also confirmed by the General Court, unsatisfactory. Likewise, there are a number of flaws in the Opening Decision. This is particularly the case for the preliminary findings that the scheme meets an objective of common interest and is necessary, despite the fact that the market reforms undertaken by the UK and the current situation of capacity surplus (by 11.7%) plead for the contrary. The scheme is still not open to direct foreign participation, nor yet to renewable energy technologies and the reforms of the rules shall still ensure a better and more effective participation of demand side management. The Commission must ensure that the formal investigation is truly an in-depth investigation, taking into account all relevant information that is or could be available, publicly or not (and can be requested from the UK authorities or third parties), as well as all information provided by third parties and the reports expected to be produced by BEIS and Ofgem in summer 2019, and must also take due account of the evolution of the UK and EU regulatory frameworks.

81. In particular, we recommend that:

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- An analysis of the lawfulness and compatibility of the extraordinary T-3 auctions for delivery year 2022 and of the T-1 "conditional agreement auctions" for delivery year commencing on 1st October 2019, both to be held in 2019, shall be conducted.
- The Commission gather more information, including through the responses to Ofgem's First Policy Consultation launched on 16 April 2019 on the Five Year Review of the Capacity Market Rules, the subsequent report published by Ofgem in the summer 2019 and amendments resulting therefrom.<sup>58</sup>
- The reform consisting in opening eligibility to the scheme to onshore wind, offshore wind and photovoltaic solar, must be pursued. The Commission should also critically assess the reasons why the UK authorities have not extended their reform proposal to other renewable energy technologies, and why the scheme was not open to those at the origin, in 2014.
- The final decision takes due account of the new rules for capacity mechanisms contained in the recast Regulation on the internal market for electricity. This would ensure that the Capacity Market, if deemed compatible in all or in part with the internal market for the future, complies with those new rules as soon as they enter into force on 1st January 2020.
- The UK commits to comply with their own policy of unabated coal closure by 2025 and adopt an emission intensity limit of 450gCO<sub>2</sub>/KWh preventing solid fossil fuel generators that exceed that limit from bidding to the auctions for delivery in 2025/2026, or earlier.

We remain at the Commission's disposal should you have further queries on these observations.

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<sup>58</sup> <https://www.ofgem.gov.uk/publications-and-updates/five-year-review-capacity-market-rules-first-policy-consultation>

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**Annexes:**

1. ClientEarth's and The Regulatory Assistance Project's observations to the Commission on the GB capacity market, dated 2014;
2. ClientEarth's and The Regulatory Assistance Project's follow-up observations to the Commission on the GB capacity market, dated 2014;
3. ClientEarth's response to BEIS' consultation on "Response to Capacity Market Review - Call for evidence", dated 1st October 2018
4. ClientEarth's analysis on "What does the General Court ruling mean for Great Britain's Capacity Market?", dated 19 November 2018
5. ClientEarth's response to BEIS' consultation on "Proposals for technical amendments to the Capacity Market", dated 10 January 2019
6. ClientEarth's request for information to BEIS, dated 12 April 2019
7. BEIS' reply to ClientEarth's request for information, dated 12 April 2019

ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. We are activist lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

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