The electricity price drop

Prof. Dr. Lion Hirth

Strommarkttreffen | 28 July 2017 | hirth@neon-energie.de
Ex-post analysis

• Econometric analyses study the past

• Analyses that use fundamental models often study the future – in form of projections or scenarios

• Today: let us study the past

• More specifically: quantify the impact of one or more factors on the historical development of a variable of interest

• Variables of interest
  • wholesale electricity price
  • CO$_2$ certificate price
  • Stock market value of energy companies
Motivation: the electricity price plunge

Since 2010, Swedish prices declined even faster than German prices.

Electricity prices have declined about 60% from their peak in 2008-10 (day-ahead base price, inflation-adjusted).
The price structure has changed as well

The price structure of German prices changed dramatically with the rise of solar.

Sunny hours became relatively much cheaper, and night hours more expensive.
Some price recovery

• CAL18 base future hit a low of 21 €/MWh in February 2016 and recovered by 50% to 31 €/MWh today

• Spot prices during the winter reached 100 €/MWh

• Nevertheless, prices remain far below long-term sustainable levels, where contribution margins are sufficient to cover capital costs
Three drivers of falling prices

1. Reduced electricity demand
2. Increased low-variable cost supply
3. Reduced variable cost

[Diagram showing the impact of reduced demand and increased supply on variable costs.]
Potential drivers in detail

1. Reduced demand
   - Decline in final demand for electricity
   - Reduced export capacity, particularly from the Nordic region to the Continent

2. Increased low-cost supply
   - Additional thermal capacity (mostly coal-fired plants)
   - Year-to-year variation of water inflow to hydro reservoirs
   - Additional wind, solar, and biomass capacity
   - Availability of (Swedish) nuclear power
     - Decommissioning of conventional plants
   - Nuclear phase-out (in Germany)

3. Reduced variable cost
   - Declining coal price
   - Declining CO₂ price
   - Improved thermal fleet efficiency (heat rate)
   - Increased natural gas price
Which electricity prices are we interested in?

One can analyze spot or financial markets. On average, they should be identical, but in the past years they often deviated significantly for extended periods of time.

Spot (day-ahead) markets

• How did realized prices develop?
• How did market fundamentals (supply, demand, costs) change?

Financial (future) markets

• How did expectations develop?

A spot market analysis is easier to interpret, and data availability is better (expectations are private information) → we study spot prices.
Kallabis, Pape, Weber (2016)

What Caused the Drop in European Electricity Prices?
A Factor Decomposition Analysis

Lion Hirth*

Hirth (2018)

An analysis of the decline of electricity spot prices in Europe: Who is to blame?

Andreas Bublitz*, Dogan Keles*, Wolf Fichtner*

*Karlsruhe Institute of Technology, Chair of Energy Economics, Hertzstraße 16, D-76187 Karlsruhe

Bublitz, Keles, Fichtner (forthcoming)

Politics vs markets: how German power prices hit the floor

Martin Everts, Claus Huber and Eike Blume-Werry*

Everts, Huber, Blume-Werry (2016)
What caused the drop in European electricity prices?

A factor decomposition analysis

The Energy Journal (open access)

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Research question

In short:
Why did the power prices drop?

More precisely:
Which factors contributed by how much to the drop of the Swedish and Germany electricity day-ahead base prices between 2010 and 2015?
Methodology
Methodology

1. Replicate prices for the years 2010 and 2015
   • With a fundamental power market model
   • Using the full set of input factors of the respective year (electricity demand, RES generation, hydro inflow, fuel prices, ...)
   • → Model check: can prices be replicated?

2. Quantify impact of individual factors
   • Substitute one individual factor (e.g. coal price) from 2010 with 2015 value
   • Leave all other factors (e.g., RES generation, hydro inflow, fuel prices, ...) unchanged at 2010 values
   • By how much did the modeled 2015 price change vs modeled 2010 price?
   • Replicate this procedure for each factor one-by-one
   • → Estimate the impact of individual factors on price drop
The **Electricity Market Model EMMA**

*Numerical partial-equilibrium model of the European interconnected power market*

**Objective:** minimize system costs
- Capital costs
- Fuel and CO2 costs
- Fixed and variable O&M costs
- ... of thermal and hydro power plants, storage, interconnectors

**Decision variables**
- Hourly dispatch
- Yearly investment
- ... of plants, storage, interco’s

**Constraints**
- Energy balance
- Capacity constraints
- Volume constraints of storage/hydro
- Balancing reserve requirement
- CHP generation
- (No unit commitment, no load flow)

**Resolution**
- Temporal: hours
- Spatial: bidding areas (countries)
- Technologies: eleven plant types

**Input data**
- Wind, solar and load data of the same year
- Existing plant stack

**Equilibrium**
- Short-/mid-/long-term model (= dispatch / capacity expansion / greenfield)
- Equilibrium (“one year”) rather than a transition path (“up to 2030”)

