An Electricity Price Modeling Framework for Renewable-Dominant Markets

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Abstract
Renewables introduce new weather-induced patterns and risks for market participants active in the energy commodity sector. We present a flexible framework for power spot prices that is capable of incorporating a weather model for the joint distribution of local weather conditions. This not only allows us to make use of a long history of local weather data in the calibration procedure but also makes it possible to assess how changes in the renewable generation portfolio impact the characteristics of future wholesale spot prices. Empirical tests demonstrate the model's capability to reproduce salient features of market variables. We furthermore show why our model offers unique benefits for market players compared to existing approaches.
Abstract

Renewables introduce new weather-induced patterns and risks for market participants active in the energy commodity sector. We present a flexible framework for power spot prices that is capable of incorporating a weather model for the joint distribution of local weather conditions. This not only allows us to make use of a long history of local weather data in the calibration procedure but also makes it possible to assess how changes in the renewable generation portfolio impact the characteristics of future wholesale spot prices. Empirical tests demonstrate the model’s capability to reproduce salient features of market variables. We furthermore show why our model offers unique benefits for market players compared to existing approaches.

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1 Introduction

State-of-the-art energy commodity models rely on well-established reduced-form approaches from the fixed-income literature; yet the transition to a low-carbon economy gives birth to renewable-dominant electricity markets and weather risk advances to a major risk factor. Meteorological studies provide concise and reliable information on weather data and have put forth powerful tools for modeling and understanding weather dynamics. Our contribution is to combine these insights and develop a new electricity price model that uses local weather conditions and the spatial distribution of renewable assets to model dynamics in wholesale electricity prices.

There are two main ingredients in the model. First, we rely on a suitable approach to model electricity prices. Instead of using reduced-form approaches that refrain from explicitly modeling fundamental supply and demand factors we take advantage of hybrid structural models. They allow us to incorporate the drivers of the supply side and consequently permit power prices to directly depend on weather conditions. Second, we model the temporal as well as spatial distribution of wind speed and solar irradiation, map these local weather conditions to electricity production, and incorporate the renewable electricity supply in our hybrid structural model. We show that this two-step specification has clear advantages in times of deep structural changes, which potentially render most parts of the historical price data obsolete.

The major strength of our stochastic price model is its ability to guide investment decisions, the assessment of hedging strategies, or policy decisions in a rapidly changing market environment. A natural first application is to study the quantitative impact of the local distribution of renewable generation capacities on the risk characteristics of power prices. Such an analysis should not only provide important insights on the potential future impact of the fast growing amount of renewable generation technology from a regulatory point of view but might be of interest for many other stakeholders in the electricity sector from owners of conventional power plants to potential investors in wind parks or solar farms at different locations.

Generally, stochastic price models allow market participants to calculate risk measures, to price certain risks and assets, or to deduct reasonable hedging strategies. By now, power prices require different modeling techniques than other energy commodities such as crude oil or natural gas for which established reduced-form approaches from the fixed-income literature have been shown to work quite satisfactory (e.g. Trolle and Schwartz [2009], Brooks and Prokopczuk [2013], or Hain, Uhrig-Homburg, and Unger [2016]). First, electricity markets are usually much more local in nature due to the fact that storing the
commodity is mostly impossible and thus, power has to be produced to match local demand exactly in every instant. Paired with mostly price-inelastic demand this makes wholesale prices very sensitive to shocks in fundamentals such as unexpected weather changes or supply disruptions. These characteristics have prompted researchers to look into pricing models that consider the interaction of major supply- and demand factors and wholesale prices (e.g. Barlow [2002] or Coulon and Howison [2009]).

Second, once we add renewables to the equation things become even more complicated. Electricity generation from wind and solar power is itself highly sensitive to local weather conditions. Also, and in strong contrast to conventional power plants, the spatial distribution of installed renewable capacity has a considerable impact on the characteristics of market-wide renewable power production. Compare, for example, a scenario in which all available renewable capacity is clustered within one single location with a more diversified scheme. Conditional on the joint distribution of local weather variables production in the former case is potentially much more volatile. This special “localness”-characteristic of wind and solar power complicates projections with regard to how wholesale prices react to capacity additions at different locations. And with renewable generation becoming more and more economically feasible, its share to total power production will almost surely continue to rise.

Our flexible approach is able to deal with the above challenges. Given that energy systems worldwide are entering a phase of transformation our approach may prove its benefits in a variety of electricity markets around the world. In this paper we detail the implementations for the German market: Germany has grown to the leader of power generation out of renewable energy sources among large industrial nations (Bloomberg [2016]), its electricity market currently represents the one with the largest share of wind and solar power, and Germany has set very ambitious targets to further cut emissions drastically. So there is still much change ahead.

