



November 2018

## UK left out in the cold following ECJ ruling on Capacity Market

On 15 November 2018, the European Court of Justice ("ECJ") found in favour of a challenge to the European Commission's 2014 decision to give state aid approval to the scheme establishing a Capacity Market in the UK. As a result, the Capacity Market has entered into a 'standstill period' - preventing the Government from holding any capacity auctions or making any capacity payments, until such time as it successfully obtains state aid clearance. The repercussions for those participating in (or intending to participate in) the scheme, as well as the electricity market and investor confidence more generally, will be significant.

### BACKGROUND TO THE CHALLENGE

The UK established the Capacity Market to incentivise back-up electricity supply that could meet peak demand at times of system stress, which intermittent renewables (such as wind and solar) may not be able to meet. Regular competitive Capacity Market auctions are held, with winning generators effectively paid to guarantee availability of an agreed capacity, under agreements which may last up to 15 years. With renewable subsidies falling away, this mechanism had - rather ironically given the latest news - been increasingly popular as a means to reliable, longer term revenue support, helping many projects get funding. A number of similar schemes exist in other EU countries.

Given the scheme involves support provided by national public authorities to private undertakings on a selective basis, state aid approval from the European Commission was required under EU rules. The UK applied for this approval in June 2014, and received it within one month - with the Commission deciding that an in-depth investigation into the impact of the mechanism on the market was not warranted.

However, in December 2014, Tempus Energy Limited ("**Tempus**") applied for a declaration that the Commission's 2014 approval was unlawful. Tempus - who provide electricity consumption management technology (also known as demand-side response or "**DSR**") - argued that the Capacity Market discriminates against DSR providers, and favours large fossil fuel generators. DSR providers are restricted to one year agreements on the Capacity Market, in contrast to generators who are able to bid for agreements up to 15 years.

Tempus claimed that the Commission did not undertake an adequate investigation into the UK scheme, and that had there been a proper investigation of the DSR role in the market the Commission would not have concluded the UK Capacity Market satisfied state aid rules. Tempus also submitted that the Commission had failed to state the reasons for its decision, but this was not commented on by the ECJ.

## THE ECJ RULING

The ECJ – in a judgment which has taken the market by surprise - agreed with Tempus's primary submission on inadequate preliminary investigations, and found that the Commission should have instigated a formal investigation to assess compatibility with state aid rules. The ECJ ruling noted that the Commission should not have simply relied on information provided by the UK to reach its conclusion, particularly given the differentiated approach to DSR, stating:

*"In such circumstances, taking into account, inter alia, the importance of the role that could be played by DSR within the capacity market, the available elements concerning the potential of DSR are such as to give an indication that there were doubts as to the compatibility of that scheme with the internal market, which, upon reading the contested decision, cannot be held to have been allayed following the Commission's preliminary examination."*

## REAPPLYING FOR APPROVAL

As noted above, the ruling has led to an immediate 'standstill period' on the Capacity Market, meaning no more capacity market auctions will be run or payments made, until such time as state aid approval is (re)secured. The Government has stated that they are *"working closely with the Commission to aid their investigation and seek timely State aid approval for the Capacity Market."* The Government's position is still that *"Capacity Market auctions are the most appropriate way"* to deliver a balanced network at the least cost.

Given the existence of similar schemes around the EU, and the fact that the ECJ judgment was focused more on process and the treatment of DSR, there doesn't seem to be any suggestion that the Capacity Market scheme is in principle incompatible with state aid rules - but it is possible that upon further investigation the UK may need to consider some changes to the regime to get approval.

Moreover, state aid approval applications which undergo a formal investigation are not quick. It may well be that the UK has left the EU before a decision is made by the Commission – and in the event of a 'no deal' Brexit, the UK would no longer be directly subject to EU state aid rules. However, the UK government has (possibly with an eye to Labour's nationalisation proposals) stated that it will transpose EU state aid rules into UK domestic legislation, with approvals required from the UK's own Competition and Markets Authority ("**CMA**"), rather than the Commission. It is not clear what impact this would have on the outcome of a Capacity Market state aid application - the CMA has recently stated *"the substantive body of EU case law on the interpretation of the state aid provisions of the Treaty, and related case law, is likely to remain important for state aid practitioners at least in the short term, whatever shape our exit from the EU might take."*

## REPERCUSSIONS

Clearly, those generators relying on (or developing projects in reliance on) the income stream from Capacity Market payments will be hard hit by this development. With Capacity Market payments currently estimated to be nearly £1 billion a year (and growing) it represents a very significant loss of revenue. Generators may look to recover some of this in wholesale markets, leading to a rise in prices.

The status of plants under existing Capacity Market agreements is unclear (beyond the fact that payments are suspended). These complex agreements – which are an unusual hybrid of rules and regulation rather than a typical private law contract – do not contain the type of change-in-law or force majeure clauses (indeed the latter is excluded) which deal with this type of situation. National Grid, as the 'Delivery Body' co-ordinating the scheme, have simply noted in their FAQs on continuing compliance obligations that *"BEIS is reviewing the judgment, including its implications for capacity providers, and will provide guidance to the Delivery Body as soon as possible"*. This includes guidance on whether capacity providers will even be permitted to withdraw from their agreements. The status of previous payments and possibility for deferred payments (albeit that would be fraught with difficulty) are also likely to be matters which Government is exploring.

# TRIVERS SMITH

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More generally, investor confidence will be shaken. The issue has provided a timely reminder of the legal difficulties and political risk that can arise with state support and subsidy mechanisms. As always, time will tell what the fuller ramifications of this ruling will be, but what is already clear is that suspending the Capacity Market adds to further uncertainty over the security of supply of energy to the UK in a market where a large number of plants are closing or set to close without a new generation in the pipeline to replace them. That said, the good news is that Government has confirmed its absolute confidence that the lights will stay on this winter.

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