**Economic assumptions**
- Price-inelastic demand
- No market power
- Carbon price

**Implementation**
- Linear program
- GAMS / cplex

**Applications**
- Four peer-reviewer articles
- Various consulting projects
- Copenhagen Economics

**Open source**
1. **Sum of individual effects does not equal joint effect**

- If a change in a non-linear system is de-composed into individual factors, the sum of the individual factor in general do not equal the joint effect.
- Hence the “interaction effect”
- An interpretation: the interaction effect represents the balancing forces of markets.
- An illustrative example:
  - Increase in RES is estimated to reduce prices by 20 €/MWh and decline in demand by another 18 €/MWh.
  - The joint effect of both changes simultaneously is likely to be less than 38 €/MWh, as the power market adjusts to the larger (joint) shock by adjusting dispatch and trade. (Let us assume, the joint effect is 30 €/MWh.)
  - Then the interaction effect is positive. (In the example, 8 €/MWh.)
2. Alternative benchmarks

• The two following questions are not identical
• “What would be reduction of the electricity price if all parameters are at 2010 levels, only RES supply is increased to 2015 levels?” (2010 benchmark)
• “What would be the increase of the electricity price of all parameters are at the 2015 level, only RES supply is decreased to 2010 levels?” (2015 benchmark)
Conceptual remarks on the methodology (3)

3. Individual (“separate”) vs. cumulative (“added”) effect
   • We test factors individually, starting always with the 2010 parameter set
   • In other words, we test each effect individually, always holding all other effects at 2010 levels
   • A different approach would be to add changes on top of each other

4. Cumulative (“added”) effect: order matters
   • If effects are added one on the other, order of effects impacts their size
   • For example:
     • Start with 2010 parameters, decrease demand first, increase RES supply then
     • Start with 2010 parameters, increase RES supply first, decrease demand then
     • This is the reason we do not follow such an approach
Data
## Crucial parameters 2010 vs. 2015 in the model region

<table>
<thead>
<tr>
<th>Parameter</th>
<th>2010</th>
<th>2015</th>
<th>Data source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity demand</td>
<td>1723 TWh</td>
<td>1647 TWh</td>
<td>IEA Monthly electricity statistic</td>
</tr>
<tr>
<td>Wind + solar generation</td>
<td>75 TWh</td>
<td>193 TWh</td>
<td>IEA Monthly electricity statistic</td>
</tr>
<tr>
<td>Hydroelectricity output</td>
<td>282 TWh</td>
<td>302 TWh</td>
<td>IEA Monthly electricity statistic</td>
</tr>
<tr>
<td>Net exports of model region</td>
<td>38 TWh</td>
<td>90 TWh</td>
<td>ENTSO-E Statistical factsheet</td>
</tr>
<tr>
<td>Net demand (demand minus wind, solar, hydro, net imports)</td>
<td>1404 TWh</td>
<td>1246 TWh</td>
<td>Own calculation</td>
</tr>
<tr>
<td>Coal price</td>
<td>92 $/t 8.4 €/MWh</td>
<td>59 $/t 6.4 €/MWh</td>
<td>IHS McCloskey Northwest Europe Marker Price</td>
</tr>
<tr>
<td>Natural gas price</td>
<td>21 €/MWh</td>
<td>22 €/MWh</td>
<td>IMF German border import price</td>
</tr>
<tr>
<td>CO₂ price</td>
<td>16 €/t</td>
<td>6 €/t</td>
<td>EUA price</td>
</tr>
</tbody>
</table>

Conventional capacity includes nuclear and hydro power as well as all fossil fuel generators. Numbers are shown for the entire model region (Sweden, Norway, Germany, France, Poland, Belgium, The Netherlands). Electricity consumption and wind/solar generation is estimated based on Nov 2015 data, because Dec data are not published yet. All prices are nominal values (not inflation-adjusted). Dollar-denominated prices were converted into Euro using exchange rate data from the ECB. ATC values are used until the introduction of flow-based market coupling.
First observations: volume changes

Electricity demand from power plants with positive marginal costs (thermal plants) declined by 158 TWh (9%).

Changes to net demand

Neon analysis.
First observations: price changes

Fuel prices fluctuated widely, but net change 2010-15 is pretty small. The carbon price declined strongly during the same period.

Some fuel prices declined, while others remained stable

- Coal -24%
- Natural gas + 5%
- CO₂ -63%
- (Fuel prices in nominal terms denominated in Euro)
- → It is pretty obvious that a 24% decline in coal prices can, by itself, not explain a 65% decline in electricity prices.
Replicating historical prices (Step 1)
The model is able to replicate historical prices...

