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**Subject: State Aid SA.44475 (2016/N) - United Kingdom
Supplementary Capacity Auction**

Sir, Madam,

1. PROCEDURE

- (1) Following pre-notification contacts, the UK authorities notified to the Commission on 17 August 2016, in accordance with Article 108(3) of the Treaty on the Functioning of the European Union (TFEU), a supplementary capacity auction (or in short the "SCA") as an amendment to the GB capacity market (the "approved capacity mechanism"), a State aid scheme approved by the Commission in decision SA.35980 (2014/N-2) on 23 July 2014 (the "2014 Decision").

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2. DETAILED DESCRIPTION OF THE MEASURE

2.1. The supplementary capacity auction

2.1.1. Rationale for a supplementary capacity auction

- (2) The UK Government has put in place a capacity market (CM), approved by the Commission in the 2014 Decision, to ensure security of electricity supply in Great Britain (GB). The mechanism provides capacity remuneration to capacity providers who in turn must ensure that their capacity is available at times of system stress. The recipients and levels of capacity remuneration are determined by a capacity auction process.
- (3) The process includes three types of capacity auctions:
 - (a) a ‘T-4’ capacity auction, four years ahead of the capacity delivery year;
 - (b) a ‘T-1’ capacity auction, one year ahead of the same delivery period; and
 - (c) two Transitional Arrangements (TA) auctions as a temporary measure to grow and develop the less-mature demand side response (DSR) sector.
- (4) The approved capacity mechanism was launched through the first T-4 auction in December 2014 for the first delivery year starting on 1 October 2018 and ending on 30 September 2019. A second T-4 auction took place in December 2015 for the delivery year 2019/20.
- (5) The approved capacity mechanism moreover covers two TA auctions to deliver a limited amount of DSR capacity. The first TA auction was held in January 2016 and will deliver 803 MW of DSR capacity between 1 October 2016 and 30 September 2017. A second TA auction is yet to be held and would deliver DSR capacity between 1 October 2017 and 30 September 2018.
- (6) The UK authorities argue that since the 2014 Decision was adopted, electricity market conditions in GB have changed considerably. Due to significantly reduced electricity wholesale prices, the commercial viability of plants which are required to meet the UK Government's reliability standard is under threat. Decline in profitability has led operators of power stations to announce their intention to close earlier than was assumed at the time the capacity mechanism was notified by the UK authorities in 2014. The UK authorities estimate that, if no action is taken, a capacity of up to 10.5 GW may close or be mothballed by 2017/18 – consisting of 6 GW of coal and 4.5 GW of gas plants.
- (7) According to the UK authorities, even plants which have won CM agreements for 2018/19 are at risk of closing or mothballing as this can be a commercially more attractive option. For example, [...] would have losses of £ [...] in the period 2016-2019, which are significantly in excess of its capacity contracts termination fee liability of £ [...] – making it commercially more attractive to close than honour their CM agreements.* The UK Government will increase termination

fees for new CM contracts – however these would not be applicable to existing CM contracts.¹

- (8) The most recent adequacy assessments carried out by the UK authorities indicate that Loss of Load Expectation (LOLE) would amount to 10 hours in 2017/18 and therefore exceed the UK Government’s reliability standard of 3 hours. Consequently, the System Operator has informed the UK authorities that it will be unable to meet the reliability standard in 2017/18 without further intervention.
- (9) In spite of ongoing reforms (e.g. to enable more DSR, for example through national deployment of smart meters by 2020 and by simplifying the process of half-hourly settlement, and to improve the price signals in the energy markets by reforming the electricity cash-out arrangements (also see recital 128 of the 2014 Decision)), the aforementioned UK Government’s assessment suggests there is a threat to security of supply as early as 2017/18 – a year earlier than previously anticipated.
- (10) For those reasons, the UK authorities propose to introduce a supplementary capacity auction in January 2017 to contract capacity for delivery from 1 October 2017 to 30 September 2018 (i.e. one year earlier than authorised in the 2014 Decision).
- (11) In terms of timing, the interplay with the ongoing auctions would be as follows (note the auctions under points (a) and (c) are covered by the 2014 Decision):
 - (a) the third T-4 auction, for delivery year 2020/21, would take place in December 2016;
 - (b) the SCA for delivery year 2017/18 would take place in January 2017; and
 - (c) the second TA auction, for delivery year 2017/18, would take place in March 2017.

