

# Suspension of the GB capacity market:

What's happened, what does it mean  
and what could happen now?

2 January 2019



## Introduction

*Following the decision by the General Court of the EU in relation to the GB capacity market (CM)<sup>1</sup>, GB power generators, interconnectors, Demand Side Response (DSR) and storage providers would have gone into Christmas this year deprived of capacity payments they expected to receive. In this briefing, we provide the context behind the Court's ruling and comment on the implications of the standstill period the ruling has imposed, commercially and for the system as a whole.*

Any capacity remuneration mechanism (CRM) is a form of 'state aid' since it represents an intervention by the state to provide additional revenue over and above earnings in the energy and ancillary services markets. European law requires that state aid measures are approved by the European Commission (the EC). The EC also has the power to order recovery of state aid which has not been approved.<sup>2</sup>

<sup>1</sup> Judgement in Case T-793/14.

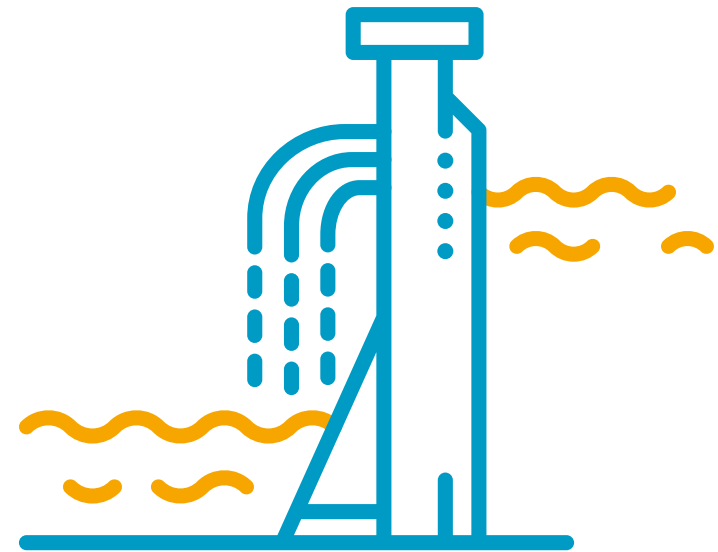
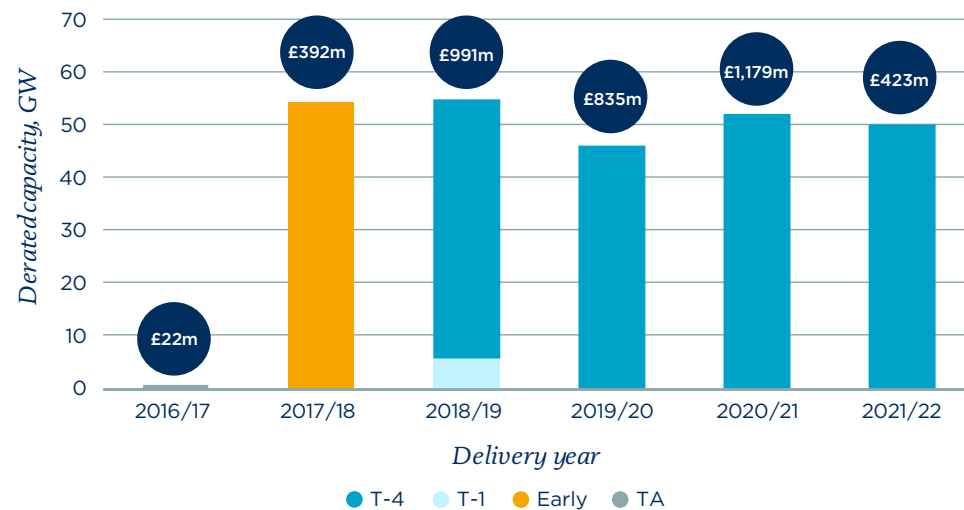
<sup>2</sup> European Commission website. State aid control. Available at: [http://ec.europa.eu/competition/state\\_aid/overview/index\\_en.html](http://ec.europa.eu/competition/state_aid/overview/index_en.html)

