

Subject: FEBEG position on the public consultation on
CRM Design Note: Payback Obligation

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Please find here below the FEBEG's reaction on Elia's public consultation on the CRM design notes (Part II). For the sake of clarity, a separate document has been made for each document under consultation. This document addresses the **Payback Obligation**.

Disclaimer

The present position is based solely on the documents submitted to consultation. The comments on specific elements are thus based on available information on this specific topic and might evolve as additional elements are clarified in future documents and/or public consultation. Obviously, the availability of all documents in a pre-final stage is required in order to provide a global overview allowing the stakeholders to take a final position on the matter.

Main comments

Main remarks

The design of the Payback Obligation and its concrete translation into practice is for FEBEG a core element in the CRM mechanism implementation. On the one hand this will limit the possible 'double remuneration' for contracted capacity when set at a rather extreme level, and on the other hand it can reduce the overall risks related to the participation in the CRM, which will be positively translated in the bids and therefore again in the cost of the CRM. 2 main possibilities, independently from each other, should be implemented to avoid that the Payback Obligation creates risks for capacity providers, namely by setting a single strike price at a sufficiently high level and by allowing exemptions to not having to pay back unearned revenues.

Setting a single strike price to a sufficiently high level

The strike price should determine the price level above which revenue could not reasonably be foreseen or expected by all participants to the capacity market. When pricing the reliability option, these prices cannot be accounted for by the market players, and are therefore not included in the pricing of the bids in the capacity market and are so the only ones likely to generate double remuneration. Such price level should be the same for all technologies, as they all participate to the same energy market and, optionally, to the same capacity market.

FEBEG agrees that the concepts of the design note in question support the design choice of one strike price at a sufficiently high level for all market participants. This choice makes it possible to ensure a transparent, competitive, non-discriminatory and cost-effective approach towards the payback obligation.

FEBEG also agrees with the consideration of Elia on the level of the Strike Price, i.e. that a choice for a too low Strike Price level would increase the cost of the Capacity Market and impact the Energy Market.

With respect to the methodology to determine the strike price level, FEBEG takes note of the methodology put forward by Elia, but remains unfulfilled about its more precise implementation. The methodology should provide more clarity on how Elia will **limit the possible range of the strike price level and how it will prevent a strike price volatility** going beyond market price evolutions.

Without more precise information on the possible strike price level, it remains very difficult to evaluate the possible risks related to the payback obligation.

FEBEG has some first proposals, which we ask Elia to consider in the determination of the strike price level in the proposed methodology:

- narrow down the range to 83–92%, as we don't see how a 70% level can be in line with the objective to also incentivize participation of DSR in the CRM (as the strike price will in that case for many DSR applications be too low compared to the activation price).
- put a floor to the strike price.
- the strike price evolution should be in line with market price evolutions. We see currently no other reasons why the strike price could differ from one year to another. For FEBEG it's clear that a different % can't be used for a same delivery year.
- put the level of strike price in a Royal Decree to provide more stability.
- In case we missed some good reasons for a variation in the strike price level, FEBEG asks Elia to elaborate on this and to foresee in a limited number of possibilities that can lead to a modification of the strike price (after consultation).

All these recommendations have the objective to determine one single strike price that is transparent, known in advance,... in order to allow market participants to properly include this element in their bids. FEBEG therefore urges ELIA to consider the requirements of having such a clear and transparent strike price in its methodology.

Finally, FEBEG is concerned by the lack of 'indexation' mechanism to the Strike Price for multi-annual contracts.

Allowing for exemptions

Payback Obligation has as a fundamental principle that revenues not earned by capacity should not be subject to a payback obligation. Hedging practices are an industry standard benefiting the society as a whole and is well documented. The solution to address these practices should be straightforward – there is no need to over-complexify the solution. FEBEG therefore repeats its proposal of a single exemption ratio applicable to all capacities. The overall share of capacity in the market earning (and not earning) the reference revenue can be approximated and thus a correct reimbursement of any 'excess revenue' towards the capacity market is ensured.

In addition to hedged volumes, the capacity reserved for providing Ancillary Services should be exempted as this capacity will not be participating in the market and can therefore not earn the revenue to be paid back under the pay-back obligation.

Detailed comments

1 Introduction & context

1.1 Context and Goal of the Design Note

1.2 Structure of the design note

1.3 Concept of Reliability Option & Payback Obligation

In general, the chapter provides good arguments and reasoning around several concepts of the payback obligation. FEBEG appreciates the effort by Elia to base the necessary choices behind the contentious design aspect of Payback Obligation on reasoned argumentation. While FEBEG may not agree with all elements put forward, the approach does make choices based on objective arguments.