2.1.2. *The design of the supplementary capacity auction*

- (12) The SCA design will be very similar to the design of the auctions in the approved capacity mechanism - as set out in Section 2 of the 2014 Decision. As with the approved capacity mechanism, capacity will be contracted through a competitive bidding process (auction format) and the SCA will be open to all types of capacity providers² including existing and new build generation, storage, DSR and interconnectors. The prequalification process, the delivery obligations and the payment arrangements will be identical to the approved capacity mechanism's design (see Sections 2.3 to 2.7 of the 2014 Decision).

¹ For example the termination fee for existing generation units that cease to have a grid connection agreement (which is the objective standard used by the UK Government to consider that a unit is closed or mothballed) is increased from £25,000/MW to £35,000/MW.

* This sentence contains commercially sensitive information.

² The CM measure is in principle technology neutral and therefore open to participation of all eligible technologies, including fossil fuel power plants. In any event, the UK Government confirmed that it is seeking to set an end to unabated coal generation by 2025 and is currently consulting on proposals to put this into effect; see <https://www.gov.uk/government/consultations/coal-generation-in-great-britain-the-pathway-to-a-low-carbon-future>.

- (13) The SCA will however require some modification of the auction process compared to the approved capacity mechanism. In particular, due to the limited time before the required delivery period (as of 1 October 2017) the lead time between the SCA and the delivery period will be only eight months.
- (14) As no T-4 auction was held for 2017/18, the SCA will procure the entire capacity volume for that delivery year. The target for the SCA is set at 53.6 GW (following the process described in Section 2.4 of the 2014 Decision).³ The actual volume of capacity secured will depend on the clearing price and ranges from 52.6 GW to 54.6 GW.
- (15) Agreements longer than 1 year are only available to participants in a T-4 auction and therefore will not be available in this one year ahead SCA (see recital 57 of the 2014 Decision).
- (16) The UK authorities consider this to be appropriate to avoid the risk of:
 - (a) over-procuring for delivery years where the majority of capacity has already been secured before the SCA (i.e. 2018/19, 2019/20 and 2020/21); and
 - (b) ‘locking in’ for 15 years limited new build technology types that are capable of building within the short lead-time between the SCA and the start of the delivery year (small diesel and potentially OCGT units).
- (17) Since the SCA requires a short lead-time and will offer only one-year agreements (as are available in T-1 auctions in the approved capacity mechanism), the UK authorities have taken specific measures to increase participation to the SCA as much as possible.
- (18) Firstly, capacity that is already subject to capacity agreements secured in the first three T-4 capacity auctions will be eligible to participate. The SCA therefore provides new build projects with an opportunity to accelerate their completion to bring capacity online sooner than originally intended. Such projects would have an ‘early’ one year capacity agreement for the delivery year 2017/18 complementing an already secured fifteen year capacity agreement for later delivery years.
- (19) Secondly, the UK authorities have taken measures to increase the participation of (mature and immature) DSR capacities to the SCA, in particular by holding the SCA before the TA, although they relate to the same delivery period.
- (20) Both DSR capacity that won agreements in the first TA auction and immature DSR capacity will be able to participate in the SCA and, if eligible, will also be able to prequalify for the 2016 T-4 auction (for delivery year 2020/21) and the second TA auction. Such capacity will have to be withdrawn from the second TA if successful in either:
 - (a) the 2016 T-4 auction (in accordance with recitals 102 jo. 107 and 140 of the 2014 Decision); or

³ <https://www.gov.uk/government/publications/capacity-market-auction-parameters-open-letter-from-beis-to-national-grid>.

