

## European Commission's First State Aid Sector Inquiry Identifies Preliminary Concerns with Capacity Mechanisms

***Today's Interim Report is critical of price-based mechanisms and calls for harmonized methods to determine generation adequacy levels and reliability standards.***

The European Commission (Commission) today published its Interim Report and Staff Working Document (SWD) on capacity mechanisms.<sup>1</sup> As part of the sector inquiry (the first into State aid), the Commission reviewed responses from 124 organizations, including public bodies, energy regulators, network operators and market participants commercially active in the 11 Member States covered. The report and SWD describe capacity mechanisms across Member States and come to a number of tentative conclusions as to how the Commission considers the mechanisms could be improved to create a better functioning and competitive electricity market in Europe. The report is now open for consultation until 6 July 2016.

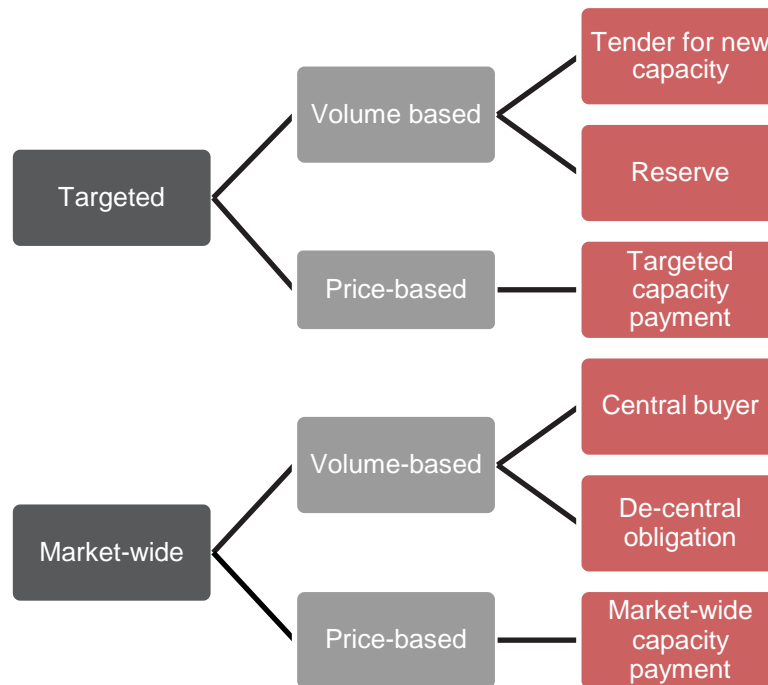
### Background to the sector inquiry

The electricity sector in the European Union is experiencing radical change. Market liberalization and the increasing share of renewables in the energy mix are giving rise to concerns that today's electricity markets fail to provide the investment signals required to ensure generation adequacy.

Against this background, Member States have introduced capacity mechanisms in order to maintain security of supply. On 29 April 2015, the Commission launched the sector inquiry because of concerns that capacity mechanisms risk distorting competition and undermining the EU internal energy market (ultimately) leading to higher prices for consumers.

### Preliminary factual findings on capacity mechanisms

***Types of capacity mechanisms:*** The SWD identifies six types of capacity mechanisms: (i) tenders for new capacity; (ii) strategic reserves; (iii) targeted capacity payments; (iv) central buyer models; (v) decentralized obligations; and (vi) market-wide capacity payments. Strategic reserves are the most common form of capacity mechanism and include capacities that are not participating in the wholesale market, but that are kept apart to maintain security of supply. The following chart illustrates a further taxonomy of capacity mechanisms:



Source: based on the European Commission's SWD accompanying the Interim Report, page 37.

**Adequacy assessment and reliability standards:** One of the problems the Interim Report identifies, is the mismatch between the methodologies Member States apply in relation to the adequacy and reliability of existing capacities. The Commission believes that there is (at best) a weak relationship between the level of capacity procured and the level of reliability desired. The lack of common methodologies reinforces the national focus of most mechanisms and does not allow for cross-border action at EU or regional level. The Interim Report proposes an alignment of methodologies used to define generation adequacy and reliability standards and notes that this will likely be a key element in the Commission's market design initiative.

**Design features of capacity mechanisms:** The three main choices that Member States make when determining the design of a capacity mechanism relate to eligibility, allocation and design.

As regards eligibility, the Commission is concerned that the restricted number of participants entitled to participate in the scheme may lead to overcompensation due to the lack of competitive pressure and the need for additional capacity mechanisms to compensate capacity providers which were not included in the original capacity mechanism. However, the Interim Report does acknowledge that an increasing number of capacity mechanisms allow the participation of capacity providers from other Member States. For example, as part of the Commission's investigation into State aid for the UK capacity mechanisms, the UK authorities committed to opening the participation to interconnectors as of 2015 and this became a reality in the 2015 capacity auction.<sup>2</sup>

The report identifies two different approaches to allocation of capacity remuneration, namely administrative and competitive allocation processes. The Interim Report is critical of administrative allocation processes in that they do not normally determine the true value of capacity. As a result, they are unlikely to be cost-effective and are also unlikely to send the proper signals for investors.