# Introduction

## Continued

In July 2014, the EC concluded that the proposed GB CM was compatible with state aid rules, noting that it would “contribute to ensuring the security of energy supply in the United Kingdom (UK), in line with EU objectives, without distorting competition in the Single Market.”<sup>3</sup> Subsequently, four T-4 auctions and one T-1 auction have been held. Two so-called “Transitional Auctions” were also held to support certain technologies, including DSR. The Early Auction held in January 2017 was granted separate state aid approval.<sup>4</sup> Collectively, these auctions have resulted in £3.8bn of payments due to capacity providers.

**Capacity Market: cleared capacity and payments**



<sup>3</sup> European Commission. State aid: Commission authorises UK Capacity Market electricity generation scheme. Available at: [http://europa.eu/rapid/press-release\\_IP-14-865\\_en.htm](http://europa.eu/rapid/press-release_IP-14-865_en.htm)

<sup>4</sup> European Commission website. Available at: [http://ec.europa.eu/competition/state\\_aid/cases/265707/265707\\_1850846\\_123\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/265707/265707_1850846_123_2.pdf)

# *The legal proceedings and their impact on capacity providers and suppliers*

In December 2014, Tempus Energy appealed the EC's approval of the CM, arguing that the EC could not have concluded that the CM design was compatible with the European internal market following only a preliminary investigation. More specifically, Tempus argued that the CM disproportionately advantages generation over DSR, and that the EC failed to assess this aspect despite being aware of the issues raised by the Panel of Technical Experts who had been tasked with reviewing the CM design by the UK government. A key point of contention was that DSR providers (like existing generators) can only receive one year capacity contracts whereas refurbished and new generators could receive up to three-year and fifteen-year contracts, respectively.

On 15 November 2018, the Court issued a judgement annulling, effective immediately, the EC's approval of the CM, stating that that the EC should have initiated a formal investigation procedure prior to granting approval instead of simply relying on information submitted by the GB authorities. The Court emphasized that the EC failed to investigate how DSR participates alongside generation.<sup>5</sup> The UK government has since stated that the Court did not find the design of the CM to be incompatible with state aid guidelines; rather it found that the process undertaken by the EC prior to granting approval was insufficient.<sup>6</sup>

The EC now has to consider its next move.

The UK government expects the EC will launch a formal investigation in early 2019 – likely to take at least six months – after which it can potentially re-approve the CM. It remains unclear what will happen if the Commission finds that the design of the CM needs to change as a condition of being re-approved.

Of particular importance is whether the results from existing auctions can stand. This is clearly the UK government's hope, and it has stated its intention to work with the EC to aid the investigation. Separately, the government is hoping to obtain a “fast-track” state aid approval from the EC to run a one-off ‘replacement’ T-1 Auction for Delivery Year 2019/20 in the summer of 2019, and is also planning to run the postponed T-4 auction for Delivery Year 2022/23 as a T-3 Auction in early 2020 instead of February 2019, subject to having received state aid approval by then.

It is possible that the EC may want to appeal the ruling to a higher court.<sup>7</sup> This might be attractive if the EC is concerned about the precedent the existing ruling might set (and there is already a challenge pending against the state aid approval of the Irish CRM).<sup>8</sup> The downside, however, is that it would be likely to result in a lengthy legal process during which the CM might remain suspended.<sup>9</sup>

Either way, pending a resolution, the ruling has imposed a ‘standstill period’ for the CM, during which all capacity payments have been suspended. The T-1 and T-4 auctions planned for early 2019 have been postponed.