1.3.1/2 Technology neutrality / Technology openness

FEBEG appreciates that distinction being made between the concepts of technology neutrality versus technology openness. However, in the reasoning this distinction is not always kept; e.g. the second and third paragraph of 1.3.1 is rather concerning technology openness than technology neutrality. Technology neutrality should rather focus on the homogenous rules explained in the first paragraph of 1.3.1.

FEBEG agrees that the concepts support the design choice of one strike price at a sufficiently high level for all market participants.

1.3.3 Limitation of the CRM overall cost

FEBEG supports the approach to avoid addressing design elements individually but “also considering them in the bigger picture of the entire CRM”. FEBEG has from the beginning – and continues to ask – that design choices should be approached holistically. As a result, all answers to individual Concept Notes cannot be considered final until the full design of the Capacity Market is known.

1.3.4 Windfall profits avoidance

FEBEG appreciates the effort by Elia to delineate the concept of ‘Windfall Profits’. FEBEG would rather prefer the more neutral term of (potential) double remuneration – as also suggested by Elia as an alternative term.

FEBEG agrees – and has presented it as such during a TF CRM – that double remuneration could arise as from a price level that was not accounted for during the setting of the capacity auction bid. This approach should be kept in mind when the design of the strike price is discussed; FEBEG deplores that this key element again disappears when Elia presents its methodology to define the strike price level in chapter 6.

FEBEG does not agree that the thresholds between market revenues above which one could consider the revenue earned as double remuneration, could vary from technology to technology, as all technologies are participating to the same electricity market. **The key differentiator between such thresholds would rather be market participants that may have different revenue calculation, different hedging strategy and different market expectations and risk approaches, something that Elia does also mention as a possible differentiator.**

1.3.5 Respect of the Reliability Option principle

FEBEG agrees that the concept of Payback Obligation should focus on extreme price levels. This is in line with the concepts elaborated in the previous chapter that the double remuneration only potentially arises when market participants did not take it into account while setting their capacity auction bids.

1.3.6 / 7 Limiting energy market interference / 1.3.7 Overall complexity & feasibility

FEBEG appreciates that simplicity is explicitly recognized as a valuable design characteristic. It should indeed be clear that complexity is literally an expensive choice, as it will make the overall Capacity Market cost higher.

2 Overall Payback Obligation design

FEBEG would once again like to reiterate the need for a Payback Obligation exemption for two types of volumes:

- Capacity already sold on the forward markets. FEBEG has extensively explained and provided reasoned argumentation why capacity that has already been sold on the forward markets should be exempted from the Payback Obligation. Further comments are provided in this answer under section 3.1.2.
- Capacity reserved for providing Ancillary Services. Such capacity is removed from the Day-Ahead Market (DAM) to provide the necessary services towards Elia. As a result, this capacity cannot capture any price spikes on the DAM that the Payback Obligation aims to remove. As a result, such capacity should be deducted from the Payback Obligation and this should be reflected in the Payback Obligation formula presented in Design Proposal #1.

2.1 Reliability Option & Payback Obligation

2.2 The Payback Obligation formula

Payback Obligations (CMU, t) = Sum on all Transactions of the CMU:
 $\max[0; \text{Reference Price (t)} - \text{Strike price (CMU, at Transaction Date)}] * \text{Payback Obligated Capacity (CMU, t, Transaction Id)}$ [in €]

As mentioned, FEBEG is of the opinion that this formula should subtract the ancillary services volume as well as a proxy for the volume which is not participating in the DAM.

3 Reference Price design

3.1 Reference market choice

3.1.1 A standardized, market-wide Reference Price is preferred in the Belgian context

FEBEG agrees with Elia's approach to simplify the design of the reference price by avoiding an individual Reference Price approach per CMU.

3.1.2 The Day-Ahead Market is considered as most suitable standardized, market-wide reference in the Belgian context

FEBEG agrees with the choice for the DAM as the reference market for reliably signaling possible scarcity, as concluded in Design Proposal #2.