First and foremost, our research contributes to the field of electricity price modeling by proposing a methodology capable of incorporating renewables. While several approaches incorporate renewables as exogenous variables for modeling wholesale power spot prices (e.g. Cludius, Hermann, Matthes, and Graichen [2014] or Kallabis, Pape, and Weber [2016]) studies that explicitly model the stochasticity from renewable generation and incorporate it within a power price modeling framework are rather scarce. Keles, Genoese, Moest, Ortlieb, and Fichtner [2013] use a regression-based approach to incorporate global wind power generation within a regime-switching model for electricity spot prices. Perhaps closest to our approach is the residual demand framework by Wagner [2014], which considers weather-driven demand and both market-wide wind and solar power production. Since direct modeling of wind and solar power completely ignores the spatial distribution
and dynamic variations thereof, Wagner’s residual demand framework cannot distinguish between the potentially different impact of capacity additions at distinct locations. We therefore choose to model the local constituents forming the market-wide renewable generation. Intuitively, this can be seen as applying the basic idea behind structural price models for electricity markets recursively by additionally modeling the driving forces behind local renewable production which in turn drive wholesale electricity prices - an approach which we label the “Second-Layer Hybrid Structural model” (SLHS model in short). A major advantage of our SLHS-modeling approach is the disentangling of the various drivers of wholesale electricity prices (demand, installed capacity, wind speed, solar irradiation) making it possible to calibrate part of our model to a rich history of weather data (over 20 years of local hourly weather variables). This is advantageous because there is only a relatively short history of renewable generation available and the potential impact of changes in the spatial distribution is captured naturally in our case while existing approaches can at best account for an absolute increase in installed capacity and might be misleading if the spatial distribution changes once again. Empirical tests furthermore demonstrate that our methodology is well capable of reproducing salient features in the time series of renewable production and wholesale day-ahead spot prices in Germany.

Our work is also related to the strand of literature analyzing the impact of renewable generation on wholesale electricity prices. Early work mostly considers how the average price level is affected (e.g. Jacobsen and Zvingilaite [2010] or Paraschiv, Erni, and Pietsch [2014]) whereas in more recent studies additional focus is put on price volatility as well (e.g. Jonsson, Pinson, and Madsen [2014], Ketterer [2014], or Wozabal, Graf, and Hirschmann [2016]). All of the above studies rely on historical observations of aggregate renewable generation and spot prices entirely. However, as pointed out above, we cannot be sure how an increase of renewable capacity at different locations translates into the volatility of wholesale electricity prices. Our model could therefore help in fostering the understanding of this largely unexplored characteristic and may be used as a smart extrapolation tool to assess such impacts quantitatively.

Finally, our study is linked to the literature dealing with the assessment of site potential when faced with the difficult decision of choosing an optimal location for new physical assets. While Ritter, Shen, Cabrera, Odening, and Deckert [2015] and Pieralli, Ritter, and Odening [2015] outline potential issues with using idealized production curves for assessing wind power production potential, Grothe and Muesgens [2013] and Ritter and Deckert [2016] discuss spatial differences of revenues from wind parks. All of the above studies remain silent with regard to the associated revenue uncertainty of specific sites. Also, as these studies rely on historical bootstrapping methods they are not well suited to validate how alterations to the renewable generation portfolio (or other important
market variables) translate into the risk characteristics of different sites. In contrast, our methodology could help investors to form a better understanding of potential risks and returns associated with renewable energy projects without being purely backward-looking.

The structure of this chapter is as follows. Section 2 introduces our general modeling framework, whereas Section 3 gives details on how our approach allows us to incorporate a model for the joint distribution of weather variables. Section 4 then looks at other model components on the demand and supply side while Section 5 discusses possible model extensions. Section 6 entails an analysis of the model’s capability of reproducing salient features of important market variables and furthermore contains examples of how market participants can benefit from using our model. Section 7 concludes.

2 A Residual Demand Approach with Local Information

This section entails a detailed discussion of our chosen modeling framework. We briefly discuss how our model connects with various existing streams of modeling approaches and then show why and how we seek to introduce local information with regard to weather conditions and installed capacity into the framework.

2.1 Hybrid Structural Price Modeling

Modeling approaches for electricity prices can broadly be separated into two categories. On the one side of the spectrum are approaches which heavily borrow from reduced-form models from equity- or interest-rate markets. Early studies use low-dimensional stochastic processes to capture patterns such as mean-reversion and seasonality (Lucia and Schwartz [2002]). In order to capture pronounced price spikes, unmatched in other commodity markets, Deng [2000], Cartea and Figueroa [2005], Geman and Roncoroni [2006], Seifert and Uhrig-Homburg [2007] or Hambly, Howison, and Kluge [2009] consider variations of jump processes. Although these models generally share nice properties such as closed-form pricing formulas for derivatives, they are often difficult to use in the rapidly changing electricity markets. For instance, changes in fundamentals (e.g. new large consumers (demand-side) or producers (new wind capacity)) can render historical price data completely useless in extreme cases. Also, since power exchanges’ liquidity of option contracts is usually very thin there is generally no reliable forward-looking information
with regard to higher-moment price risk to look at in order to re-calibrate a reduced-form model.\footnote{Although future contracts tend to be very liquid in European power markets, they usually carry not much information with regard to volatility risk.}