- (b) the SCA (as the SCA and TA relate to the same delivery year). This is not in itself a variation to approved capacity mechanism design but addresses the need to set out the relationship between two auctions relating to the same delivery year.
- (21) The SCA and TA relate to the same delivery year but the SCA will be held before the second TA. The UK Government however wants to secure all capacity required for delivery year 2017/2018 in the SCA while at the same time retaining some volume for the TA (to stimulate immature demand response). To reconcile these objectives and to avoid over-procurement, the UK authorities have proposed the measures described at recitals (22) and (23) below.
- (22) The UK authorities expect a large amount of immature DSR capacity to prequalify for both auctions. Therefore, once the results of the SCA are known, the UK authorities will reduce the target capacity for the TA *pro rata* i.e. by the amount of immature DSR capacity that was prequalified for both the SCA and TA but has already successfully secured contracts in the SCA. By clarifying this in the SCA and TA rules, the UK authorities will make it clear that the SCA and the TA target capacities are related and allow participants to make more informed prequalification and bidding decisions.
- (23) In the approved capacity mechanism, the UK authorities have flexibility on the amount of capacity bought in the auction depending on the price, with a sloping demand curve allowing a trade-off between reliability and costs (see recital 36 and beyond of the 2014 Decision). This flexibility has so far been set at 1.5 GW above or below the target capacity for the T-4 auctions. The UK authorities will reduce this flexibility to 1 GW for the SCA and 100 MW for the TA. In so doing, they ensure that the maximum total capacity which could be procured in the SCA and TA together for delivery year 2017/2018 can never exceed the maximum that could have been procured had there only been one auction.
- (24) Lastly, as regards interconnection, the SCA will be explicitly open to interconnectors, which was not the case for the first T-4 auction for the delivery year 2018/19. In the first T-4 auction, the expected contribution from interconnection at times of GB system stress was taken into consideration implicitly, by reducing the amount of capacity auctioned. In the 2014 Decision, the UK authorities however committed (see recital 95 of the 2014 Decision) to allow explicit participation of interconnectors to the auctions. This modification will equally apply to the SCA.
- (25) Overall, in view of these measures, the UK authorities expect that the amount of eligible capacities for the SCA will exceed the required capacity volume by around 10 %, ensuring the competitive pressure in the auctions.

2.2. Legal basis

- (26) The SCA will be implemented through the Electricity Capacity (Amendment) Regulations 2016 and the Capacity Market (Amendment) Rules 2016. The granting authority is the UK Government.

2.3. Recipient(s)

- (27) The beneficiaries of the SCA are the same as those mentioned in Section 2.3 of the 2014 Decision, taking into account the variations to the CM design described in Section 2.1.2 above.

2.4. Financing of the measure and budget

- (28) Financing of the measure will be identical to the financing for the other capacity auctions, as described in Section 2.7 of the 2014 Decision.
- (29) The budget for the measure is the same as that for the other capacity auctions, as described in recital 7 of the 2014 Decision.

3. ASSESSMENT OF THE MEASURE/AID

3.1. Existence of aid

- (30) As explained in Section 3.1 of the 2014 Decision, the CM constitutes State aid within the meaning of Article 107(1) TFEU. The notified amendment to the CM with a supplementary capacity auction does not affect the qualification of the measure as State aid. The Commission therefore maintains its view that the measure falls within Article 107(1) TFEU.

3.2. Lawfulness of aid

- (31) The Commission considers that the amendment to the CM (a supplementary capacity auction) constitutes a notifiable change within the meaning of Article 108(3) TFEU. By notifying the measure before its implementation, the UK authorities have fulfilled their obligations under Article 108(3) TFEU.

3.3. Compatibility with the internal market

- (32) The Commission has assessed the compatibility of the amendment to the CM (i.e. the SCA) with the internal market on the basis of the conditions established in Section 3.9 of the Environmental and Energy Aid Guidelines (EEAG)⁴ which set specific conditions for aid to generation adequacy.

3.3.1. Objective of common interest and need for State intervention

- (33) The SCA must pursue a common objective and be considered necessary in accordance with Sections 3.9.1 and 3.9.2 EEAG.
- (34) The objective of the SCA is the same as that for the CM recognised in the 2014 Decision (see recital 126 of the 2014 Decision), i.e. to ensure security of electricity supply by procuring the necessary amount of capacity to meet the UK Government's reliability standard.
- (35) In order to be considered necessary, the measure should meet several conditions: i) the generation adequacy concerns must be identified through a quantifiable indicator and the findings must be consistent with the analysis carried out by the

⁴ Guidelines on State aid for environmental protection and energy 2014-2020 (OJ C 200, 28.6.2014, p. 1).