FEBEG does not agree with the Elia reasoning on whether an exemption should apply on the forward hedged volumes. Elia refers to the fact that the literature is inconclusive as an argument that no exemption should be applied. At the same time, the literature that is then referred to in the argumentation points to theory that supports 'backwardation' but practical tests that fail to actually observe such 'backwardation'. Elia then concludes

with “*The Bessembinder and Lemmon realization*” [i.e. backwardation] has been tested and is therefore not sufficiently validated by the empirical literature to be proven applied in the Belgian energy market context’. As a result, FEBEG would expect that this lack of proven backwardation should be an argument in favor of exemptions for capacities sold on the forward markets, rather than against as eventually concluded by Elia.

Additionally, to the previous comments, FEBEG would once again reiterate the need to exempt capacity sold on the forward capacity from the payback obligation. The full reasoning and alternative solution are provided in the FEBEG position paper that was published in April 2019. FEBEG would like to reiterate in this context the most important conclusions of the position paper:

*“Scarcity prices are most likely to appear in short-term markets. However, producers do not capture the prices in short-term markets for all the energy they sell. Consumers are likewise not necessarily exposed to them, because of their respective hedging activities on the forward markets. **The methodology to compute the pay-back has to correctly reflect both the revenues that assets actually earn on the short-term markets – compared to forward markets – and the associated volumes.** If this distinction on prices and volumes is not properly made or skewed, it will create a risk for producers that are securing their earnings partly or wholly on the forward markets. This may be detrimental to the cost-efficient functioning of the forward markets and the capacity market. The objective of the capacity market is to reduce risks for market participants to encourage investment to ensure adequacy. The payback obligation should not undermine this objective by introducing a new risk for capacity holders.*

[...]

The preferred solution to take account for hedged volumes would be to use a general reference level of the volume exposed short-term markets that is then applied to the contracted capacity for the calculation of the pay-back. This provides visibility to the capacity holder on the risk exposure, excludes any possibility to manipulate the payback obligation through hedging strategies and is sufficiently simple to avoid costly implementation requirements.”

FEBEG would also reiterate the need to exempt capacities that are reserved for Ancillary Services from the payback obligation, as such capacities are also unable to capture price spikes on the DAM. This point has also been brought by FEBEG through its position paper published in April 2019:

“In addition to the consideration of forward markets in the calculation of the pay-back amount, it should also reflect whether an asset is delivering ancillary services for the TSO. The delivery of such services should be considered as being available for supporting security of supply, even when the asset is not delivering its full, contracted capacity at the moment of scarcity. Without such consideration, the delivery of ancillary services generates additional risks that will be reflected in the price of delivering such services.”

3.1.3 Other Reference Price aspects

3.1.4 Conclusion

3.2 Choice of the specific Day Ahead NEMO

4 Strike Price design

4.1 Decision & Choice: storyline

FEBEG fully supports the choice to apply a single Strike Price to all capacities participating to a capacity auction, as concluded in the Design Proposal #5. The reasoning of Elia is correct that with multiple strike prices the entire Capacity Market would be much more complex, the technology neutrality would be undermined and it would also lead to issues with multiple other design aspects.

But FEBEG does not agree with the statements in this chapter linking the occurrence of ‘Windfall Profits’ to lower SRMC–technologies. As Elia itself points out in 3.1.4, the occurrence of ‘Windfall Profits (or double remuneration)’ should be based on the level of market price above which the revenues are no longer accounted for in the capacity auction bid. Such price level is based on the market participants’ view of market evolution and risk assessment, and not only on the underlying technology. Moreover, such statements overlook the general tendency that lower SRMC–technologies have large investments or fixed costs that have to be covered by the inframarginal rents. As a result, the statement that lower SRMC–technologies are more prone to “Windfall Profits” is incorrect.

4.2 Strike price in time

It is not clear for FEBEG whether the same Strike Price will be applied in the Y–4 and Y–1 capacity auctions for the same Delivery Period. Without price market evolution, Y–4 and Y–1 should have the same Strike Price for the same delivery period. Otherwise participants in T–4 and T–1 will have different contract conditions and the result could be technologies could be treated differently for the same delivery period.

As put forward in the FEBEG main messages, the level of the strike price should remain fairly stable throughout the years, only taking into account the electricity market price evolutions.

FEBEG is concerned by the lack of ‘indexation’ mechanism to the Strike Price for multi–annual contracts. In previous presentations, Elia referred to a Strike Price formula composed of the maximum of two elements: an absolute number that constitutes the Strike Price under ‘normal’ circumstances; and a formula of underlying cost drives that would protect against spiking or rising costs. FEBEG considers this a necessary and low–impact design feature to provide visibility to Capacity Market participants that cost drivers would not cause price spikes that trigger a Payback Obligation, as this would not constitute double remuneration as underlying costs would be the principle drivers.