The other extreme consists of so-called structural production cost models. In these approaches wholesale market clearing prices result from a cost minimization problem in which demand must be satisfied under certain side restrictions such as transmission constraints (Eydeland and Wolyniec [2003]). The approach requires very detailed information on technical peculiarities of power plants or environmental constraints of the whole power market in question. A significant drawback is the fact that such models generally only make predictions on expected price levels and do not allow inference on higher moment price risks. This disqualifies them as a viable tool for risk management purposes such as hedging. Still, the approach reveals how fundamental factors drive market prices and has therefore served as inspiration for the development of the hybrid structural models.

Hybrid structural models lie somewhere in between the two above categories - basically resulting from a trade-off between analytical tractability and the degree of granularity with which specific market characteristics are captured. As opposed to reduced-form approaches that try to grasp how prices move this model class looks beyond prices and asks why prices move in the first place (Eydeland and Wolyniec [2003]). Key fundamental factors driving prices consist of market-wide demand or supply-side variables related to the cost or availability of generation capacities. For instance, a more volatile demand process usually results in larger swings in wholesale spot prices. In electricity markets dominated by renewable generation, such as Norway, Spain, or Germany, weather variables can play a major role for the characteristics of available power generation over time. The stochasticity of such factors can then be captured by well-established reduced-form modeling approaches of the financial literature. Existing hybrid models range from slightly altered reduced-form models (e.g. Eydeland and Wolyniec [2003] or Cartea, Figueroa, and German [2009]) to more involved modeling frameworks varying in the number of fundamental factors considered and the kind of information being used for calibration (e.g. Burger, Klar, Mueller, and Schindlmayr [2004], Coulon and Howison [2009], Aid, Campi, and Langrene [2013], Füss, Mahringer, and Prokopczuk [2015], or Ziel and Steinert [2016]). Nevertheless, studies taking renewable generation into account are still scarce. Keles, Genoese, Moest, Ortlieb, and Fichtner [2013] proposes a methodology to incorporate wind power and solar generation in reduced-form model whereas Cludius, Hermann, Matthes, and Graichen [2014] include these as an exogenous variable in a structural model. Wagner [2014] uses a residual demand framework and explicitly models the uncertainty of solar and wind generation as additional fundamental factors. Note however, that the
above approaches neglect the spatial distribution of the renewable generation portfolio completely.

As hybrid structural models seem to be best suited to match our purposes we pursue a residual demand approach similar to Wagner [2014] in which renewable electricity production is fed into the system with priority. The basic intuition behind such a model lies in the fact that conventional generators satisfy the corresponding (inelastic) demand in hour $t$ which has been adjusted by the uncertain amount of renewable generation $re_t$ in the system. Figure 1 shows the relationship between spot prices during peak and offpeak hours with both demand $d_t$ as well as residual demand $\hat{d}_t = d_t - re_t$. As expected, the figures show that given a level of raw demand $d_t$ there is still considerable variation in wholesale spot prices $s_t$. This variations (along the y-axis) are clearly reduced if we instead consider residual demand $\hat{d}_t$. Also note that for offpeak hours there are many cases of very low and even negative spot prices whereas demand was not even exceptionally low. A direct comparison with the residual demand - spot price relationship shows that these low prices were in fact caused by exceptionally large production levels from renewables. This shows that in a market with a significant presence of renewables such as Germany a modeling approach for wholesale electricity prices should account for the stochasticity from renewables. This leads us to the first building block of the modeling framework.

**Model Component 2.1** The model for hourly wholesale day-ahead spot prices $s_t$ is

$$ s_t = f_t(\hat{d}_t) + \sigma_t $$

$$ \hat{d}_t = d_t - re_t $$

where

- $f_t$ corresponds to the supply curve function, and
- $\sigma_t$ is a residual volatility process.

The supply function $f_t$ thus maps the current inelastic demand to a respective hourly day-ahead spot price $s_t$. This curve basically results from an auction which orders the generators according to their bids. Generators offer their generating capacities at marginal costs and market-wide inelastic residual demand $\hat{d}_t$ determines the intersection with the supply curve and with it the resulting market clearing price. $\sigma_t$ is an error term accounting for randomness unexplained by the structural modeling framework such as capacity outages or transmission issues.

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Because the feed-in of wind/solar is basically free of marginal cost, we assume their generation bids to be accepted on the wholesale market independent from wholesale market prices (which is true, unless very negative prices occur).
Figure 1: Empirical relationship between load, residual load, and spot prices
The figure depicts the relationship between load and spot price (top two figures) as well as between residual load and spot price for peak- and offpeak hours. Data source is the EEX-transparency plattform and ranges from January 2010 to mid 2014. Peakload hours correspond to all hours within 8 am to 20 pm whereas offpeak hours correspond to the remaining ones.

