Client Alert | Power

UK Capacity Market suspended after European General Court ruling – A Detailed Analysis & What Next?

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Following on from our previous piece, White & Case takes a deeper look at the background, judgment and what is next for the UK Capacity Mechanism after the adoption of the Tempus Energy Decision by the European General Court ("EGC").[1]

Background to the Decision: the UK Capacity Mechanism

The UK Capacity Mechanism (the "**Capacity Mechanism**"), introduced as part of the UK Government's Electricity Market Reform programme in 2014, is structured around a centrally-managed dual auction process to procure the capacity needed each year to ensure sufficient generation is potentially available at all times. Successful bidders, (which can include new and existing generators, demand side response ("**DSR**") providers, interconnectors and storage operators) receive steady payments from National Grid during the term of their respective agreements in return for a commitment to deliver electricity (or reduce demand) at times of "system stress". The term of capacity agreements varies. Contracts are available for up to 15 years for new facilities, for up to three years for refurbished facilities and for one year for existing facilities. Whether a facility will fall into the "new" or "refurbished" categories will depend primarily on their planned levels of capital expenditure which must meet a per/MW threshold.

Two auctions are held in respect of every supply year:

- **The T-4 Auction** which is held four years in advance of the supply year; and
- **The T-1 Auction** which is held one year before the expected supply year.

The amount of capacity required each year is ultimately determined by the UK government[2] after receipt of advice from National Grid.

The gross revenues under the Capacity Market Agreements which were expected to be paid to Capacity Agreement holders between 2018 and 2024 under the Capacity Mechanism were estimated at between GBP 8.1 billion and GBP 23.4 billion.

State Aid Assessment Principles

In accordance with its obligations under Article 108 (3) TFEU[3], the UK sought State aid approval for the Capacity Mechanism from the European Commission prior to its implementation. UK authorities notified the EU Commission on 23 June 2014, following pre-notification contacts.

1 Case T-793/14, Tempus Energy and Tempus Energy Technology v Commission.

2 Department for Business, Energy and Industrial Strategy.

Article 107(1) TFEU defines State aid as: "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods…in so far as it effects trade between Member States".

There was no disagreement as between the UK and the EU Commission that the proposed Capacity Mechanism constituted State aid.

The Commission had to determine whether the Capacity Mechanism as notified was compatible with the Guidelines on State aid for environmental protection and energy 2014-2020 (the "**2014 Guidelines**"). The 2014 Guidelines set out the rules with which State aid measures in the energy sector must comply.[4]

In terms of assessing the compatibility of a measure with the internal market all State aid measure must satisfy certain State aid principles, set out below. Section 3.9 of the 2014 Guidelines provides specific guidance on the satisfaction of these principles for generation adequacy measures.

A measure must contribute to an objective of common interest and be necessary.

Key factors include the identification of generation adequacy concerns through a quantifiable indicator, pursuing a well-defined objective, addressing the nature and causes of the identified market failure that prevents the market itself delivering the required level of capacity and consideration of alternative options.

Appropriateness of the aid.

In this instance the choice of instrument must be coherent with other measures, the aid must only compensate the availability of capacity, the mechanism must be open to all relevant capacity providers and take into account the extent to which interconnected capacity can contribute to remedy generation adequacy concerns.

Measure must have an incentive effect

The measure must incentivise the beneficiaries of the State aid to change their behaviour to act in a way which they would not, i.e. provide security of supply services, if the measure were not introduced.

Measure must be proportionate.

A measure must permit beneficiaries a reasonable rate of return and have in-built structures to prevent windfall profits arising. Where a measure incorporates a competitive bidding process on the basis of clear, transparent and non-discriminatory criteria, this reasonable rate of return requirement will be presumed to have been satisfied.

Measure must avoid negative effects on competition and trade.

The measure must be designed in such a way to ensure that a sufficient number of suppliers take part to establish a competitive price, and that these suppliers are drawn from a range of different technologies including DSR, interconnectors and storage.

