Introduction

On 13 April 2016 the Commission published its interim report in the State aid sector inquiry on capacity mechanisms (Report).¹ This is a key milestone of its first State aid sector inquiry, which was announced in April 2015. It follows from the Commission’s concern that capacity mechanisms may run counter to the EU’s Energy Union objectives by favouring particular producers and creating barriers to electricity trade across Member States.² One of the underlying reasons for the inquiry was the Commission’s suspicion that it could only scratch the surface of the issue through its regular State aid powers. In the year following the adoption of the Energy and Environmental Guidelines (EEAG) it has only been able to conclude a review of the capacity mechanism in the UK.³ Through the inquiry the Commission collected information from over 120 market participants and public bodies on existing and planned capacity mechanisms in 11 Member States: Belgium, Croatia, Denmark, France, Germany, Ireland, Italy, Poland, Portugal, Spain and Sweden. The preliminary conclusions in the Report show the Commission’s determination to crack down on the uncoordinated proliferation of national capacity mechanisms which can have a disproportionate negative impact on the internal energy market and competition.

Capacity mechanisms: what and why?

Member States implement capacity mechanisms to ensure there is enough energy resources available to meet peak demand. Typically capacity mechanisms offer further rewards to capacity providers, in addition to income gained by selling electricity. These rewards can be designed to encourage investment in new power plants or to ensure that existing power plants continue to operate. This market intervention changes the way generation is rewarded by recognising the value of capacity rather than output.

A number of Member States have recently introduced or are considering introducing capacity mechanisms in response to concerns that the energy market may no longer be able to deliver sufficient capacity adequacy in the coming years. The increase in prominence of capacity mechanisms is mostly attributable to the decline in wholesale energy prices and lower productivity of conventional power plants, especially in markets with a high proportion of renewable energy.

¹ You can find copies of the Commission press release here, the FAQ regarding the inquiry here, the interim report here and the working paper here.
² Linklaters has continued to follow developments in this area with their thought leadership report Capacity mechanisms. Reigniting Europe’s energy market (available here), and further client alerts published November 2013, January 2014, April 2014, April 2015 and May 2015.
³ You can find a copy of our client alert on EEAG here.
3 What are the Commission's interim findings?

The Report sets out two overarching concerns:

> firstly, the Commission believes Member States should be more thorough in testing whether a capacity mechanism is necessary for security of supply reasons
> secondly, more thought should be given when designing capacity mechanisms to ensure they are cost-effective and not distorting competition

*Necessity for capacity mechanisms*

The Report notes that:

> many capacity mechanisms have been adopted without any prior assessment of whether a security of supply problem existed. According to the Commission, nearly half of the 11 Member States had not adequately studied what the appropriate level of supply security should be before implementing a capacity mechanism
> methods for calculating security of supply varied significantly between Member States, making comparison and cooperation across borders difficult. The Commission considers that a more harmonised approach to generation adequacy and reliability standards is necessary to enable coordination between Member States.

*Design of capacity mechanisms*

The report sets out six types of capacity mechanism:

(i) tenders for new capacity; (ii) strategic reserves;
(iii) targeted capacity payments; (iv) central buyer models;
(v) decentralised obligations; and (vi) market-wide capacity payments. The Commission categorises the first three types as targeted mechanisms and the latter three as market mechanisms. The Commission found that strategic reserve mechanisms, which keep power plants separate from the wholesale market to be used in emergency situations, are the most frequently implemented. The Commission notes that the adequacy assessment will vary according to these categories. The Commission also concluded that there are a number of issues associated with the design of capacity mechanisms:

> in many instances Member States have mechanisms in place where the price paid for electricity is set administratively rather than determined through a competitive process. This can lead to overpayment which in effect subsidises the provider
> many capacity mechanisms target only one source of generation such as coal. Failing to allow all potential capacity providers or technologies to participate leads to an unnecessary limit on competition among suppliers. However, the Commission notes that there is a growing trend towards more inclusive mechanisms
> many capacity mechanisms ignore power plants in other Member States. Including foreign capacity providers in national mechanisms would enable Member States to procure capacity at a lower cost and help build an integrated EU energy market
> capacity payment schemes, which lack a competitive price setting process are the least appropriate type of mechanism

The Commission concludes that there is a strong case for “better alignment of methods used to define generation adequacy and reliability standards”, signalling a concrete area for future initiatives. Nonetheless, the Commission recognises that there is no perfect approach. Different models are appropriate depending on the specific energy problem. In most instances open and inclusive capacity models deliver the most cost-efficient outcomes.

The Report does not prejudge any State aid analysis of the capacity mechanisms under review. Such an analysis would require a case-by-case study of each mechanism.

4 Next steps?

The inquiry has now been opened up to public consultation. The Commission has invited Member States, stakeholders in the electricity sector and others to submit comments by 6 July 2016, and will use these responses when it publishes a final report, currently scheduled for the end of 2016.

During the remainder of the sector inquiry, the Commission will continue to monitor the compliance of capacity mechanisms with EU State aid rules. The Commission opened an in-depth State aid investigation on 13 December 2015, regarding two planned capacity mechanisms in France4. The first measure under investigation relates to a market-wide capacity mechanism where capacity obligations are traded between electricity capacity providers and suppliers. The second parallel measure concerns a tender launched to support the construction of a new gas-fired power plant in Brittany. As the Commission announced in April 2015, it is not ruling out opening further individual investigations in coming months pending the outcome of the sector inquiry.

The sector inquiry results will ultimately feed into the Commission’s planned new electricity market design, which is intended to be adopted later in 2016. The results may also inform a review of the Guidelines on State Aid for environmental protection and energy scheduled for 2017-2019. While in the short term the Commission can only resort to its hard State aid powers, its objective in the mid to long term is clearly to pursue a more coordinated EU-wide approach through legislative means5.

If you require any assistance in responding to the consultation or have any questions on the Report or the sector inquiry, please get in touch with your Linklaters contact.

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4 The Commission's press release can be found [here](#).

5 The Energy Union Package can be found [here](#), subsequent communications on the design of the electricity market and the retail market [here](#) and [here](#), a roadmap [here](#) and the preliminary results of the public consultation [here](#).
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