POSITION

Subject: FEBEG's reaction to FPS's consultation regarding specific values to be used for the IPC derogation

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FEBEG would like to thank FPS Economy for the public consultation on the concrete values that will be used in the methodology for obtaining an individual derogation from the intermediate price cap[1]. We understand that this consultation has been organised following our comments to the consultation regarding the adaptation of the royal decree methodology of 28/04/2021[2].

The amendment concerns the determination of the concrete values for the required total return (i.e. the weighted average cost of capital and the required technology-specific additional return) for the purpose of the applications for exemption from auctioning in 2021, which can be submitted as of 16 July 2021 (Article 21).

Executive summary

There is no European requirement to use the average revenue instead of a median revenue for the determination of the expected revenues in the frame of an IPC derogation. **Therefore, there is no reason to align the methodology for the calculation of the missing money in the frame of an economic viability calculation for an adequacy assessment with the one in the frame of an IPC derogation,** especially as these aim at different purposes, have different prerequisites and different assessments. **Febeg considers that the median revenue should be used for assessment of the IPC derogation.**

Regarding the values proposed for the total required return, FEBEG considers that these are too low and should be increased. The premisses for the determination of the WACC and additional return are incomplete and/or flawed. It must also be underlined that the uncertainties on most of technologies (with investments or not) remains important, even in a CRM context as the reliance on merchant revenues and successive CRM contracts is very uncertain. These elements justify a higher total required return for an investment decision.

[1] https://economie.fgov.be/fr/themes/energie/securite-dapprovisionnement/mecanisme-de-remuneration-de/contexte-du-mecanisme-de - "Troisième consultation: valeurs"
The documents submitted for comments are a draft Royal Decree amending the Royal Decree of 28 April 2021 (https://economie.fgov.be/sites/default/files/Files/Energy/Ontwerp-KB-wijziging-KB-28042021-verwachte-inkomsten.pdf) & an explanation of the value to be used (https://economie.fgov.be/sites/default/files/Files/Energy/CRM-Toelichting-waarden-KB-wijziging-IPC-derogatie.pdf)

[2] https://economie.fgov.be/fr/themes/energie/securite-dapprovisionnement/mecanisme-de-remuneration-de/contexte-du-mecanisme-de - "Deuxième consultation: revenus attendus

Context

As mentioned in its previous contributions[3], FEBEG deplores the limited time given to market parties to react, but, more importantly, that the IPC derogation methodology is still not finalized at such a la stage. The absence of a clear 'design' on some key features of the CRM has a negative impact on the investment decisions as it raises concerns regarding the regulatory stability at this stage of the preparation for the first upcoming auction.

The consultation concerns the concrete values to be used for the total required return in the framework of the calculation of the missing money.

FEBEG also reiterates its general concerns regarding the IPC individual derogation procedure that has been put in place by the Belgian Authorities because it considers that the process and modalities are still not suitable to ensure a proper investment framework[4].

Comments on the methodology

Comments on the choice for the average revenues vs. P50 revenues

First we wish to underline that there is no requirement at European level to adopt the principles of the European adequacy methodology with respect to economic viability to the determination of the missing money in the frame of an IPC derogation.
On the contrary, FEBEG believes that the objective of these calculations is fundamentally different as the exercise in the frame of adequacy aims to verify the economic viability of an asset, while the calculation of the missing money in the frame of an IPC derogation should aims to assess the viability of an investment. Therefore, **the market parties should be able to assess themselves on which basis (methodology/hypothesis/scenarios) they will make an investment decision.**

FEBEG would like to remind that (i) Elia does not have the full competences to make such computation and that (ii) the computations are not verifiable/challengeable by market parties.

We hereafter provide the key drivers on investment decisions.

General considerations on investment decisions

The assessment of an investment decision is particularly complex given the important capex and time-horizons involved in the development of new assets or refurbishment of existing assets in electricity markets. Such a decision is usually relying on a broad range of models, scenarios and criteria.

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[3] FEBEG reaction to the IPC derogation consultation (dd. 03/06/2021)
[4] Extended comments on the individual derogation procedure can be found in our previous contribution

As the development of new assets in electricity markets require large upfront costs and cover long payback periods (>20 years) which is beyond the liquidity horizon of forward markets (< 3 years), investors clearly need a solid business case to approve such a financial commitment.

The standard industry practice is to consider a set of market scenarios and to evaluate the distribution of revenues and costs over the economic lifetime of the asset considered (e.g. CCGT covers approximately 20-25 years). Such an analysis aims to compute a distribution of expected gross margins over this lifetime. Depending on whether these margins are covering the fixed and investment costs, a new investment can be approved. This is also the case for investments to be performed on existing assets.

