

## What does the future look like for the capacity market in the UK?

28/03/2019

**Energy analysis:** Anna Sweeney, senior knowledge lawyer in the infrastructure, projects and energy team at Addleshaw Goddard, outlines the government's latest consultations on the capacity market (CM) and explains what's coming next.

### Original News

Court annuls state aid approval for UK Capacity Market, [LNB News 15/11/2018 90](#)

*The General Court of the Court of Justice of the European Union has annulled the European Commission's state aid approval for the UK CM, by ruling in favour of Tempus Energy, in a case against the Commission. The Department for Business, Energy & Industrial Strategy (BEIS) has announced the court's decision, and links to information and guidance for suppliers are available below. This ruling imposes a 'standstill period' on the UK's CM.*

### What is the current status of the CM?

The UK CM is currently in a standstill period following the ruling in *Tempus Energy and Tempus Energy Technology v Commission*, Case [T-793/14](#) by the General Court of the EU that annulled the European Commission's 2014 decision that the CM scheme was compatible with state aid rules. This means that the European Commission now has to carry out an in-depth investigation to assess whether the CM scheme is compatible with the state aid rules (the European Commission has also appealed against the court's ruling). The investigation began on 21 February 2019 and could take up to 18 months.

On 22 March 2019, the European Commission [announced](#) that it had preliminarily concluded that the UK CM contributes to an 'objective of common interest' and is necessary. The European Commission has invited parties in the UK to submit their comments and to provide all information that may help assess the measure as part of its investigation. Comments are required to be submitted by 22 April 2019.

BEIS has welcomed the European Commission's preliminary conclusion that 'the UK CM contributes to an objective of common interest and is necessary' and is confident that the investigation will determine that the CM is fully compliant with state aid rules upon a full review of the evidence. However, the European Commission wants to know from demand side response (DSR) providers whether they think that the CM is disadvantaging them compared to generators, since DSR providers can only bid for shorter capacity contracts. It also seeks views on whether the CM should be open to direct foreign generator participation, not just through interconnectors bidding for capacity.

Until the CM regains state aid approval (and there is no guarantee that it will), the UK government cannot make any capacity payments under the scheme as that would be giving unlawful state aid.

In the meantime, the UK government is continuing to operate the CM as far as it can, while waiting for state aid approval. What this means in practice is that electricity generators who already have a CM contract still have to comply with their contractual obligations to provide capacity on demand, they just cannot be paid for doing so at the moment.

Legally, electricity suppliers do not have to make payments to the settlement body to fund capacity payments while the CM is in standstill, but the government intends to enforce full back-payment as soon as the standstill period ends. It is in suppliers' interests to continue to make their CM payments on a voluntary basis so they are not hit with a large back-bill once the CM gets state aid approval (assuming it does). The CM supplier charge has been factored in to the latest retail price cap, so suppliers can continue collecting it from customers (who ultimately fund the scheme) on their energy bills.

BEIS seems confident that the CM will get state aid approval, but Tempus (the company that successfully challenged the original state aid grant) has now launched a further challenge (see further: [LNB News 08/03/2019 32](#)) to the

government's recent decisions, claiming this is an unlawful attempt to keep the CM going when it does not have state aid approval.

## What changes are to be made to the capacity market regime?

There are two recent consultations on making changes to the CM so that it can continue running, as far as possible, during the standstill period.

The first was '[Technical amendments to the capacity market](#)' (technical amendments), which launched on 19 December 2018, with the government's response published on 28 February 2019. Following the consultation, the government will proceed with making the necessary legislative changes to:

- conduct a replacement T-1 auction
- allow capacity providers holding agreements greater flexibility in dealing with forthcoming milestones affected by the standstill period
- broaden the Secretary of State's discretion with regard to dealing with termination and non-completion notices
- enable suppliers to make payments to the settlement body during the standstill period towards their post-standstill supplier charge liability to fund deferred payments to capacity providers who have met their obligations during the standstill period (subject to a positive final state aid decision)

For more information, see [LNB News 01/03/2019 50](#).