During the standstill period, the Electricity Settlements Company (ESC) is under instruction from the Secretary of State not to collect CM payments from suppliers. While BEIS has asked suppliers to pass down their “savings” to end consumers, if the CM is re-instated in a way which means retrospective payments to capacity providers are still due, suppliers will be asked to fund those repayments. A Balancing and Settlement Code modification has recently been proposed to allow suppliers to continue collection of payments from customers during the standstill period.<sup>10</sup>

<sup>5</sup> General Court of the European Union. Press release No. 178/18. Available at: <https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-11/cpl180178en.pdf>

<sup>6</sup> Department for Business Energy and Industrial Strategy (BEIS). Capacity Market. Available at: <https://www.gov.uk/government/collections/electricity-market-reform-capacity-market?8766>.

<sup>7</sup> The Court of Justice.

<sup>8</sup> Action brought on 22 February 2018 — Grange Backup Power v Commission, which similarly refers to the EC's failure to conduct a formal investigation as part of the State aid approval process. See <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62018TN0110&from=EN>

<sup>9</sup> Unless a suspension to the ruling is separately requested and granted.

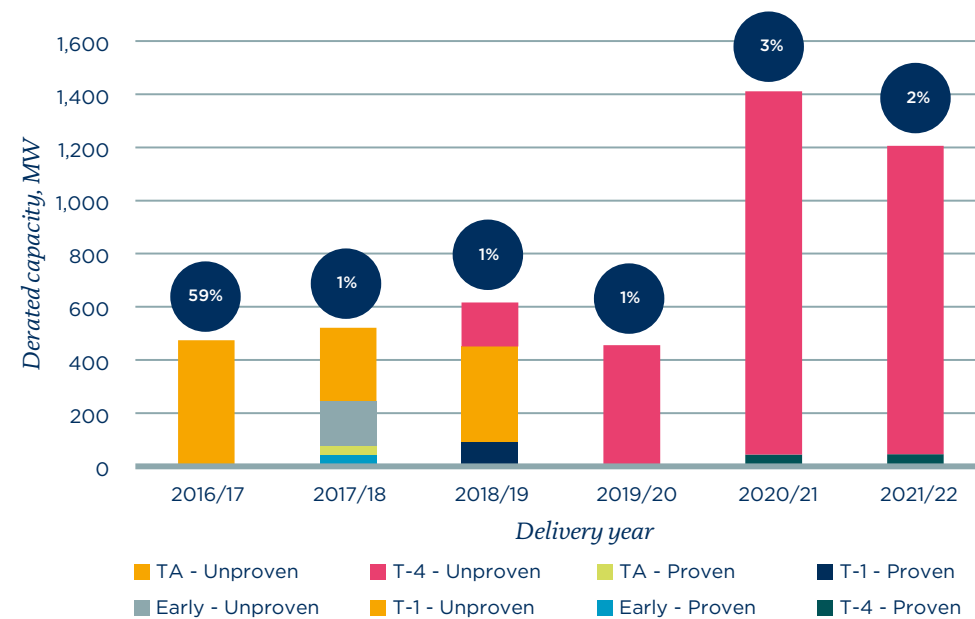
<sup>10</sup> BSCP40/04. Available at: <https://www.elexon.co.uk/documents/change/issues/101-150/issue-76-proposal-form-2/>

## Issues for the EC to consider in relation to DSR

As part of any new approval process, the EC may need to consider a number of issues in relation to DSR.

First, it is likely to examine the participation of DSR in CM auctions held to date. In fact, across both the Transitional Arrangement auctions (whose stated aim was to provide a test-bed for the inclusion of DSR) and the main auctions, increasing volumes of (albeit unproven) DSR have been clearing.

**Contracted DSR capacity and proportion of total cleared capacity**



Second, the EC may take into consideration the way in which DSR participates in CRMs in other Member States. Even looking at a subset of EU states, it is clear that experience is mixed.