State Aid Approval Process

The approval process is governed by the Procedural Regulation which, as the name suggests, sets out the procedural aspects for conducting State aid assessments.[5] That procedure dictates that the notification of any State aid measure to the Commission generally triggers what is called the **preliminary investigation** phase. This phase lasts two months from the time a complete notification of the measure is deemed submitted. If during the preliminary investigative phase the Commission finds that no doubts are raised as to the compatibility of the measure with the internal market, i.e. the applicable State aid rules, it can conclude that the measure is compatible with the internal market.[6]

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3 Treaty on the Functioning of the European Union.

4 2014/C 200/01, Section 3.9.

5 Regulation 659/1999 OJ L 83/4.

6 Article 4(3) of the Procedural Regulation.

If, however, after a preliminary examination the Commission finds that the doubts are raised as to the compatibility of the measure then the Commission is obliged to open the **formal investigation** procedure. The formal investigation procedure, established under Article 108(2) TFEU, involves both a consultation period during which both the Member State and third parties are invited to make submissions on the proposed measure and an in-depth investigation. The Commission must initiate the formal investigation procedure where, after a preliminary investigation, it has doubts on compatibility.[7]

In addition to the above procedures Member States also have the option, often strongly encouraged by the Commission, to "pre-notify" measures before submitting a formal notification and triggering the preliminary investigation.[8] The intention of this **pre-notification** phase is to afford the Member State and the Commission the opportunity to engage informally on the legal and economic aspects of the measure before a formal notification is submitted.[9] As the European Court noted in the Tempus Decision, this is seen as a means of paving the way for a more speedy treatment of a notification once it is formally submitted.[10]

Following a pre-notification period and a preliminary investigation, the Commission issued its decision that the newly designed UK Capacity Market was compatible with EU State aid rules on 23 July 2014. The Commission did not open a formal investigation before issuing its decision.

The Tempus Decision

The Tempus Decision annulled the Commission decision that the Capacity Mechanism is compatible with State aid rules on grounds that the Commission had not followed the procedural requirement under EU State aid rules.

The case before the European Court was based on two contentions: (i) that the Commission could not have concluded that the Capacity Mechanism did not raise doubts as to its compatibility with the internal market and so the Commission should have opened the formal investigation procedure before reaching its decision; and (ii) that the Commission failed to state reasons for its decision as required under EU law. Given that the European Court found that the first contention was satisfied, it did not find it necessary to consider the second.

There were essentially two elements to the assertion that the Commission could not have had any doubts, on the evidence available to it, as to the Capacity Mechanism's compatibility with the internal market. The first element concerned the length and content of the Commission's discussions with the UK before it adopted its decision; and the second concerned the evidence available to the Commission during the preliminary investigation phase and whether it was sufficient to support the Commission's conclusions.

1. **The length and content of the discussions between the Commission and the UK:** The European Court first of all noted that the Capacity Mechanism is "*significant, complex and novel"*. Indeed this assessment by the Commission was the first assessment of a generation adequacy measure under the 2014 Guidelines rendering it "*novel in terms of both its subject matter and its implications for the future".* The Court also noted that the measure involved "*particularly high*" levels of aid.

   On the length of the discussions, the UK and the Commission highlighted that the preliminary investigation phase itself lasted only a month. They argued that such a short investigation period indicates that there were no doubts present on the measure's compatibility at that time.

   The European Court did not accept, however, that this one month investigation period was a reliable indication that there were no doubts on compatibility at this stage given the length and the content of the contact between the Commission and the UK before the preliminary investigation phase, i.e. during pre-notification talks.

   The purpose of this pre-notification phase is essentially to get the notification in the best shape possible and not, as the European Court noted, to conduct a compatibility assessment

7 Deutsche Post International v Commission, T-388/03, para. 90.

8 Per the Best Practices Code on the conduct of State aid control proceedings, OJ 2009 C 136.

9 Ibid, paragraph 10.

10 Paragraph 87.

of the measure.[11] In this case, the Commission was first informed of the content of the planned measure approximately 18 months before the Commission initiated its preliminary investigation. Further, it seems that during this period the Commission asked detailed questions on the compatibility of the measure – an assessment which is only supposed to commence during the preliminary investigation phase.