2.2 Localizing Renewable Generation: The Second-Layer Hybrid Structural Price Model

Why is localizing the renewable generation important? In a rapidly changing market environment market participants need to be capable of assessing the impact of capacity additions at some given location. Existing approaches may run into difficulties if there has not been any installed renewable capacity at the given location before or a historical track record of (local) renewable production is not available, which is usually the norm. Deducing the impact from the historical (aggregate) renewable generation process can thus be fatally flawed (out-of-sample problem). Alterations to the renewable portfolio might also introduce difficulties if one tries to calibrate a model that solely considers the aggregate generation of the renewable technology. Fitting a single stochastic process to the aggregate wind (solar) power generation then might at least necessitate time-dependent parameters to accommodate for any changes happening over time (in-sample problem). To resolve these problems we do not model the aggregate generation of a specific renewable
technology directly but rather focus on its local constituents. This results in the following description of the second main model component:

**Model Component 2.2** *The model for the hourly renewable generation process $re_t$ is*

\[
re_t = \sum_{u \in U} re_t^u \\
re_t^u = \sum_{k \in K} g^{u,k}(y_t^{u,k})
\]

where

- $K$ is the set of different locations covering the market area,
- $U$ corresponds to the set of different renewable technologies in the market,
- $re_t^u$ is the technology specific aggregated generation,
- $g^{u,k}$ is the production curve mapping weather conditions to output (in MWh), and
- $y_t^{u,k}$ is the location- ($k$) and technology-specific ($u$) weather variable.

The approach thus incorporates the modeling of the distribution of local weather conditions and their corresponding mapping $g^{u,k}$ to local and with it market-wide generation of a certain renewable technology. In other words, we recursively adopt the basic idea behind hybrid structural modeling approaches on a “deeper” layer of model structure by asking “what drives the drivers of wholesale market prices?” We therefore label the approach “Second-Layer Hybrid Structural model” (SLSH model). Thus, instead of modeling the resulting process of renewable generation of various technologies directly, we instead choose to model the underlying drivers of renewable generation, the weather, and use suitable transformations to map from local weather conditions to aggregate output. Below we show how to estimate these mapping functions from local weather conditions. This allows us to incorporate a long history of weather data.

### 3 Making Weather Data Useful: Modeling Details and Estimation Strategy

Our model philosophy hinges on the idea of a “smart disentanglement” of major contributors of electricity production from renewable energy sources. These consist of local weather conditions on the one hand and the amount of local renewable generation technology on the other hand. Ongoing research in the field of meteorology has broadened our possibilities to better understand the dynamics of key weather variables. Most importantly, one can resort to publicly available comprehensive databases covering highly
detailed weather information. Similarly, information with regard to the geographical locations of renewable power plants across market areas is usually publicly available with reasonable temporal frequency as well.

Figure 2 showcases publicly available market-wide renewable production data for solar (bottom) and wind (top) for the case of the German power market from late 2009 to 2014. Clearly, time series properties are very different for the two technologies considered which proves us right to model power production from wind and solar separately. It is also apparent that renewable production has experienced considerable growth over the last few years indicated by a clear trend in average yearly production volumes. The question is now why one should refrain from modeling these aggregates directly. First, one is left with a relatively short period of data to calibrate model parameters. Second, such a modeling approach is completely blind for any spatial variations in the renewable generation portfolio, potentially necessitating time-dependent parameters. And third, one basically skips a large amount of weather data which could otherwise be of use in the calibration procedure.
In order to bypass these issues and to make use of weather data with a high spatial resolution this section showcases our new empirically-driven approach to estimate the mapping functions $g^{u,k}(.)$ from aggregated production data and corresponding weather variables.

### 3.1 Weather Data

Obtaining a time series of wind speed and solar irradiation with a sufficiently high spatial as well as temporal resolution is usually very difficult. For once, meteorological stations tend to be situated near airports and thus one is usually left with large gaps in geographical coverage (Rose and Apt [2015]). We therefore opt for reanalysis data that are based on a mix of meteorological observations as well as model-based interpolations in space and time offering a rich history (usually up to several decades) and very high spatial granularity.$^{3}$

For our analysis we use a historical time series of solar irradiation as well as wind speed at 120 m above ground supplied by Anemos [2016]. The data is generated through downscaling of reanalysis data from the NASA program Modern-Era Retrospective Analysis for Research and Applications (MERRA) applying the Mesoscale Model MM5 PSU/NCAR [2016]. It offers a temporal resolution of 10 minutes (spanning from 1990 to 2012) and a spatial resolution of 20km x 20km.$^{4}$ For simplicity, we divide the German market area into a grid of 100 $\times$ 100 km areas resulting in $K = 38$ weather cells (see Figure 3) for which we compute hourly averages. Our choice of the spatial resolution is mostly motivated by the fact that we want to limit the computational burden in the estimation and scenario generation of our weather model later on. The choice of the temporal resolution appears reasonable, as most other variables of interest (e.g. demand or day-ahead spot prices) are of hourly frequency as well. Note that our weather grid also entails two offshore regions in the North Sea as well as the Baltic allowing the incorporation of wind power generation at offshore sites.