# Issues for the EC to consider in relation to DSR

## Continued

Country	DSR in capacity mechanism?	Are conditions on DSR participation different from generation?
GB	Yes	Yes. DSR, like existing generators, may only receive one-year contracts but refurbished and new generators can receive up to 3-year and 15-year contracts, respectively.
France	Yes	No. DSR can help suppliers meet their obligation, and receive certificates like any other capacity including generation.
Germany	Yes, but only certain types of load not active in the energy markets. <sup>11</sup>	Yes. The initial eligibility criteria for DSR would have made it very hard for DSR to participate and were amended to address concerns raised by the EC <sup>12</sup> . DSR can still only participate for a limited period (either for two years, or for four years with a cooling-off period of one year) and they must choose before they take part in the auction.
Ireland	Yes	No. Any new capacity provider meeting the significant financial commitment criteria (“new build”) is able to bid for a Reliability Option up to a maximum of ten years. <sup>13</sup>
Belgium	Yes	No. Original Belgian law provided longer contracts (up to three years) only to generators, with DSR being limited to one-year contracts. Following discussions with the EC, Belgium committed to only award one year contracts to both generation and DSR. <sup>14</sup>

Third, the EC may need to consider the “in principle” question as to whether there is a justification for DSR to be granted a longer contract. For generation, longer term contracts were justified on the grounds of the potentially significant upfront capex required, and the benefits of a longer contract in securing (particularly debt) financing. Securing DSR does require investment, both in relation to customer engagement and potentially in relation to equipment (e.g., to allow remote control of on-site load or generation, or to upgrade connections) but the scale of capex per kW of DSR can vary considerably as requirements are often site-specific. In many cases securing specific term financing may not be a relevant consideration.

In coming to a conclusion on the treatment of DSR in GB, the EC will need to balance conflicting factors. There appears to be no clear answer to the “in principle” question as to whether the rationale for long term contracts for generation holds up for DSR providers. And in terms of evidence from the auctions, it is clear that DSR is participating in T-4 and T-1 processes, and with increasing volumes (despite the fact that four years ahead of delivery it is harder for DSR providers to have certainty over their availability or costs). On the other hand, there is evidence from other countries that regimes have been put in place which treat DSR more equally.

<sup>11</sup> Referred to as “inflexible” load, defined as DSR that has NOT been: 1) Active on reserve energy markets within the last 36 months; 2) Active as abschaltbaren Lasten or ‘ABLAV’ within the last 36 months.

<sup>12</sup> The concerns raised by the EC pertained to the restrictive eligibility criteria that would have de facto excluded demand response from the German Capacity Reserve. German regulators responded to these concerns by easing the eligibility criteria. EC. Commission Decision on the aid scheme SA.45852 - 2017/C (ex 2017/N). Section 6. Available at: [http://ec.europa.eu/competition/state\\_aid/cases/269083/269083\\_1983030\\_171\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/269083/269083_1983030_171_2.pdf)

<sup>13</sup> Single Electricity Market Committee. Capacity Remuneration Mechanism Detailed Design. Third Decision Paper. 8 July 2016.

<sup>14</sup> EC. SA.48648 (2017/NN) - Belgium - Strategic Reserve. (45). Available at: [http://ec.europa.eu/competition/state\\_aid/cases/272020/272020\\_1964726\\_118\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/272020/272020_1964726_118_2.pdf)

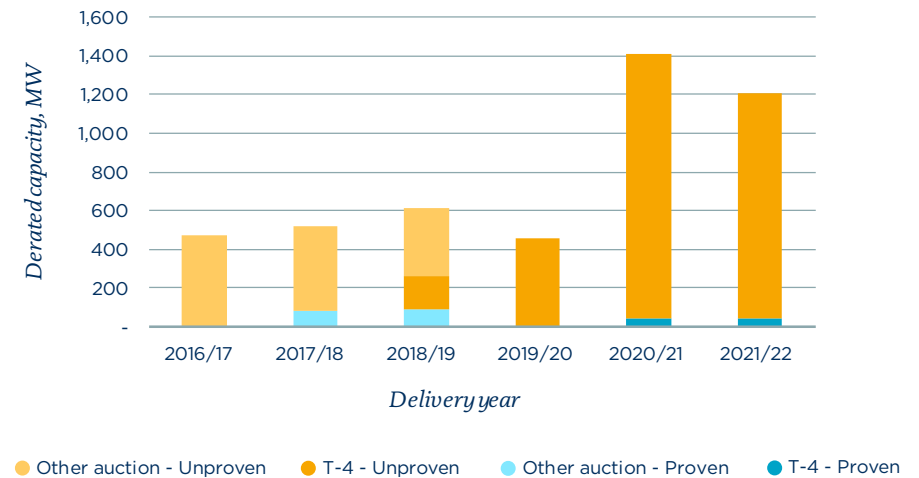
## Will the lights stay on during the ‘standstill’?

