

# The GB Capacity Market returns

## The EU Commission approves the GB Capacity Market following an in depth Phase 2 State aid investigation



### Key points

- Following an in-depth review, the EU Commission has reapproved the GB Capacity Market (CM) meaning the mechanism is now legal and all previous agreements are reinstated with immediate effect, provided the UK Government prospectively addresses a number of conditions
- Generators will be relieved by this decision but some small suppliers may find it difficult to meet the CM supplier obligation as back payments for 2018/19 can now be collected from suppliers, processed by Electricity Settlement Company (ESC) and paid out to agreement holders. This process may take up to three months meaning that payments should begin by January 2020
- Many of the conditions imposed by the EU Commission are either reflective of existing domestic policy or restate existing legal requirements as members of the EU – so may not appear particularly burdensome to BEIS.
- One complex condition for BEIS will be regarding the foreign participation issue. Once resolved, we expect interconnectors as a technology type will become ineligible for the CM. This will represent a hit to interconnector revenues and whilst their participation was never intended to be enduring, this could potentially have some impact on the attractiveness of future interconnection projects coming, as it does on the back of the uncertainty caused by Brexit
- **Next steps:**
  - Upon the publication of the decision in the Official Journal of the EU, there is a two month appeals window for any potential challenges
  - Further consultations on the CM are to be expected from UK Government
  - The implication for Tempus Energy's judicial review (JR) claim against the UK Government in the English High Court alleging that they had failed to comply with the EU courts decision are unknown
  - The upcoming T-3 (January), T-1 (February) and T-4 (March) auctions will take place as planned in Q1-2020

### Background

In November 2018, following a challenge from Tempus Energy, the European General Courts (EGC) ruling against the European Commission annulled the State aid approval for the GB CM, the main tool for ensuring the security of GB's electricity supply. This immediately suspended almost £1bn of payments to capacity providers with agreements for delivery year 2018/19.

The EGC found that "the Commission should have concluded that there were doubts which should have led it to initiate the formal investigation procedure". In January 2019, the EU Commission appealed the EGCs decision and the UK Government announced that they would support them in this appeal. This remains an ongoing process, with the outcome potentially having wider implications for other CM schemes operating across Europe.

Whilst BEIS continued to operate elements of the CM which they believed did not legally constitute State aid (for example, running a "Conditional" T-1 auction for 2019/20), they did not mandate suppliers to continue making payments to ESC (subsidiary of Low carbons contracts company responsible for the CM payments). Instead ESC offered them the chance to make payments on a voluntary basis during the standstill. There are no obvious commercial justifications for suppliers to have made these payments on a voluntary basis, so we would expect ESC to still have a large number of invoices to issue and payments to collect before remunerating generators.

In March 2019, the EU Commission published their opening decision which concluded "that the UK Capacity Market contributes to an objective of common interest and is necessary" but under instruction

from the EGC, announced the decision to undertake a formal phase 2 investigation into the GB mechanism. This triggered a four week consultation process which closed in April 2019 and the EU Commission went away to consider all of the evidence.

### The Decision

Following this in-depth investigation, the EU Commission has approved the GB Capacity Market provided the UK Government prospectively addresses a number of conditions.

The fact that the conditions outlined by the EU appear to be prospective is critical as it is interpreted by the UK Government that the mechanism is now legal and back payments can be made to those capacity providers who fulfilled their obligations in the 2018/19 delivery year.

Equally, it ensures that capacity agreements awarded in previous auctions for current and future delivery periods are re-instated and the T-3, T-1 and T-4 auctions due to take place in Q1-2020 can go ahead as planned.

In the event that the decision is appealed and we leave the EU on 31<sup>st</sup> of October without a deal, given the wider implications for other EU CM schemes we eluded to earlier, we believe the Commission would seek to defend its decision, with the UK government maintaining its role as an interested party. We believe the jurisdiction would not fall to the CMA unless the Commission lost and the decision was overturned.