### 3.2 The Renewable Generation Portfolio and Production Curves

The missing link to incorporate the large panel data set of weather variables into our modeling framework now lies in the specification and estimation of the production curve

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$^{3}$Although Rose and Apt [2015] have expressed some concerns and demonstrated the presence of a small bias for reanalysis data in the US we have yet to find any better alternative that allows for such high granularity, both in the temporal as well as in the spatial dimension.

$^{4}$A detailed comparison between the model’s irradiation data and measurements from weather stations is done by Schermeyer, Bertsch, and Fichtner [2014].
functions $g^{u,k}(\cdot)$. One approach is to set these functions exogenously by making use of production curves. However, such published relationships usually only hold under idealized conditions and numerous studies document substantial bias and deviations from empirical production curves published by manufacturers (e.g. Pieralli, Ritter, and Odening [2015] or Ritter, Shen, Cabrera, Odening, and Deckert [2015]). Furthermore, using such power curves would furthermore require the consideration of wind direction and angle of solar irradiation which would add another layer of complexity to our weather modeling framework.\textsuperscript{5} As a result, we opt for a more empirically-driven approach by looking at observable aggregates of renewable generation across several weather cells. We then use these aggregates to calibrate a representative production curve $g^{u,k}(\cdot)$ for the respective candidate weather cells by using the times series of suitably weighted local weather conditions as input variables. Before going into the details of how the production curves are estimated, however, we discuss two key ingredients in our calibration procedure: (1) the dynamics of the spatial configuration of the renewable generation portfolio and (2) the time series of observable aggregates of renewable generation:

(1) Capturing developments in the spatial configuration of renewable power plants over time is an integral part of our modeling approach. EnergyMap [2016] tracks the exact amount and geographical locations of renewable generation capacities on a monthly basis. Since there are more than 1.5 million renewable energy plants in Germany (Bundesnetzagentur [2015]), we have to simplify this diversity and aggregate the installed capacity. We allocate the capacity of wind and solar generators to one of our $K = 38$ weather

\textsuperscript{5}We actually tested a simplified approach using power curves of turbines most often sold and installed in the German market area. However, as expected we ended up with a substantial positive bias in generated output when comparing model-implied with observed values.
Figure 4: Balancing-areas in the German power market

The figure visualizes the separation of the German market area into four distinct balancing-areas (source: Netzentwicklungsplan [2017]): 50Hertz, TenneT, Amprion, as well as TransnetBW.

cells according to monthly values from EnergyMap [2016]. To arrive at hourly values we then linearly interpolate between adjacent monthly values for installed capacity. For simplicity, we furthermore refrain from accounting for any renewable generation located in Austria as the amount of renewable capacities is very small compared to Germany. This results in a multivariate hourly time series of installed wind and solar power from 2010 to 2014 for each of our weather cells.

(2) Ideally, one would like to use a time series of renewable generation for every location considered to estimate a corresponding production curve. Unfortunately, such data does not exist for most markets and the German one is no exception in this regard. What we do observe is the aggregate renewable generation for four so-called “balancing-areas” though. There are four of such areas which, taken together, form the complete German

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6 Due to the fact that the extraction of geographical locations from EnergyMap [2016] is relatively time consuming, we started off with a yearly updated dataset for each technology and use linear interpolation in between adjacent years. This should capture potential rapid growth happening throughout the year for the most part.

7 Note that the German and Austrian power grid actually belong to one market area.

8 Note that there are studies making use of proprietary data sets for specific wind parks (e.g. Ritter, Shen, Cabrera, Odening, and Deckert [2015]). Nevertheless, even if we had access to several such data sets this would not be sufficient for our purpose as we require information regarding generated power from wind and solar for each of our weather cells which are unlikely to exist.
market area and which incorporate all 38 weather cells in our modeling framework. Figure 4 shows these four balancing-areas. Data is provided by EEX [2016] and leads to hourly wind and power generation for each of these four balancing-areas from 2010 to 2014.\textsuperscript{9}

To finally estimate representative production curves for the renewable power plants we have to incorporate local weather data. We consequently make use of a panel set of hourly wind speed and solar irradiation for each of the $k \in K$ weather cells for the respective time frame.\textsuperscript{10} In order to estimate a representative curve for each balancing area we have to specify how the set of input variables (weather) is aggregated when held against the output variable (aggregate renewable production). A straightforward approach could consist in averaging respective weather variables included.

However, this neglects the fact that the amount of installed renewable generation capacity of each weather cell contained within the respective balancing-area is not necessarily identical. The relative contribution to renewable production in a given balancing area tends to be larger for cells with a larger amount of renewable power plants. Obviously, this renders the weather conditions of these cells more important, too. Furthermore, the local amount of installed capacity might change throughout the year and thus result in sudden changes of renewable production within certain weather cells. To cover the above effects we assign weights normalized by the overall installed capacity of a certain technology in

\textsuperscript{9}Note that we expect to incur some error by allocating renewable generation assets to the nearest weather cell in terms of geographical distance as this does not guarantee that it matches with the affiliation to a respective balancing area.