Integral parts of such an analysis are

(i) expected prices and revenues on the electricity markets, based on market fundamentals;

(ii) the likely consequences of policy decisions (e.g. the energy transition); and

(iii) the impact of the market design.

Such analysis also includes the possibility of price spikes. However, given the uncertainty and infrequency of such price spikes, they are heavily discounted in any such assessment.

When making an investment decision, investors will rely on a 'most likely' scenario rather than averaging results of many scenarios, many of which are extreme and unlikely. The median value will therefore reflect market player decisions better than an average and is more appropriate for the purpose of this exercise. FEBEG refers for its additional comments on the matter made in the frame of the previous consultation organized by the FPS Economy[5].

The whole point of the CRM is to give investors a stable revenue because, as observed in Europe in the last years, the market participants will not be investing in centralized power generation without a certain degree of certainty related to the revenues given the long lifetime of the assets and high degree of risks due to the fast evolution of the market. Moving from a median to an average is negating the fact that the investors in the energy sector have a need for certain or likely revenues more than less likely, higher revenues.

[5] FEBEG reaction to the IPC derogation consultation (03/06/2021)

Comments regarding the values proposed for the total required return

In general, considering the above elements, FEBEG believes that the figures put forward for the required rate of return based on Professor Boudt's study[6] are insufficient in order to reflect correctly the values that a market party would consider in the framework of an investment decision.

Regarding the WACC

With regards to the WACC, it is a value that market parties should be able to choose according to the company profile and its risk management policy. In general, **the WACC of 5,53% is too low compared to sector practices.**

FEBEG has analysed the report of Professor Boudt. Different specific elements regarding the proposed WACC calculation can be pointed out and should be properly addressed:

- The ACER methodology[7], basis of the methodology used by Professor Boudt, proposes a **differentiated WACC by technology** when appropriate, which is not the case here, while technologies and associated risks are quite different.
- The **risk free rate and equity premium do not seem to be considered at a same timing**, as they seem to come from different sources, while these are two elements which have an impact on each other. These elements should thus come from a single source, assessing both elements at the same moment in time.
- In addition, the **equity beta is coming from a dataset of only two companies** (ENGIE, ENI) and is therefore not representative. Moreover, using ENGIE as a reference is not correct as this company has a wide portfolio of activities with different risk profiles. This can not be reduced to electricity generation only. The same applies to ENI, which is mainly an oil and gas company rather than an electricity producer. Therefore this beta should not be used for this purpose. The beta should be higher for this type of investment.
- Finally, it is unclear where the gearing of 40% assumption comes from. On existing assets, it seems extremely unlikely to get external financing due to the re-contracting risk (consecutive one-year contracts). The gearing should therefore be zero for assets having only one-year contracts.

[6] Accounting for model, policy and downside risk in the economic viability assessment of investments in electricity capacity: The hurdle rate approach, Professor Boudt, 2021

[7] Methodology for the European resource adequacy assessment, ACER, 2020

Regarding the additional return

With regards to the additional return, we understand that the results for the technologies included in Professor Boudt's study were also extrapolated to a wider list of other technologies, mainly on the basis of their place in the merit order.

It is important to bear in mind that some technologies, next to CRM revenues, will still depend on merchant revenues in order to remain profitable. In addition, participants may participate in the T-4 auction and ask a derogation at that moment with an incomplete view on the market and its future evolutions (RES penetration, uptake of new technologies, etc.). Additionally, as mentioned by the FPS Economy in the consultation's documents, technologies requesting an IPC derogation will have to rely on successive yearly contracts in order to fully recover their investments. Finally, the participation to the CRM as such also brings financial risks (e.g. payback obligation on unearned revenues, penalties in case of outages on an installation, etc.).

For these reasons, the uncertainty on most of technologies (with investments or not) remains important, even in a CRM context: (i) reliance on merchant revenues, (ii) reliance on successive CRM contracts and (iii) participation in an auction organized before the delivery year. Furthermore, if the computation of the revenues by Elia is overly optimistic, which FEBEG considers it will be the case (see comments above on the median/P50 vs. average revenues), **a required return higher than the ones currently proposed need to be taken into account.**

In addition, FEBEG does not agree with the fact that the proposed additional required of return for DSM is a lot higher than many other technologies. First, the capex is very limited for the participation of the DSM to the electricity market. Second, most of these technologies will primarily or even solely rely on CRM revenues, making their risk very limited. The 7,5% proposed value is thus certainly not appropriate in comparison with other capex-intensive technologies such as CCGTs.

Finally, it is unclear how the artificial split of investment below and above 3y has been made. FEBEG proposes to introduce a linear value for the additional required return. Having only 2 categories for investments with lifetime below or after 3y can be limiting in some situations.