European Network of Transmission System Operators for electricity (ENTSO-E) (points 221 and 222 EEAG); ii) the Member State should indicate the reasons why the market cannot be expected to deliver the required capacity (point 223 EEAG); and iii) the measure must address the nature and causes of the problem and in particular the market failure that prevents the market from delivering the required level of capacity (Section 3.2.2 EEAG).

- (36) At the time of the 2014 Decision, the UK Government identified a number of market failures in the GB electricity market – principally that reliability is a public good and the “missing money” problem (see recitals 84 and 85 of the 2014 Decision). These market failures were found to endanger generation adequacy as measured with the reliability standard. Although the UK Government has undertaken several market reforms to improve the price signal provided through the energy markets (in particular, for example by reforming the short-term balancing markets), several power plants have announced closure in the run up to the first capacity delivery year (2018-2019).⁵ Announced plant closures could reflect overcapacity in the system, but they may also indicate that the missing money problem identified by the UK Government has not been solved in GB for the years before the first delivery year of the approved capacity mechanism.
- (37) By applying the same methodology for its generation adequacy assessment as used for the 2014 Decision, the UK authorities have indicated that altered circumstances in the electricity market mean there is a risk that more plants close than would enable the attainment of the GB reliability standard of 3 hours LOLE in 2017/18.
- (38) In particular, the probabilistic adequacy assessment for 2017/2018 carried out by the UK authorities identified a LOLE of 10 hours, well above the UK Government’s reliability standard of 3 hours. The adequacy assessment is not contradicted by ENTSO-E’s 2016 *Mid-Term Adequacy Forecast*⁶, which provides a mid- to long-term adequacy assessment. ENTSO-E does not provide a detailed adequacy assessment for 2017/2018, but assesses adequacy for 2020 and 2025, and each time finds LOLE values for Great Britain exceeding 3 hours/year although this would be caused by not taking the results of the CM auctions into account.
- (39) For the above reasons, the Commission considers that the present measure is compliant with Sections 3.9.1 and 3.9.2 of the EEAG as it serves a common objective and there is a need for State intervention to attain that objective.
- (40) The Commission however notes that the above is without prejudice to the UK authorities’ commitment in the 2014 Decision to continuously assess the extent to which the Capacity Market effectively delivers on its objectives and remains the most effective form of intervention to address underlining market failures, and in particular to review whether the Capacity Market is still needed in the future or should be phased out (see recital 6 of the 2014 Decision).
- (41) In particular, and to avoid any misunderstanding, the Commission specifies that any changes to the legislative or regulatory framework, which may have a

⁵ See recitals (6) to (7) above.

⁶ Available here: <https://www.entsoe.eu/outlooks/maf/Pages/default.aspx>.

significant impact on the financial viability of power plants in GB, such as a review of the Carbon Price Floor or any other existing carbon pricing mechanism, is considered, in the context of this decision, to be a notifiable change in the meaning of Article 108 (3) TFEU.

3.3.2. *Appropriateness of the aid*

- (42) In accordance with Section 3.9.3 EEAG, the Commission finds a generation adequacy measure appropriate if it fulfils the following conditions: i) the choice of the instrument must be coherent with other measures targeting the same market failure (Section 3.2.3 EEAG); ii) aid must only compensate the service of availability of capacity (point 225 EEAG); iii) the measure should be open to all relevant capacity providers and allow sufficient lead times for new investments (point 226 EEAG) and iv) take into account the extent to which interconnected capacity can contribute to remedy the generation adequacy concerns (point 226 EEAG).
- (43) First, the measure addresses the same market failures as the approved capacity mechanism, referred to in recital (36) above, only one year earlier than expected, as explained at recitals (6) to (10) above. The measure moreover addresses those market failures in the same way as the approved capacity mechanism, namely by contracting capacity through a central auction.
- (44) Secondly, the measure does not alter the availability obligations in the approved capacity mechanism. The conclusions regarding the mere compensation of availability as opposed to the production of electricity (see recitals 132 to 133 of the 2014 Decision) can therefore equally apply to the SCA.
- (45) Thirdly, in terms of its openness to all relevant capacity providers, as explained at recital (12) the UK authorities have confirmed that all types of capacity providers will in principle be able to participate: existing and new build generation, storage, DSR and interconnectors.
- (46) Fourthly, the lead time of 8 months before delivery and the lack of long term capacity agreements however make the participation of refurbishing plants and new build generation more difficult compared to the approved capacity mechanism. Indeed, in the approved capacity mechanism, refurbishing and new generation plants could participate in a four year ahead auction to benefit from sufficient lead time for their refurbishing/construction works and from three and fifteen year capacity agreements respectively (see in particular recitals 57, 134 and 139 of the 2014 Decision).
- (47) There are a number of reasons why longer lead times and longer contract lengths are not feasible or appropriate in the present case. Firstly, longer lead times are not possible in view of the imminent nature of the targeted capacity problem. In this context, the envisaged SCA has to be seen as an immediate and transitory measure before the approved capacity mechanism begins to take effect on 1 October 2018. Secondly, longer contract lengths going beyond 2017/18 would interfere with the results of the outcome of the previous capacity auctions for later delivery years (as of 2018/19) as they would add capacity to the already