The system is in a relatively secure position for the current (2018/19) winter. NG predicted a 7.1GW de-rated capacity margin and a Loss of Load Expectation (LOLE) of 0.001 hours in their 2018 Winter Outlook. This is significantly more secure than the stated reliability standard (a LOLE of 3 hours). This results from factors such as lower demand than previously forecast and recent low clearing prices (meaning auctions cleared further down the demand curve and hence procured above the target level of capacity).

Relatively higher expected profits from the wholesale energy market should also incentivise capacity to stay online for the duration of the winter, and many of the fixed costs of staying online over this period will have already been sunk. This means that the likelihood of lights going out this winter as a direct result of the Court’s ruling should, thankfully, be very low.

Looking forward to the 2019/20 winter, the outlook becomes slightly less rosy. The T-1 auction that was scheduled for January 2019 was set to procure 4.6GW of capacity, providing a LOLE of 3 hours and a derated capacity margin of 3.2GW (based on NG’s Electricity Capacity Report). This capacity would be sourced from a pool containing a variety of generation types, as shown right.

**Contracted DSR capacity**



## *Will the lights stay on during the ‘standstill’?*

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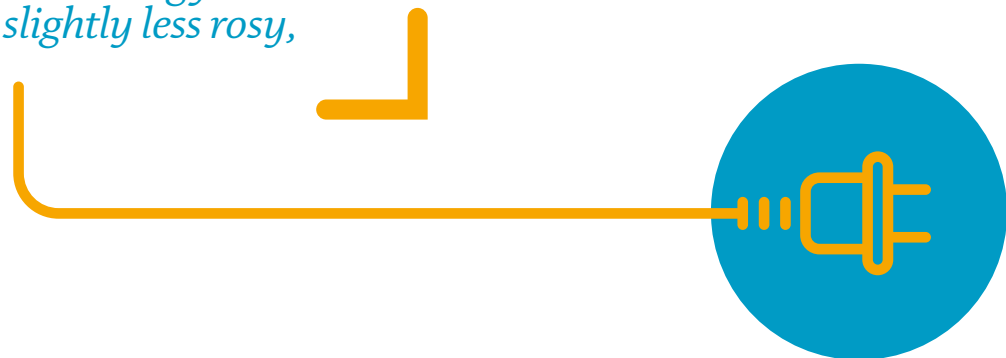
Existing coal, CCGT and OCGT make up 7.4GW, over half of the 14GW prequalified for this auction. Much of this capacity may have been relying on 2018/19 capacity payments to cover the costs of staying online through the 2019 summer. Failing to buy any of the 4.6GW would, on NG’s figures, imply a derated margin of -1.4GW, short of the reliability standard (although there is a chance that NG’s figures are conservative, and in any case some of the capacity might be encouraged to remain open by the healthy energy profits that tight margins would imply).

However, the 4.6GW is not the only capacity being counted on to meet the reliability standard next winter. Capacity that held T-4 contracts for 2019/20 (and were set to receive payments of £18/kW/year) might also be at risk if there are material delays or a negative outcome from an investigation by the EC. Older existing plant may decide to close early. Similarly, investors in new plant which cleared in the auction for 2019/20 but who have not yet committed significant funds may now delay or cancel their plans. If the EC decides that auctions held to date are void, for some this may present an opportunity to exit, without penalty, a capacity agreement that they now consider to be out-of-the-money (e.g., as a result of Ofgem’s decision to reduce embedded benefits).