Regarding the example 2 on secondary market transactions, FEBEG is concerned that updating the strike price level for transactions made will have large, unintended effects on this secondary market. For example, will there be vast liquidity when the strike price increases as participants will be looking to increase the strike prices of their contracts. When the strike price then decreases, it will have the opposite effect; there will be lack of liquidity as participants will want to avoid decreasing the strike price of their assets. This will be specifically addressed in FEBEG’s response to the secondary market design paper.

5 Calibration methodology of the Strike Price

5.1 Considerations and objectives of the Payback Obligation

FEBEG understands the sensitivity of the discussion and appreciates the Elia effort to further objectify the choice.

5.2 Calibration methodology

The methodology of Elia aims to collect historical offer and demand curves, but before using such data relevant prefiltering is done to be consistent with and to focus on adequacy relevant moments. The methodology of this pre-filtering should be further clarified. Is Elia aiming at a methodology to exclude outliers? Or is Elia with this prefiltering referring to the weekly peak hours during the winter months?

As already mentioned under 1.3.6, FEBEG appreciated the approach taken by Elia regarding the determination of ‘Windfall Profits (or double remuneration)’ as price levels above which are not taken into account when setting capacity auction bids. FEBEG deplores that this key consideration is not taken onboard in the calibration methodology of the Strike Price. Instead, the Elia approach exclusively focusses on the technology openness consideration also touched upon in the chapter 1.3. While technology openness is indeed an important consideration, FEBEG does not think this should – or can – be the only consideration. Instead, if the criteria of technology openness and the delination of ‘Windfall Profits (or double remuneration)’ are both integrated in the methodology, the range of the resulting price levels – which is rather broad in the current proposal from 150eur/MWh to 950eur/MWh – could be further reduced.

Given the broad range currently provided in the proposed methodology, it will be important to:

- See if the range cannot be further reduced towards the range between 83 and 92 %; ; FEBEG already provides potential avenue to do so in the previous comment.
- Provide transparency how Elia will derive a Strike Price from the resulting price range; a consideration in this regard should also be to ensure some level of stability in the Strike Price from one year to another. Otherwise, the potential impacts by market participants subject to widely varying Strike Prices on the Energy Market and the Secondary Market can be considerable.

6 Modalities of Payback Obligation

6.1 Payback Obligated volume of an obligation

FEBEG would like to reiterate once again the need for exemptions from the Payback Obligation for two reasons:

- Capacities that have already been sold on the forward markets for risk mitigation purposes;
- Capacities that are reserved for Ancillary Services contracted by Elia.

For further explanations on both reasons, see comments to chapters 2 and 3.1.2, as well as the FEBEG position Paper of April 2019.

6.2 Availability Ratio

FEBEG agrees to exempt all planned and unplanned unavailabilities from the Payback Obligation. However, given the importance of this exemption, Elia should clarify how ‘duly communicated’ is defined.

Under particular circumstances, it may be more attractive for a capacity provider to declare an unavailability and pay the corresponding penalty instead of exposure to a Payback Obligation. For example, a severe price spike that is for one reason or another, cannot be captured by the capacity holder, may induce such behavior. Elia should pay

sufficient attention in the design to avoid as much as possible the occurrence of such circumstances, as well as such behavior.

6.3 Load Following Ratio

No comments.

6.4 Application of the Payback Obligation on CMUs with an Energy-Constrained service level

The Payback Obligation for Energy Constrained CMUs should be related to the Obligated Capacity (i.e. Reference Power) instead of the Transaction Capacity, as the derating factor is taken into account by limiting the Payback Obligation to the AMT moments. This logic is not obvious from illustration in Figure 17, nor is it covered in the Examples and uses cases in chapter 7.

6.5 Stop-Loss limit on the Payback Obligation

FEBEG supports an overall stop loss limit which is linked to the yearly contract value.

7 Examples and uses cases

FEBEG appreciates the illustrative examples to clarify several principles, which contributes to the correct understanding of the proposals in this Design Note.

7.1.1 Example 1: Classical existing Production asset 400MW CCGT

7.1.2 Example 2: Demand-Side management 10MW with 423€/MWh activation cost

7.1.3 Example 3: Aggregate of capacities delivering a SLA of 2h and 5MW

FEBEG wonders if it is not an obligated capacity of 5 MW (instead of 25 MW)?

8 The Rules Set

No comments.