The European Court also noted that at the end of this informal procedure the Commission was still asking the UK about the role of interconnectors, DSR Operators ("**DSROs**") and the difference in treatment between generators as well as other assessment criteria referred to in the 2014 Guidelines. To this end the European Court seems to have concluded that even at the end of this procedure the Commission was still conducting a compatibility assessment appropriately left to the preliminary investigation phase.

Given all of the foregoing, and the multiplicity of spontaneous observations submitted by third parties in the same period expressing concerns on the measure's compatibility with State aid rules, the European Court held that it could not accept that the one month long preliminary investigation period was an indicator that no doubts existed as to the Capacity Mechanism's compatibility with the internal market at the time the Commission issued its decision.

2. **The lack of appropriate investigation by the Commission with regard to certain aspects of the Capacity Mechanism:** A number of arguments were raised to contend that the evidence available to the Commission at the time could not have been sufficient to dispel all doubts as to the Capacity Mechanism's compliance with State aid rules.

a) *The Commission failed to properly assess the role of DSROs in the capacity mix.*

Among the principles which the design of a capacity measure must satisfy under the 2014 Guidelines is the facilitation and encouragement of DSROs. It was claimed that had the Commission conducted its own assessment of the potential of DSR it would have concluded that DSR could play a greater role in the Capacity Mechanism than the notified measure envisaged. The European Court held that the key question in this regard was whether the Commission adequately assessed the role that DSR was capable of playing in the Capacity Mechanism with regard to those principles of the 2014 Guidelines around the facilitation and encouragement of DSR.

The European Court accepted that the Commission had considered the evidence adduced by the UK. However, by failing to itself examine the potential role and capacity of DSR the European Court opined that the Commission had in essence accepted the UK's assumptions. The European Court held, given the Commission had not conducted its own investigation using its formal investigative powers, it could not be excluded that the Capacity Mechanism, as designed, did not encourage and facilitate DSR as required under the State aid rules.

b) *The Commission's assessment should have given rise to doubts with respect to the discriminatory or disadvantageous treatment of DSROs.*

It was argued that the Capacity Mechanism disadvantaged DSROs as compared to conventional generators. The length of the contracts offered to DSROs was highlighted. The availability of longer term contracts of up to 3 and up to 15 years for refurbished and new plants respectively are based on minimal capital outlay thresholds and the sensitivities of project finance. This effectively excludes DSROs from longer term contracts and so the access to the financing that longer contracts would bring.

The European Court found that this difference in treatment should have raised doubts in respect of the compatibility of the measure on non-discrimination grounds, which would have merited the opening of the formal investigation procedure. The European Court concluded that the Commission had failed to analyse in detail the capital expenditure and financing needs of DSROs in contrast to the detailed information which had been provided on the capital requirements of conventional generators.

11 Paragraphs 88-90.

It was, the European Court held, for the Commission to inform itself further by seeking relevant information if necessary. Without having done so, the European Court held, it was appropriate to conclude that the difference in the length of the contracts offered to DSROs means there should have been doubts as to the compatibility of the Capacity Mechanism on grounds of discrimination and disadvantageous treatment.

The Capacity Mechanism's participation conditions were also the subject of scrutiny. It was argued that by failing to offer different conditions to DSROs the Capacity Mechanism failed to meet the requirement under the 2014 Guidelines that capacity measures provide adequate incentives for DSR participants. The particular features highlighted as problematic were:

- The requirement that auction participants bid in respect of open-ended (rather than time specific) capacity events;
- The bid bond requirements (which were not varied by participant); and
- The 2MW de minimis threshold on participation.

The European Court again concluded that doubts as to compatibility of these aspects of the Capacity Mechanism could not have been dispelled at the time the decision was taken.