The conditions, along with KPMGs view on their implications, are outlined overleaf:

Condition	Current BEIS position	Implementation timeframe	Implications for stakeholders
<b>Reduce 2MW minimum threshold</b> for participating in the CM	The minimum threshold is currently 2MW  BEIS tested smaller thresholds in the transitional auctions designed for DSR and found the utilisation to be low	BEIS committed to consult on this in the 5-year review and any policy changes are likely to be implemented in time for the pre-qualification process starting in early 2020	Whilst a lower threshold will be welcomed by participants, we would be surprised if BEIS reduce it to the level which has previously been pushed for by Tempus Energy (100kW). BEIS will have to weigh up their ambition against: a. the operational burden for the Delivery Body; and b. the low utilisation rate of a lower thresholds tested during the transitional auctions
Enabling the <b>participation of foreign capacity</b> in the GB CM	It is a long-standing BEIS policy ambition to allow foreign generation participation in the GB CM with interconnectors acting as a temporary proxy. It is also an existing legal requirement under the EU Electricity Regulation	The implementation timetable will be driven by the detail in the EU Commission decision which has yet to be disclosed.  The main determinant on timing will be whether the Commission has viewed this as an approval of a new or operational mechanism – the prior will likely come with an expedited delivery timeframe for this condition.  However, given the complexity of the issue we can expect a degree of flexibility from the Commission.	Once this commitment is implemented, we do not believe that interconnectors will continue to be eligible to participate in the CM.  This will impact interconnector revenues and could potentially have some impact on the attractiveness of future interconnection projects, coming as it does on the back of the uncertainty caused by Brexit. We believe there is a small net benefit for domestic generators once this issue is resolved and interconnectors are no longer eligible for CM revenues.
The participation rules for <b>new technology types</b>	This is existing policy as a core principle of the CM is technology neutrality and participation of renewable technologies (solar, offshore and onshore wind) has been allowed in all future auctions.	New technologies which demonstrate they contribute to security of supply will likely be incorporated incrementally	The upcoming T-3 and T-4 auctions held in January and March 2020 will be the first to date where subsidy free solar (c.1-2% de-rating), onshore (c.8-9% de-rating) and offshore wind (c.12-15% de-rating) will be able to participate. Whilst we would not expect CM revenues to form a significant part of their business case given the relatively low de-rating factors, subsidy free renewables are increasingly feasible as reiterated by the recent CfD AR3 results which cleared at parity with wholesale market prices. Renewable projects which roll off subsidies such as the RO will also likely benefit from CM revenues.
<b>Access to long term agreements</b> available to all technologies	Long term agreements are limited to "generation" assets with significant upfront capital expenditure requirements whilst DSR are currently ineligible	This will likely require a subtle change to the legislation to open up long term agreements to "capacity" rather than it being exclusive to "generation". We would expect this change to take place in time for next years pre-qualification process (i.e. in the next 6 months)	Whilst this may seem a significant condition, it is unlikely to have a significant impact on the CM given the capital expenditure thresholds will likely remain in place, and prove too high for DSR. BEIS will need to be careful in its implementation of any changes as they could create an incentive for batteries to move behind-the-meter and pre-qualify as DSR to access 15-year agreements with more favourable de-rating factors.
Reviewing the volume in the <b>year-ahead auction</b> (T-1 auction)	Whilst BEIS have previously committed to holding T-1 auctions for at least 50% of the set aside capacity, regulations do not currently oblige them to do so	Considered current practice but BEIS may look to formalise this in the CM regulations	Reducing the flexibility from BEIS and the NG Delivery Body when setting the parameters could increase the risk of over procurement in future T-1 auctions  This is demonstrated by their decision to run a 300MW T-1 auction for 2020/21 despite the Delivery Body stating the capacity is not required.
<b>Complying with the new EU Electricity Regulation</b>	Whilst this is a generic commitment, an example of this would be that BEIS are currently considering the evidence from a recent consultation on emission limits with the view to making changes for upcoming auctions. It is an existing legal requirement under EU Electricity Regulation	The EU Regulations require that the UK must adopt by the end of 2020, regulatory changes to ensure that, by 01/07/25, generation capacity that started commercial production before 04/07/19 and that emits more than 550gCO2/kWh and more than 350kgCO2/kWh on average per year, does not receive CM payments	This legislation is essentially aimed at unabated coal and diesel fired power generation. It is inline with the UK's commitment to close all unabated coal by 2025. It will also limit the annual emission allowed from unabated diesel-fired, and less efficient gas-fired power generation

## Potential for appeal

Upon the publication of the decision in the Official Journal of the EU, there is a two month appeals window for any potential challenges. Given that the recent Phase 2 investigation addresses the procedural issued raised by Tempus in 2014, any appeal will likely have to be against the substance of this decision itself.