... as well as German prices.

Swedish prices are replicated quite well ...
... as well as historical generation pattern

**Observed generation mix in Germany.**

*Neon analysis.*

**Modeled mix. The model overstates coal generation somewhat, but replicates structural shifts well.**

*Neon analysis.*
Factor decomposition
(Step 2)
The impact of individual factors: Germany

Increased exports and the nuclear phase-out stabilized prices most.

<table>
<thead>
<tr>
<th>Driver</th>
<th>Share in price drop</th>
</tr>
</thead>
<tbody>
<tr>
<td>Renewables growth</td>
<td>54%</td>
</tr>
<tr>
<td>Final electricity demand</td>
<td>25%</td>
</tr>
<tr>
<td>Coal/gas invest</td>
<td>24%</td>
</tr>
<tr>
<td>CO₂ price</td>
<td>24%</td>
</tr>
<tr>
<td>Hydro inflow</td>
<td>10%</td>
</tr>
<tr>
<td>Coal price</td>
<td>8%</td>
</tr>
<tr>
<td>Nuclear availability SWE</td>
<td>-1% (increasing)</td>
</tr>
<tr>
<td>Nat. gas price</td>
<td>-8% (increasing)</td>
</tr>
<tr>
<td>Imports/Exports</td>
<td>-31% (increasing)</td>
</tr>
<tr>
<td>Nuclear phase-out GER</td>
<td>-41% (increasing)</td>
</tr>
</tbody>
</table>

Neon analysis. The share in price drop is the effect of the individual effect relative to the total drop modeled. Renewables comprise wind power, solar PV, and biomass – hydroelectricity is listed separately.

How to read: if the only change was the decline in CO₂ prices, the electricity price drop would have been a quarter of the actual drop.
Six factors reduced the electricity price, four increased it. The decline of coal prices by itself would have reduced prices by 3%, the decline of the CO\(_2\) price by 10%. The additive decomposition into individual effects works quite well: the non-linear interaction term is small.
The impact of individual factors: Germany

7 factors reduced the electricity price, 3 increased it. The decline of coal prices by itself would have reduced prices by 12%, the decline of the CO₂ price by 19%. The additive decomposition into individual effects works quite well: the non-linear interaction term is small.
Swedish price are much more sensitive to changes in fundamentals. This is the nature of a hydro system where small changes in the yearly energy balance can lead to large shifts of prices. An additive decomposition leads to a significant residual.
Conclusions
Most impacts are transitory – but might take a while

• A **cost** shock (e.g. a change in fuel or CO₂ prices) can have a lasting impact, if most (or all) price-setting technologies are affected

• A **volume** shock (e.g. decrease of demand or increase of RES supply) affects the wholesale electricity price temporarily, as it triggers market exit which re-establishes long-term equilibrium price levels

• → Crucial question: *how long is “long-term”?*

• → In power systems with long-living assets and little demand growth (like Sweden), reaching the long-term equilibrium can take decades

• → In power systems with assets near the end of their live-time and/or strong demand growth, it will be reached sooner

“In the long term, we are all dead” – John Maynard Keynes
Summary and conclusions

- Wholesale power prices throughout Europe have declined substantially
- Several factors depressed, several increased the price
- The Nordic system, where most electricity is generated in zero-marginal cost plants (hydro, nuclear, CHP) is more sensitive to volume changes: they have a larger price effect

Germany: important price drivers
- **Downward**: RES growth was largest driver; demand, new investments and the CO₂ price were about half in size
- **Upward**: nuclear phase-out, followed by increased exports

Sweden: important price drivers
- **Downward**: RES growth and demand decline about the same size; followed by hydro inflow
- **Upward**: increase exports (very large effect)
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Why do studies differ?

• **Time horizon**: This paper covers 2008-15, while Kallabis et al. cover 2007-14, Everts et al. 2008-14, and Bublitz et al. 2011-15. Important input parameter differ significantly between these time periods. During 2015 the CO$_2$ price somewhat recovered, which helps explain why Kallabis et al. attribute a larger impact on carbon prices than this paper does.

• **Geographic coverage**: Kallabis et al. and Everts et al. model the German market, while Bublitz et al. and this study include a broader set of countries. The latter two studies consistently report that changed net export had a strong effect, something the former two studies miss out by design.

• **Type of electricity price**: Kallabis et al. model future prices while the three other papers model spot prices. As outlined in section 2.1, future prices reflect expectations while spot prices reflect fundamentals. If market fundamentals change but these changes are anticipated by market actors, spot prices will change but future prices will not.

• **Other assumptions**: the studies also differ in other crucial assumptions. Only Bublitz et al., for example, assumes market power to be present.