contracted capacity for those years.⁷ Thirdly, new (or refurbished) capacities are in principle not excluded from the SCA provided they can be developed in time for the delivery year. As described in recital (18), capacity providers that already benefit from a long-term capacity agreement for later delivery years can participate in the SCA.

- (48) The UK authorities have moreover taken specific measures to ensure the openness of the SCA and maximise competition in the SCA. This concerns in particular the participation of new capacity, demand response and interconnection capacity. As mentioned at recital (18), new projects are incentivised to participate in the SCA by means of ‘early’ one year capacity agreements to complement the already-secured 15 year capacity agreement. Regarding demand response, as explained at recital (19) et seq. unproven demand response will find in the SCA an additional opportunity (in addition to the second TA) to get contracted. Thirdly and lastly, as mentioned at recital (24), interconnection can participate in the SCA in the same way as it participated in the second T-4 auction in December 2015, i.e. in conformity with the UK Government’s commitment in recital 95 of the 2014 Decision to allow explicit participation of interconnectors to the auctions.
- (49) In conclusion, the Commission agrees that the one-off SCA is appropriate, in accordance with Section 3.9.3 EEAG, to attain the UK Government’s immediate security of supply objectives.

3.3.3. *Incentive effect*

- (50) As explained at recital (8) above, absent the measure, the UK Government holds that its reliability standard of 3 hours LOLE would not be reached in 2017/18 in any of the adequacy scenarios produced by the System Operator. By contracting capacity providers to be available at times of system stress, and in particular by imposing penalties on the providers that do not comply with their contractual obligations, the measure changes the behaviour of the benefitting capacity providers who may otherwise close down operations due to continuous losses or may not necessarily be available during times of system stress.
- (51) The Commission therefore finds that the measure has an incentive effect as required by Section 3.2.4 EEAG.

3.3.4. *Proportionality*

- (52) In order to be considered proportional in accordance with Section 3.9.5 EEAG a measure must meet the following conditions: i) the compensation allows beneficiaries to earn a reasonable rate of return (point 228 EEAG); when the measure is based on an effective competitive bidding process on the basis of clear, transparent and non-discriminatory criteria, it will be considered as leading to reasonable rates of return under normal circumstances (point 229 EEAG); ii) the measure should also have built-in mechanisms to ensure that windfall profits cannot arise (point 230 EEAG).
- (53) As explained at recital (12), the SCA will include the same safeguards as the approved capacity mechanism to ensure that the aid remains proportionate.

⁷ See recital (16).

Firstly, the SCA is a market-wide capacity mechanism where all eligible capacity providers compete in a single capacity auction to discover the lowest sustainable price at which the necessary capacity can be brought forward (see recital 145 of the 2014 Decision). Secondly, the auction follows a pay-as-clear descending clock design where successful bidders are paid the same clearing price, which hence constitutes a competitive bidding process in the sense of point (43) EEAG (see recital 146 of the 2014 Decision). The SCA thus entails a competitive bidding process to ensure a reasonable rate of return and built-in mechanisms to ensure windfall profits cannot arise.