\textsuperscript{10}Unfortunately, our weather data set ends in 2012. Therefore, we are unable to make use of data with regard to renewable production and the installed capacity in the years 2013 and 2014 for the estimation of production curves.
a certain balancing-area $TR_n$, $n = 1, \ldots, 4$ to form representative input variables:

$$\omega_{u,k} = \frac{cap_{u,k}^t}{\sum_{k \in TR_n} cap_{u,k}^t}$$

$cap_{u,k}^t$ is the installed capacity (in MW) of technology $u$ in location $k$ at hour $t$. Using these weights we compute a representative (balancing-area-specific) weather variable for hour $t$ in balancing-area $TR_n$:

$$z_{u,n}^t = \sum_{k \in TR_n} y_{t}^{u,k} \omega_{t}^{u,k}$$

Finally, these variables can be used to estimate the relationship $g_{u,n}(.)$ between balancing-area related renewable generation $re_{u,n}^t$ of technology $u$ and $z_{u,n}^t$.

Motivated by technology specific shapes of production curves indicated by Figure 5, we use a logistic function for the case of wind and a second-order polynomial for solar. We then estimate the respective parameter vector $\Theta_{u,n}$ of technology $u$ of region $n$ by means of the following minimization:

$$\min_{\Theta_{u,n}} \sum_{t \in T} (\hat{re}_{u,n}^t - \hat{g}_{u,n}^t(z_{u,n}^t, \Theta_{u,n}))^2$$

where both $g(.)_{u,n}$ as well as $re_t$ have been normalized by the sum of total installed capacity $\sum_{k \in TR_n} cap_{u,k}^t$, resulting in hourly efficiency rates $\hat{re}$ and $\hat{g}$. Using these estimated production shapes then allows us to infer local production conditional on local weather conditions and installed capacities.

Figure 6 highlights the estimated production curves for wind and solar of the Tennet balancing-area, justifying our choice of a logistic and second order polynomial function.

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11 For the case of wind speed we additionally account for the fact that measurements are taken from 120 m whereas hub heights of turbines might vary. We therefore extrapolate to the average hub height of wind turbines in each weather cell by using the power law which is common practice in literature (e.g. see Brown, Katz, and Murphy [1984]):

$$y' = y \left( \frac{z}{h} \right)^\alpha$$

where $y'$ ($y$) corresponds to the wind speed at hubheight $z$ (height of measurement $h$), and $\alpha$ being the shear coefficient ($\alpha = 0.085$).

12 Although the power curve of solar is mostly linear in irradiation levels, there is a slight decrease of efficiency for higher levels of irradiation. Solar-panel efficiency is partly reduced by higher temperatures which happens to be correlated with overall irradiation levels.

13 As expected, the second-order polynomial turns out to be significant and negative for the case of all solar production curves, resulting in deviations from the otherwise linear relationship for large levels of solar irradiation.
Figure 6: Empirical power curves

The two graphs visualize the dependency between the Tennet balancing-areas' weather variable $z_{t, n}^{u, n}$ and renewable generation for wind (left) as well as solar (right). The red line corresponds to the estimated power curves.

Figure 7: qq-plots of renewable generation

The two graphs depict qq-plots of observed vs. model-implied renewable generation for wind (left) and solar (right) in the TenneT balancing-area for 2012.

More details with regard to the parameterization of power curves and estimation results can be found in Appendix A. As indicated by the qq-plots in Figure 7 our model seems to be quite capable of capturing the distributional properties of balancing-area specific generation from wind. However, our methodology somehow fails to capture the very high peaks in solar production for some balancing-areas. Nevertheless, we obtain correlations of over 95% for model-implied and observed renewable production (for each of the four balancing-areas), giving indication for the soundness of the model.

Overall, our approach to model renewable generation production yields good results in terms of capturing time series properties of observable aggregates. More importantly, a separate modeling of the renewable generation portfolio and production curves from local weather risk makes our approach very flexible. For instance, we can calibrate weather models to a large history of more than two decades of local weather data. Once calibrated, we can also easily change the configuration of the renewable generation portfolio in order to assess its potential impact on market-wide renewable power production and with it on wholesale electricity spot prices.
3.3 Modeling Weather Risk

The last section proposed a methodology that is capable of using local weather conditions as input variables in a framework for market-wide renewable power generation. This effectively enables the researcher to model and calibrate weather risk separately by means of state-of-the-art econometric approaches.