The design of the allocation process may also impact competition in the electricity market. According to the Interim Report, where obligations imposed on capacity providers and penalties for non-compliance are limited, capacity providers have insufficient reliability incentives. The Interim Report calls on Member States to ensure that price signals are not replaced by capacity mechanisms.

## Interim Report preliminary conclusions

The Commission draws four main preliminary conclusions. **First**, it is necessary to establish a common methodology to determine generation adequacy and to define reliability standards that allow public authorities to assess the need for public intervention in an objective manner and improve cross-border comparability.

**Second**, the report is critical of price-based capacity mechanisms (*i.e.* price-based mechanisms offering market-wide or targeted capacity payments) compared to volume-based capacity mechanisms due to the higher risk of overcompensation stemming from price-based capacity mechanisms.

**Third**, the Interim Report distinguishes between short-term and long-term responses to potential capacity problems. The Commission considers that strategic reserves and tenders for new capacity can be used to tackle transitional capacity problems but are not capable of resolving underlying market failures. On the other hand, the report considers that de-central obligation mechanisms and central buyer mechanisms are adequate to address longer-term capacity problems. These capacity mechanisms also tend to increase competition for capacity remuneration by allowing the participation of different capacity providers from both the supply and the demand sides and attracting new capacity.

**Fourth**, whatever the public authority's final choice, the Interim Report encourages Member States to introduce carefully designed capacity mechanisms that do not undermine the functioning of the electricity market. In this regard, capacity mechanisms must be established according to transparent and open rules of participation.

## Next steps and implications for the energy sector

The Interim Report sets out the Commission's possible future directions in its actions in the energy sector.

From a legislative perspective, the sector inquiry will support and complement future policy and legislative work in the area of security of electricity supply in the context of the Energy Union strategy. The consultation launched in July 2015 on energy market design, as part of the energy summer package, explicitly refers to the sector inquiry as a source of information that can feed into new legislative initiatives addressing security of supply in Europe.<sup>3</sup> In this sense, the sector inquiry is also intended to complement the public consultation on risk preparedness in the area of security of electricity supply, which aims to review Directive 2005/89 on security of electricity supply and infrastructure investment.<sup>4</sup>

From an enforcement perspective, the sector inquiry will enable the Commission to better understand existing or planned Member States' capacity mechanisms. Based on the findings of the final report, the Commission could be inclined to investigate those capacity mechanisms which are considered more distortive of competition and cross-border electricity trade in order to assess their compliance with the Guidelines on State aid for environmental protection and energy 2014-2020 (EEAG 2014-2020).<sup>5</sup> For example, the Commission has already initiated two in-depth investigations on capacity mechanisms in France<sup>6</sup> and the results of the sector inquiry may encourage the Commission to open further such probes. Alternatively, the Commission may informally engage with Member States in order to address potential shortcomings in the design of capacity mechanisms. An open question is whether the Commission will

assess the links between the EEAG, services of general economic interest (SGEI) and the *Altmark* judgment in the final report of its sector inquiry.<sup>7</sup>

The Commission has invited Member States, relevant stakeholders and the general public to submit comments within the next 12 weeks with the objective of preparing the final report, which the Commission intends to publish later this year. Since this is the last stage of the process in which stakeholders can participate before the Commission adopts a firm position on the design and operation of capacity mechanisms, interested parties should take advantage of the opportunity to contribute to the formation of future European energy policies.

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## Endnotes

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- <sup>1</sup> Available at: [http://ec.europa.eu/competition/sectors/energy/state\\_aid\\_to\\_secure\\_electricity\\_supply\\_en.html](http://ec.europa.eu/competition/sectors/energy/state_aid_to_secure_electricity_supply_en.html)
- <sup>2</sup> Commission decision C (2014) 5083 final of 23.7.2014 in Case SA.35980 (2014/N-2) – United Kingdom –Electricity market reform – Capacity market.
- <sup>3</sup> Section 4 of Communication from the Commission, “Launching the public consultation process on a new energy market design” {SWD(2015) 142 final} , 15 July 2015, COM(2015) 142 final.
- <sup>4</sup> Consultation on risk preparedness in the area of security of electricity supply.  
[https://ec.europa.eu/energy/sites/ener/files/documents/DG%20ENER\\_ConsultationPaperSoSelectricity14July.pdf](https://ec.europa.eu/energy/sites/ener/files/documents/DG%20ENER_ConsultationPaperSoSelectricity14July.pdf)
- <sup>5</sup> *Guidelines on State aid for environmental protection and energy 2014-2020* [2014] OJ C 200/1.
- <sup>6</sup> The first relates to a country-wide capacity mechanism in France and the second to a tender for a new gas-fired power plant in Brittany.
- <sup>7</sup> *Altmark Trans and Regierungspräsident Magdeburg*, C-280/00, ECLI:EU:C:2003:415.