- (54) However, the SCA requires a short lead-time and will offer only one-year agreements (as are available in T-1 auctions in the approved capacity mechanism): there could therefore be a risk of reduced price pressure on the capacity providers, stemming from the lack of potential competition from (larger) new build projects.
- (55) As explained at recitals (17) to (25), the UK authorities have examined this risk and expect that the amount of eligible capacities for the SCA will exceed the required capacity volume by around 10 %. They therefore believe there is sufficient liquidity to enable a competitive auction, allowing for a reasonable rate of return but avoiding windfall profits.
- (56) Firstly, as explained at recital (18), to ensure the auction is as competitive as possible despite the short lead time, the UK authorities have included a possibility for new build projects having secured long agreements in the first three T-4 capacity auctions to obtain an ‘early’ one year capacity agreement in the SCA to complement the already-secured 15 year capacity agreement, provided they can be operational in time.
- (57) Secondly, as explained at recitals (19) and (20), the UK authorities have taken measures to increase the participation of (mature and immature) DSR capacities to the SCA, in particular by allowing them to pre-qualify for the third T-4 auction, the SCA and the TA and by organising the SCA before the TA, although they relate to the same delivery period.
- (58) Thirdly, as explained at recital (24) the SCA is explicitly open to interconnectors, which was not the case for the first T-4 auction for the delivery year 2018/19. In the first T-4 auction, the expected contribution from interconnection at times of GB system stress was taken into consideration implicitly, by reducing the amount of capacity auctioned. Due to the application of more conservative de-rating factors in the first T-4 auction, the contribution of interconnection to GB security of supply was in that auction considered to be lower than the amount of interconnector capacity that will be able to participate in the SCA. The increased participation of interconnector capacity to the SCA therefore further increases the competitive pressure on the auction.
- (59) In view of the fact that the SCA and the TA relate to the same delivery year, the UK authorities have moreover taken specific measures, described at recitals (22) and (23), to avoid over-procurement. In particular, the target capacity of the TA will be reduced by the amount of immature DSR capacity that prequalified for both auctions but was already successful in the SCA. Additionally, the upper demand curve tolerance of both auctions will be set at such levels that the maximum total capacity which could be procured in the SCA and TA together

does not exceed the maximum that could have been procured had there only been one auction.

- (60) To conclude, under the specific circumstances for the SCA including a short lead time, the Commission considers that the UK authorities have built in sufficient safeguards to increase competition in the one-off SCA and to ensure that windfall profits cannot arise. It therefore considers the measure proportional as required by Section 3.9.5 EEAG.

3.3.5. Avoidance of negative effects on competition and trade

- (61) The measure must moreover not result in undue distortions of competition and trade, in accordance with the conditions in Section 3.9.6 EEAG.
- (62) The SCA does not differ from the approved capacity mechanism in its design with regard to features to avoid negative effects on competition and trade between Member States.
- (63) The conclusions drawn in recitals 149 to 153 of the 2014 Decision can therefore be confirmed in relation to the SCA.
- (64) The Commission therefore considers that the measure is in conformity with Section 3.9.6 EEAG.

3.3.6. Transparency of the aid

- (65) According to Section 3.2.7 EEAG the aid measure has to be transparent.
- (66) The UK authorities have explained that the SCA has been subject to public consultation for areas in which it deviates from the approved capacity mechanism. Final legislative provisions, rules and guidance for capacity providers will also be published on the Government and Ofgem's websites respectively, ahead of the prequalification period.
- (67) Information regarding the individual beneficiaries and the amount of the capacity remuneration will be published. The Electricity Settlements Company will also publish information regarding the actual payment amounts received by individual beneficiaries. All this information will be available online and accessible to the general public without restrictions.
- (68) The measure therefore complies with Section 3.2.7 EEAG.

3.3.7. Conclusion on compatibility

- (69) In conclusion, the Commission finds that the measure is compatible with the relevant criteria set out in EEAG.

3.3.8. Compliance with Article 30 and 110 TFEU

- (70) The conclusions at Section 3.3.7 of the 2014 Decision have been strengthened by the inclusion, since the second T-4 auction, of interconnector capacity into the CM. They can therefore be confirmed with respect to the SCA, which is equally open to interconnector capacity.

(71) The financing mechanism of the notified measure therefore does not introduce any restrictions that would infringe Article 30 or Article 110 TFEU.

4. CONCLUSION

The Commission has accordingly decided not to raise objections to the aid measure on the grounds that it is compatible with the internal market pursuant to Article 107 (3) c) of the Treaty on the Functioning of the European Union

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For the Commission

Margrethe VESTAGER
Member of the Commission

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