Literature with regard to the modeling of the temporal dimension of wind speed and solar irradiation primarily makes use of autoregressive approaches and various extensions of it (e.g. Brown, Katz, and Murphy [1984], Mora-Lopez and Sidrach-De-Cardona [1998], Caporin and Pres [2012] or Alexandridis and Zapranis [2013]). There are furthermore studies focusing on the spatial distribution only. For instance, both Papaefthymiou and Kurowicka [2009] or Hagspiel, Papaemmanouil, Schmid, and Andersson [2012] make use of copulas in order to capture the local dependencies of wind speed at different locations in Germany. Approaches dealing with both dimensions are less numerous. Morales, Minguez, and Conejo [2009] and Papavasiliou and Oren [2011] both make use of vector autoregressive (VAR) models to capture the wind speed dynamics at various locations in the United States whereas Grothe and Schneiders [2011] combine autoregressive models with pair-copula constructions (PCC) in a similar setting for German wind speed data. We follow the latter stream of literature and choose a VAR structure for the joint distribution of the multivariate times series of wind speed and solar irradiation.\footnote{Although pair-wise copula constructions offer more flexibility to capture heterogeneity and asymmetries in dependence structures, their estimation and simulation of scenarios is more demanding from a computational point of view. As a result, we stick to the simpler VAR structure and leave an incorporation of copula theory in this regard for further research.} In what follows, we give a short overview of the general idea behind the modeling approach. We then look at stylized statistical features of wind speed and solar irradiation in our data set for Germany and discuss adjustments in the model specifications necessary to capture weather-specific characteristics (e.g. time-dependent volatility) for each case.

3.3.1 A General Multivariate Weather Model

Modeling weather data necessitates a description of serial and spatial correlation among different locations along with univariate peculiarities such as non-normality. In order to account for seasonal patterns we first remove region-specific trends $\mu_{u,k}^{t}$ which yields de-trended data $y_{u,k}^{t} := y_{u,k}^{t} - \mu_{u,k}^{t}$. To capture non-normality one undertakes a transformation by using the empirical distribution function of the de-trended time series resulting...
in approximately normally distributed weather variables $\hat{y}_{t}^{u,k}$:

$$\hat{y}_{t}^{u,k} = \Phi^{-1}\left[F_{u,k}\left[\hat{y}_{t}^{u,k}\right]\right] \tag{5}$$

where $\Phi^{-1}$ is the inverse cumulative distribution function of a standard normal random variable, and $F_{u,k}$ corresponds to the (empirical) cumulative distribution function of the original untransformed (but detrended) time series $\hat{y}_{t}^{u,k}$. Note that $F_{u,k}$ should correspond closely to the distribution function of the “true” data-generating process since we can resort to a large data set of a long history spanning 23 years of hourly observations. Since the transformation preserves the covariance structure of the weather variables (e.g. see Liu [1986]), we can model their corresponding joint distribution by means of a VAR-model of order $P$:

$$\hat{Y}_{t}^{u} = \sum_{p=1}^{P} \Psi^{p}\hat{Y}_{t-p}^{u} + U_{t}$$

with $\hat{Y}_{t}^{u}$ corresponding to a vector of observations of $\hat{y}_{t}^{u,k}$'s of all regions, $\Psi^{p}$ are coefficient matrices of dimension $K \times K$, and $U_{t}$ is an error-term following a multivariate normal distribution with a mean vector of zeros and covariance matrix $\Sigma^{u}$. The optimal length $P$ is decided upon by using the AIC, whereas coefficients along with covariance matrix $\Sigma^{u}$ are estimated by maximum likelihood. Henceforth, we are capable of capturing both site-specific peculiarities of the marginal distribution but on top of that can use the normally distributed transformed data to calibrate a VAR-model that allows us to capture serial and spatial correlation as well.

### 3.3.2 Peculiarities of Wind Speed and Solar Irradiation Dynamics

As expected, an analysis of weather variables in Germany reveals distinct seasonal patterns. Wind speed exhibits highly non-normal behavior with volatility being larger during autumn and winter seasons. Skewness and kurtosis varies across the year as well. Furthermore, there is much cross-sectional variation. For instance, wind speed in northern regions is larger on average and more volatile. To capture these aspects we augment the general specification by introducing a time-dependent site-specific volatility function $\sigma_{t}^{w,k}$ used as an additional normalization factor besides the trend-function $\mu_{t}^{w,k}$. We further-

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15Some studies impose parametric restrictions on the transform (for example, both Brown, Katz, and Murphy [1984] and Morales, Minguez, and Conejo [2009] use the Weibull distribution for wind speed). However, since we have access to a long history of data it makes more sense to directly make use of the observed empirical distribution function offering more flexibility in terms of capturing site-specific peculiarities. This also allows us to capture potential seasonality in higher moments by making the empirical distribution function time-dependent.
more allow the empirical distribution function $F_{w,k}^t$ to vary across seasons in order to account for time-variation in skewness and kurtosis.