The latest consultation, entitled '[Proposals for further amendments to the Capacity Market](#)' (further amendments), proposes the following:

- 'a replacement T-3 auction to be held in early 2020, securing capacity for delivery year 2022/23 and replacing the previously scheduled January 2019 T-4 auction. Some technical changes to the Regulations and Rules would be needed to adapt them to a T-3 auction...Otherwise its structure would be as similar as possible to the planned T-4 auction'
- 'the addition of generating technology classes for certain renewable technologies [onshore wind, offshore wind and solar photovoltaic system (PV) and related changes to allow for the inclusion of these intermittent technologies in the CM'
- 'changes to the methodology for interconnector de-rating factors'—removing the requirement for historical data to provide a 'floor' for interconnector de-rating factor and retaining an 'average' de-rating methodology for all interconnectors (new and existing)
- minor technical amendments and corrections to the Electricity Capacity Regulations 2014, [SI 2014/2043](#), the main regulations underpinning the scheme

For more information, see [LNB News 07/03/2019 106](#).

## When can we expect the next auctions and how will they work?

Before the standstill, there was due to be a T-1 auction, for capacity this coming winter 2019/20, and a T-4 auction, for capacity in four years' time (2022/23). These auctions were due to take place in January or February 2019 but were postponed following the 15 November 2018 judgment.

Instead, the technical amendments proposed that the T-1 auction is held in summer 2019 (by the end of August 2019 at the latest), but this will be before state aid approval is granted, ie it will be during the standstill period. It will therefore be an auction for 'conditional' capacity agreements, where capacity providers will have the usual obligations to meet delivery milestones and provide capacity during stress events, but their entitlement to receive capacity payments, and conversely their liability to pay penalties and fees for any non-compliance, will be conditional on the CM scheme getting state aid approval. BEIS anticipate this being granted before the start of the 2019/20 delivery year, but this seems optimistic particularly given Tempus' latest challenge (which was launched after the technical amendments response was published).

The further amendments document proposes holding a replacement T-3 auction in early 2020, to replace the planned T-4 auction for delivery year 2022/23. BEIS are hopeful that by then, the CM will have regained state aid approval so this will not need to be a conditional auction and so capacity providers will actually get paid.

The shorter timescales for the auction (three instead of four years) have a number of knock-on effects:

- assuming state aid approval has been given by then, the T-3 auction will end up running alongside the usual T-1 (for capacity in winter 2020/21) and T-4 (for capacity in 2023/24) auctions that are due to take place in early 2020—the T-3 auction will run first, then the T-1 and T-4, but the prequalification process for all three will happen at the same time (the consultation seeks views on how feasible this is)
- the parameters for the T-4 auction will need adjusting to take account of the capacity awarded in the T-3 auction and the government thinks there will need to be a gap of at least four weeks between the T-3 and T-4 auctions to accommodate this
- the reduced time period between the T-3 auction and the delivery year (ie one year less) requires adjustment of some of the delivery assurance milestones in the CM regulations and CM rules, in particular:
  - the financial commitment milestone would be 12 months (rather than 16 months) after auction results day
  - the requirement to post additional credit cover would be nine months (rather than 12 months) after auction results day
  - the deadline for submitting a metering assessment would be two years (rather than three years) before the start of the delivery year

## When and for how long will these changes take effect?

The changes in the technical amendments need three new sets of regulations to bring them into effect:

- the draft Electricity Capacity (No 1) Regulations 2019 modify [SI 2014/2043](#) and the Electricity Capacity (Supplier Payment etc.) Regulations 2014, [SI 2014/3354](#) to provide for the conditional agreement T-1 auction and the operation of the CM during the standstill period, including voluntary payments from suppliers to the settlement body
- the Capacity Market (Amendment) Rules 2019 came into force on 6 March 2019 and modify some of the milestones in existing capacity agreements and the prequalification requirements for the conditional T-1 auction
- the Capacity Market Amendment (No 2) Rules 2019 will come into force alongside [SI 2014/2043](#) as they rely on the modifications those regulations are putting into effect

The changes in the further amendments will again need regulations to amend [SI 2014/2043](#), the Electricity Capacity (Supplier Payment etc) Regulations 2014, [SI 2014/3354](#), and the Capacity Market Rules. The consultation is open until 4 April 2019 and the amendments will need to be made before the T-3 prequalification process opens in summer 2019.