## Judicial Review

In addition to the 2014 challenge against the EU Commission, Tempus Energy on March 5th this year filed a judicial review (JR) claim against the UK Government in the English High Court alleging that they had failed to comply with the EGC decision.

They are looking to reverse the UK Governments decisions to:

1. Hold a conditional T-1 auction for 2019/20
2. Continue with existing agreements with deferred payments
3. Continue to collect the CM supplier charge
4. Not recover payments already made to CM agreement holders, which had primarily been paid to DSR providers

This case is due to be heard by the High Court in the week commencing 11 November 2019. It is not yet clear what impact this EU Commission decision will have on the challenge in the High Court, but it's difficult to see what outcome Tempus Energy could now look to achieve given the mechanism is legal.

## Impact on suppliers

BEIS and Ofgem have undergone a pro-active joint engagement exercise designed to gain comfort from suppliers that they have been making necessary provisions to be able to fulfil their CM supplier charge obligations. We expect that the large majority of the revenue will be recouped once invoices are issued by the ESC. However, as demonstrated by the Renewables Obligation deadline on August 31<sup>st</sup>, some smaller suppliers may struggle to fulfil their obligations. This could lead to licenses being revoked, suppliers failing and further consolidation in the market. Any unpaid CM obligations will be mutualised across other suppliers and subsequently paid to generators.

## What to expect from the 5-year CM review?

As required through legislation, the 5-year review of the CM scheme was published by BEIS in July-2019. This assessed the appropriateness of the objectives of the CM, the extent to which those objectives have been achieved and whether those objectives remain appropriate. BEIS concluded that the "scheme has been working well and performance against objectives has been good."

The CM is not perfect and will need to adapt to become more flexible over the coming years, and as the sector continues to evolve, the policy must evolve with it. BEIS have not shied away from this in discussions with stakeholder groups and we expect a comprehensive plan, addressing the issues identified through the review, to be outlined as resource is freed up from the conclusion of various legal processes.

In addition to the conditions outlined by the EU Commission, we expect BEIS will cover in detail other areas such as the reliability standard, de-ratings for all technologies, termination events, the penalty regime, and the role of hybrid (renewable and flexible generation) projects.

## Reflections and Next Steps

It remains to be seen if there are any enduring impacts of this legal challenge. We should find out in the coming months if new projects have failed to hit certain key delivery milestones which could result in terminations, and how flexible BEIS and the Secretary for State are in the subsequent appeals process.

Whilst some lenders may wait until any opportunity to appeal this decision has lapsed before releasing further funding to CM development projects, investors will be pleased that this issue has now been resolved and the auctions in Q1-20 will go ahead as planned.

Final pre-qualification results for those auctions will be published in late November.

Key dates over the coming months:

**October 2019:** Capacity Market reinstated, with conditions, following a Phase 2 investigation from the EU Commission

**November 2019:** High Court to hear Tempus challenge against UK Government and CM prequalification results published

**January 2020:** Two-month appeal deadline to challenge EU decision expires assuming the publication of the decision in the EU Official Journal comes within the next month

**January 2020:** Back payments to capacity providers likely to commence following three month ESC process

**January 2020:** Potential decision from English High Court on domestic JR. The T-3 auction for delivery year 2022/23 will take place

**February 2020:** T-1 auction for delivery year 2020/21

**March 2020:** T-4 auction for delivery year 2023/24

**April 2020:** Three-month appeal deadline to challenge the UK High Court's decision, assuming the decision comes in January

## Contact us



### Simon Virley CB FEI

Partner, Head of Energy & Natural Resources

**T:** +44 (0)20 7311 5037

**E:** simon.virley@kpmg.co.uk



### Wafa Jafri

Director, ENR Deal Advisory

**T:** +44 (0)777 500 6965

**E:** wafa.jafri@kpmg.co.uk



### Jaymes Mackay

Associate Director, ENR Deal Advisory

**T:** +44 (0)788 037 1155

**E:** jaymes.mackay2@kpmg.co.uk

[kpmg.com/uk](http://kpmg.com/uk)



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2019 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the United Kingdom. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Designed by CREATE | Date | CRT120368B