So while this winter looks safe, compliance with the reliability standard for winter 2019/20 might be more difficult without intervention and/or a return of the CM in some form.

We explore below a best and worst case scenario of that happening.

*The likelihood of lights going out this winter as a direct result of the Court’s ruling should, thankfully, be very low. Looking forward to the 2019/20 winter, the outlook becomes slightly less rosy, without further intervention.*





## Return of the CM – best case scenario

In a best case scenario, upon completing its formal investigation the EC will approve the CM without any conditions, allowing its reinstatement and allowing capacity providers to receive the payments withheld during the standstill period. Future auctions could also resume. While the market will have gone through a few uncomfortable months, things would more or less return to the position before the Court's ruling.

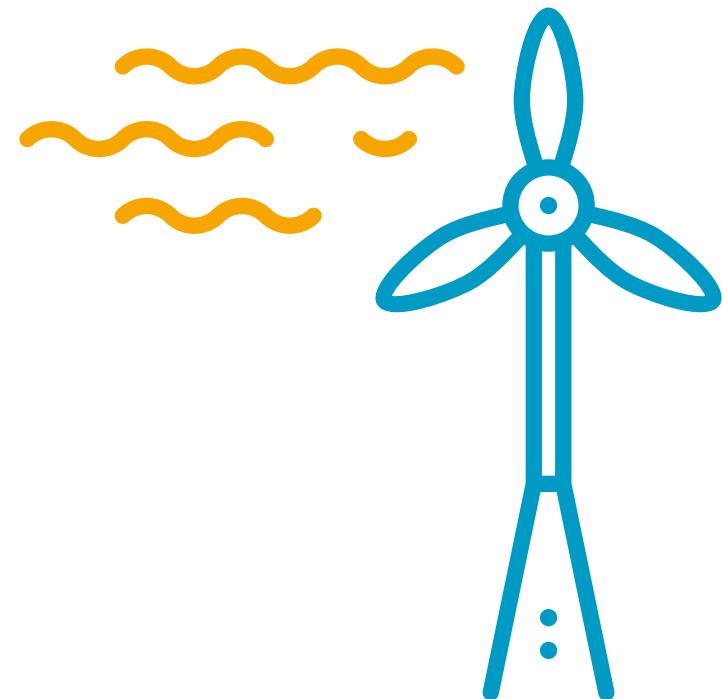
Under this scenario, the upcoming T-1 auction for delivery in 2019/20 scheduled for January 2019 would now be held in the summer of 2019 (effectively as a "T-0.5" auction, with a short lead time of 3-6 months). Capacity agreements granted in this auction will be conditional on ultimately receiving state aid approval from the EC.<sup>15</sup>

This scenario may still cause problems. In very marginal cases, some existing units may be at risk of closure, particularly as they will need to make a decision on whether to renew their Transmission Entry Capacity (TEC) from early April. Equally, prequalified new units (reciprocating engines, batteries, DSR) faced with such a short delivery lead time may conclude that they cannot participate.

Similarly, the T-4 auction for 2022/23 that was scheduled to be run in February 2019 could be delayed and held on a T-3 or T-3.5 basis. This impact of a shortening of the lead time is not clear. Bidders with long development times, such as large-scale new CCGTs, might be negatively affected. They might add a premium to their bids to reflect an increased delivery risk, or may pull out and wait for the next auction. On the other hand, the shorter lead time will give most bidders increased confidence in the broader market conditions they will face during the delivery year. Older plants considering coming off the system may be able to bid into a T-3 with a greater level of certainty than they would have in a T-4.

<sup>15</sup> BEIS. Capacity Market. Update on 6 December 2018. Available here: <https://www.gov.uk/government/collections/electricity-market-reform-capacity-market?8766>.

*A quick re-approval of the CM might see little change to market outcomes. But if existing agreements are declared void some projects may be given a "way out" of out-of-the-money obligations, whereas the outlook for others may be more uncertain.*



## *Return of the CM – worst case scenario*

In a worst case scenario, in which for example the EC's investigation concludes that the CM can only be re-instated with design changes, the outcome of previously held auctions (under the unapproved market design) might be deemed void.