For a tracker of all key developments in respect of the Capacity Market rules and underlying legislation, see: [Capacity Market \(CM\) tracker](#).

## What is the impact of these changes?

These changes are designed to keep the capacity market running, as far as possible, during the standstill period. Capacity providers with existing agreements will need to check the new Regulations to see if and how the milestones under those agreements are changed. However, the biggest impact is that they will not receive any capacity payments (but conversely will not have to pay a penalty for non-compliance) until the standstill ends. It appears from the draft regulations that the government thinks it will know one way or another by 1 October 2020 at the latest.

Regulation 6 of the draft Electricity Capacity (No 1) Regulations 2019 provides that if the Secretary of State is satisfied that there is no reasonable prospect that state aid approval will be given before 1 October 2020, then he can terminate either or both:

- capacity agreements already entered into before 15 November 2018
- conditional capacity agreements awarded in the T-1 conditional capacity auction

## What other changes are proposed?

The main change, other than the T-3 auction, proposed by the latest further amendments consultation, is to allow certain renewable technologies to participate in the CM for the first time. This was one of the reasons that Tempus originally challenged the CM's state aid approval (on the basis that it was not technology-neutral), but it also came out of the responses to a [call for evidence](#) in August 2018 on how the CM was operating.

The detail can be found in chapter three of the further amendments consultation. Onshore and offshore wind and solar PV will be able to participate in future auctions (including the proposed T-3 auction), with an appropriate de-rating factor applied, to reflect their intermittent nature (ie they might be asked to provide capacity at a time when there is no wind or sun). According to the consultation, allowing appropriately de-rated renewable technologies to participate in the CM does not increase security of supply risks, it simply alters where and how their contribution to security of supply is accounted for. An effective secondary trading market and effective penalty regime should mitigate any risk of non-delivery.

## What are the implications for participants in the market, in particular for capacity providers and suppliers?

Capacity providers (who already had a capacity agreement before 15 November 2018) still have to comply with most of their obligations, but the draft regulations extend or waive certain milestones that have a high compliance cost but are not critical to ensuring security of supply. The biggest impact is that they will not be paid unless and until the standstill period ends, but at that point they will get a deferred payment to cover all the accrued payments they were due. They are not able to withdraw from their agreements voluntarily.

Those projects that were hoping to bid for a capacity agreement in the T-1 and T-4 auctions that were due to take place earlier this year can now bid for a conditional capacity agreement in the new T-1 auction scheduled for this summer, if they are prepared to take the risk that this may never convert to a full capacity agreement if the CM fails to regain state aid approval. The T-3 auction is perhaps a safer bet, as the government seems to think that the standstill period will have ended by the time it is due to take place.

The addition of renewables will be of interest to projects whose current renewables obligation is expiring and who may wish to bid for future capacity agreements. Any renewable project without another subsidy will be able to bid for a CM contract, although the CM revenue alone would not cover the cost of the project, it would more likely be used as part of revenue stacking.

Suppliers have the choice of paying their capacity payments to the settlement body on a voluntary basis during the standstill period or waiting until the CM regains state aid approval and paying the outstanding balance in full at that point. Ofgem have factored the CM supplier charge into the latest energy retail price cap and the expectation is that suppliers will continue to collect this from customer bills.

If a supplier chooses to pay into the settlement body's account, those payments will accrue interest at the government banking service rate (Bank of England base rate minus 0.11%) and used to offset a supplier's liability for the supplier charge post-standstill. If state aid approval is not given, then the payments, plus interest accrued, will be returned to the supplier.

*Interviewed by Giverny Tattersfield.*

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