Key Conclusions

1. The **Pre-notification process**: the Tempus Decision is a clear statement on the part of the European Court that in the event of a lengthy pre-notification phase which itself throws up a significant number of issues, then this should be taken into consideration in the assessment of "serious difficulties" and the pre-notification phase may not be abused in order to deal with such difficulties with the effect of circumventing the need to initiate a formal investigation procedure and giving third parties the right to comment. In our experience, pre-notification typically functions as a "dry run" compatibility assessment, with the same case teams typically carrying out both the pre- and post-notification assessments. It is clear from the Tempus Decision, however, that pre-notification will be limited to evidential discussions henceforth forcing compatibility discussions with Member States in future into the more formal constraints of the official notification stages.
2. **Commission as evidence gatherer**: the Tempus Decision equally makes clear that where there is an absence of independent evidence the European Court expects that the Commission will conduct its own assessments, and use its powers under the formal investigation procedure to do so. This will necessarily, in our view, mean that more State aid cases will be assessed under the formal investigation procedure than has been the case to date.[12]
3. **A new design for the Capacity Mechanism?** At no point does the Tempus Decision determine or direct that the Capacity Mechanism is not compatible with the internal market, however, it is clear that the European Court considers that there are a whole range of doubts which the Commission should have had on compatibility at the preliminary assessment stage.

What next?

The European General Court is a constituent court of the Court of Justice of the European Union (ECJ). All cases heard at first instance by the General Court may be subject to a right of appeal to the Court of Justice on points of law only. Any appeal would in any event not have a suspensory effect in terms of the original court decision.

From a practical perspective, one must assume that the UK's priority will be gaining Commission approval for a compliant capacity regime that will allow it to resume supply efforts and continue its capacity auctions. Whilst the UK may re-notify exactly the same measure, from the perspective of easing the approval of any such mechanism in accordance with the 2014 Guidelines, the question will be whether the Department of Business, Energy and Industrial Strategy thinks it more expedient to go back to the drawing board on the

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12 Of the last twenty State aid Decisions adopted under the 2014 Guidelines, for example, none were subject to a formal investigation before the adoption of the Commission's Decision.

treatment of DSROs in the UK system before re-notifying or seek to push through the system on the basis of its current design.

A particular concern with any amended and re-notified mechanism would be the status of payments made to date under the existing Capacity Mechanism. Any amended and re-notified mechanism may increase the risk that previous capacity payments have to be recovered having been made pursuant to a mechanism that constituted State aid and that had not been found to be compatible with internal market rules.

In the interim, two major questions arise in terms of next steps:

1. *What happens to the holders of Capacity Agreements now?*
2. *What can the UK do about the capacity gaps that it had intended to address with the T-1 and T-4 auctions which had been set to take place on 5 February 2019?*

The UK National Grid, has published guidance to holders of Capacity Agreements which advises that credit cover can be recovered. In the meantime, Capacity Agreement holders who had been in receipt of payments until the Tempus Decision have had their payments suspended. The expectation is that the measure will need to be re-assessed for State aid compatibility, but given the content of the Tempus Decision it is, in our view, likely that the Commission may need to open a formal investigation procedure to complete their assessment unless substantial new evidence is available to it that has not been previously considered. A formal investigation procedure is a potentially lengthy process meaning the continued suspension of payments for some considerable time in the future.

Consideration must also be given to the status of payments that have already been made if, following the formal investigation procedure, the Commission finds that the Capacity Mechanism is not compatible with the internal market.

In terms of the impact on the adequacy of supply in the UK market, at present the UK has assured consumers that there is no imminent shortage. However, the UK had already scheduled the next round of Capacity Mechanism auctions for February 2019, and so long as the Capacity Mechanism remains suspended the knock-on effect on future supply projections is unknown. The latest statement from National Grid is that the UK government is intending to seek separate state aid approval from the Commission to run a one-off 'replacement' T-1 Auction. The postponed T-4 Auction is intended to be run as a T-3 Auction in next year's auction round, subject to the Commission completing its formal investigation and providing State aid approval for the main Capacity Market scheme.

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