

German power far-curve underpriced in light of coal plans, other risks

ICIS, 16 February 2018 14:47

German power far-curve contracts do not carry enough risk premium to account for the coal phase-out plans of the upcoming government, or other uncertainties.

The far curve of Europe's most liquid power market has been on a roller-coaster ride recently due to market uncertainty over the plans of the new government, which is still not in place following elections way back on 24 September.

The forward products for Cal '19 2019 out to Cal '21 moved into a full contango shape, meaning products are more expensive the further forward they deliver, when coalition talks involved the Greens party.

But this shape disappeared as the talks collapsed and a continuation of the CDU/CSU-SPD coalition became likely. Most traders took this to mean that any quick measures phasing out coal-fired generation were unlikely.

But positions may have been unwound too quickly, according to one trader: "The market is mispricing the back end of the curve," he said. The source said he is starting to build up long positions on the far curve to profit from any future price increases.

Policy plans

The upcoming coalition, which still needs approval from the SPD membership, has outlined the following key energy policy plans:

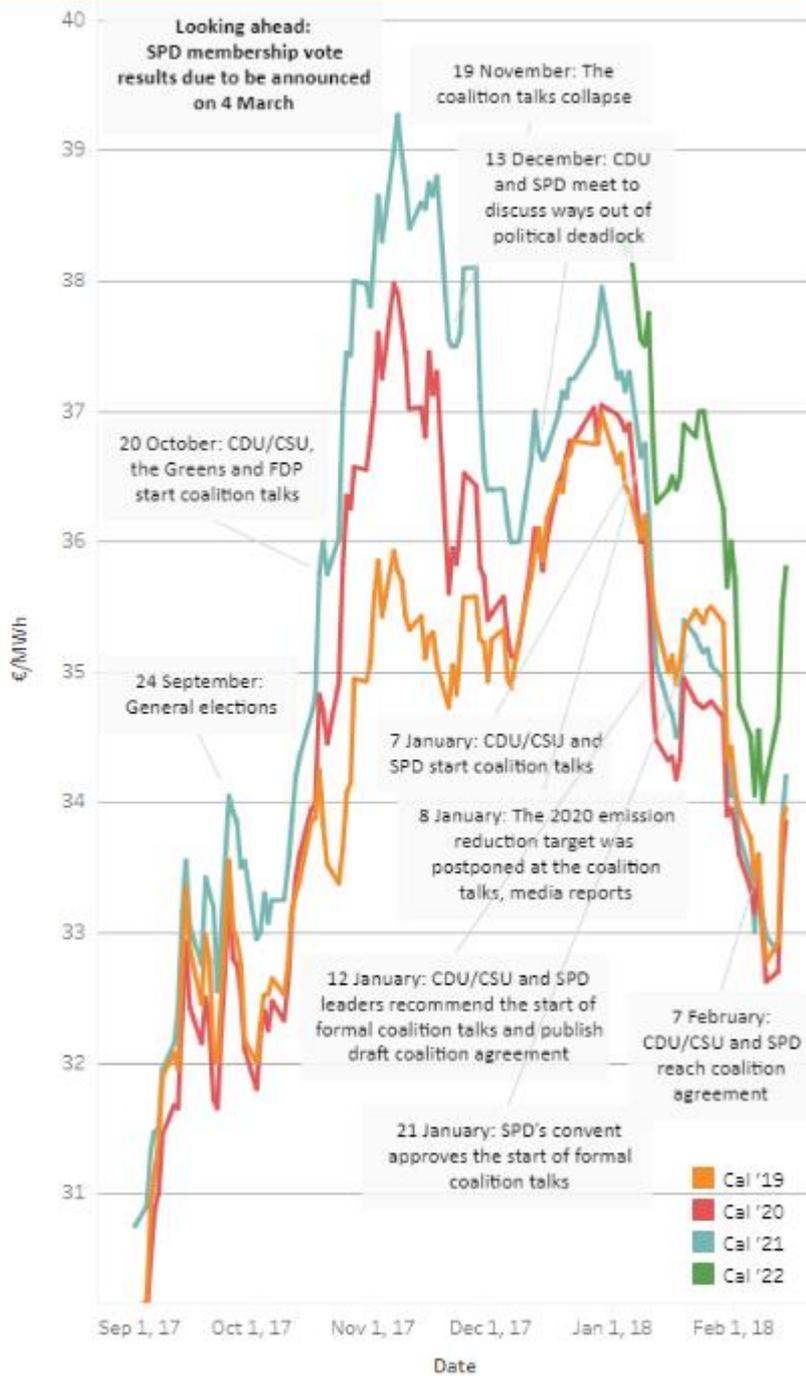
- To determine by 2019 how Germany will phase out coal-fired power generation, and by when
- To tender additional renewables capacity – 4GW solar, 4GW onshore wind and an additional offshore wind park – which should be built in 2019-2020

The price impact is difficult to determine – not only because renewables would be bearish and coal closures bullish – but also due to timing uncertainty.

Germany needs to reduce coal-fired generation to meet its 2020 emission reduction target, but the upcoming coalition has indicated the target could be missed. It has at least pledged to reduce the gap to the target by "as much as possible".

The coalition plans to set up a committee involving several stakeholders to decide on coal phase-out measures and the timeline. "I doubt anything will happen until 2020," Bernd Tersteegen, principal at consultancy Consentec said of the timeline.

German coalition talks affecting annual power contracts



Source: ICIS

* Cal '22 assessed since the start of 2018

Other factors

Additional renewables capacity might not be built as quickly as the coalition plans. The strain renewable power is putting on the German grid also limits the expansion rate. The additional capacity could come online around 2021-22, expert commentary indicates.

Besides, although another CDU/SCU-SPD coalition is likely, some sources think SPD members may still block it. The party was previously against continuing in a coalition with CDU/CSU.

A range of other factors also need to be taken into account when pricing the far curve, including:

- The already approved nuclear phase-out
- Germany's lignite reserve
- The backwardation of annual coal contracts
- The expectation of higher carbon prices
- An uncertain onshore wind expansion outlook following the success of citizen energy projects at 2017 tenders
- Possible thermal plant closures due to low profitability.

Price modelling

Analyst forecasts lean towards the very end of the curve being priced too low.

"I agree with the view that the current risk premiums are too low," Blazej Radomski, head of German analysis at consultancy Wattsight said.

A forecast by consultancy KYOS indicates the Cal '20 is quite fairly priced, but the Cal '22 is too low, its founder Cyriel de Jong said.

Further modelling by Team Consult suggests the same. Accounting for the nuclear phase-out, conventional capacity changes as reported by the regulator and renewables capacity growth in line with political targets, the Cal '22 should be about 6% above the Cal '20, which is in line with far-curve prices, Team Consult's senior consultant David Heinze said. But, when assuming the planned additional renewables tendering and an accelerated phase-out of 7GW of coal capacity – a compromise reached during the previous coalition talks with the Greens – the Cal '22 would be about 12% above the Cal '20, Team Consult's merit order model indicates.

"It seems that power contracts account for definite developments such as the nuclear phase-out, but not necessarily for uncertain changes such as an accelerated coal phase-out," Heinze said. laura.raus@icis.com