If previous contracts were ruled to be void, there would need to be replacement auctions run for 2020/21 (a T-1.5 at the earliest) and 2021/22 (a T-2.5 at the earliest). In addition, if it could be held in time, a T-0.5 auction in summer 2019 could procure approximately 51GW of derated capacity (to cover all the capacity previously contracted in the T-4 and auction, and that scheduled to be procured in the annulled T-1).

Bidders looking to compete in any reruns of previous T-4 auctions will do so under a different environment to that which existed when the original auctions took place. Some of the considerations would include:

- **Higher carbon prices**, rendering coal less competitive.
- **Greater economic uncertainty generally**, not least due to Brexit.
- **Updated forecasts on net demand**, which may lead to a lower requirement for capacity.
- **Greater levels of RES** on the system from subsidies to small and large plant alike.
- **Removal of embedded benefits** – Ofgem's reforms (including CMP264/265 and its 'minded-to' TCR position) will remove or reduce some of the revenue streams available to small-scale distributed and behind-the-meter generation. Ofgem has also proposed setting the transmission generation residual to zero (removing the benefits to transmission-connected generation that would result from the negative values projected by NG).



## Return of the CM – comparison and conclusions

The table below summarises our view on the possible outcomes from the best and worst case scenarios described above.

	<b>Best Case Scenario (CM quickly re-instated as is)</b>	<b>Worst Case Scenario (CM delayed; old contracts void)</b>
Existing Plant	<ul style="list-style-type: none"> <li>• Cashflows temporarily impacted during the suspension period but with no material operational impact</li> <li>• Likely to be the preferred outcome</li> </ul>	<ul style="list-style-type: none"> <li>• May result in accelerated closure if major financial commitments are coming up</li> <li>• Coal plant and old CCGTs nearing retirement may decide to close earlier than scheduled</li> </ul>
New plant with CM contracts	<ul style="list-style-type: none"> <li>• No significant change to investment plans</li> <li>• Preference for developers that have in-the-money CM agreements</li> </ul>	<ul style="list-style-type: none"> <li>• Developers with out-of-the-money agreements (e.g., those regretting commitment due to CMP264/265 and CMP261 changes) will welcome opportunity to get out of their obligations</li> <li>• Other developers could end up in difficulties if capital has been sunk and capacity revenues are delayed. May delay or jeopardise some projects, but may also present an opportunity for well-capitalised investors</li> </ul>
Developers of new plant which have not yet secured CM contracts	<ul style="list-style-type: none"> <li>• It may become tight for new plant to meet delivery timescales if new auction delivery periods are accelerated (T-3 instead of T-4 auction)</li> <li>• Preference particularly for plant with shorter lead times</li> </ul>	<ul style="list-style-type: none"> <li>• Delay likely to increase development costs, which may mean sponsors give up on projects. On the other hand, if the system becomes tighter, the prospect of higher power prices may be seen as a positive</li> </ul>
DSR	<ul style="list-style-type: none"> <li>• DSR likely to continue participating as previously</li> </ul>	<ul style="list-style-type: none"> <li>• Existing DSR with longer term customer contracts may end up in financial difficulties if capacity revenues are delayed</li> <li>• Some new DSR may benefit from longer contracts if these become available</li> </ul>
Interconnection	<ul style="list-style-type: none"> <li>• Unlikely to change investment or operational outcomes</li> <li>• Preference for developers unless broader project delays are putting delivery at risk</li> </ul>	<ul style="list-style-type: none"> <li>• Unlikely to change plans as project timings are primarily driven by cap-and-floor scheme</li> </ul>

It seems clear that the best case scenario would see relatively little change. This is likely to be the preference for most participants. In the worst case scenario, while some participants (with out-of-the-money agreements) may be given a “way out”, the outlook for other projects may be more uncertain. Existing investors would need to consider their resilience to delay. New investors may just be able to pick up a bargain.

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