Solar irradiation is behaving quite differently. First, seasonal patterns are much more pronounced: There is no sunshine throughout the night. Furthermore, average solar irradiation levels are ten times as high during summer season. Cross-sectional differences are much smaller if compared to the case of wind though. The absence of sunshine during night complicates the modeling of hourly irradiation levels by means of a VAR approach. Cloud formations have a considerable impact on the resulting solar irradiation and one is incapable of observing these during night time. Consequently, we are blind for any uncertainty that might affect the weather variables during the early morning hours. We therefore deviate from Morales, Minguez, and Conejo [2009] and loosely follow Wagner [2014] by instead modeling the daily maximum irradiation level $\tilde{y}_{s,k}^t$ and capture any intraday variation by means of a deterministic pattern function.

An inspection of qq-plots as well as autocorrelation- and crosscorrelation-functions reveals that the augmented modeling approaches are successful at explaining the dynamics of the considered weather variables. More details with regard to stylized characteristics of our weather data, model specifications, and goodness-of-fit tests can be found in Appendix B.

4 Conventional Supply and Demand Factors

4.1 Supply Function

A key ingredient for the model framework is how current market conditions such as demand, renewable generation, and production costs from conventional generation assets are translated into the market clearing spot price in the day-ahead market. In language of our model framework, this essentially means what kind of structure we impose on the supply function $f_t$ in (1). Existing modeling attempts for $f_t$ range from relatively simple approaches (e.g. Barlow [2002], Burger, Klar, Mueller, and Schindlmayr [2004], and Wagner [2014]) to more involved dynamic frameworks which also account for shifts in the supply function due to variations in different fuel prices (e.g. Coulon and Howison [2009], Coulon, Powell, and Sircar [2013]). Since the former approaches have been shown to work quite well and our primary goal lies in a quantitative assessment of weather risks which are mostly unrelated to global fuel prices we follow this stream of literature. $f_t(.)$ is therefore captured by means of a time-dependent deterministic function.

As can be seen in Figure 1 spot prices are non-linear in residual demand as such as they drop disproportionally if $\tilde{d}_t$ is low enough and vice versa. The relationships also seem to
be slightly different when one compares peak to offpeak hours. Apart from this, we are unable to detect other notable seasonal patterns. To capture this behavior, we use the following parametric specification:

\[ f_t(x) = h(x, c_t(x)) \]

\[ h(x, c_t(x)) = \begin{cases} 
  s_{\min}, & x \leq x_{\min} \\
  \min \left( s_{\max}, \max \left( s_{\min}, c_t(x) \right) \right), & x \in (x_{\min}, x_{\max}) \\
  s_{\max}, & x \geq x_{\max} \end{cases} \]

c_t(x) captures possible variations in the supply curves’ shape due to peak and offpeak hours:

\[ c_t(x) = \begin{cases} 
  \alpha_0 + \frac{1}{x-x_{\min}} + \alpha_2 \frac{1}{(x_{\max}-x)} + \alpha_3 x, & t \in T_{\text{peak}} \\
  \beta_0 + \frac{1}{x-x_{\min}} + \beta_2 \frac{1}{(x_{\max}-x)} + \beta_3 x, & t \in T_{\text{offpeak}} \end{cases} \]  

(6)

where \( T_{\text{peak}} \) and \( T_{\text{offpeak}} \) correspond to the set of time indices of peak and offpeak hours. Both the minimum and maximum wholesale price \( s_{\min} \) and \( s_{\max} \) as well as the minimum and maximum residual load values \( x_{\min} \) and \( x_{\max} \) are specified exogenously.\(^\text{16}\) The second and third term in both equations of (6) essentially capture the non-linear behavior for very low and high levels of residual demand \( \hat{d}_t \). Note that we deviate from the parametric structure proposed by Wagner [2014]. In his specification spot prices can basically only spike during peak hours or turn significantly negative (up to -3000 EUR/MWh) during offpeak hours. Although this might work well in-sample, we regard such an assumption as too restrictive if the model is used out-of-sample.\(^\text{17}\) We therefore opt for the above more flexible specification. Model parameters \( \Theta = (\alpha_0, \alpha_1, \alpha_2, \alpha_3, \beta_0, \beta_1, \beta_2, \beta_3) \) are estimated by minimizing the sum of squared residuals between observed spot prices and model prices \( f_t(\hat{d}_t, \Theta) \) for 2012-2014 from EEX [2016].\(^\text{18}\)

Figure 8 shows our estimate for peak and offpeak hours whereas Table 1 provides information on parameter estimates. We observe slight differences in shape for the different

\(^\text{16}\)The possible range for prices is set by the EEX (-3000 as well as 3000 EUR/MWh). The residual load boundaries \( x_{\min} \) and \( x_{\max} \) are taken from Wagner [2014] and amount to 10 GW and 85 GW. Basically, the minimum value can be interpreted as the lowest load the grid can handle without endangering system stability while \( x_{\max} \) corresponds to the total amount of conventional installed capacity. Note that the EEX recently changed the minimum price to -500 EUR/MWh.

\(^\text{17}\)For example, an analysis of alterations to the renewable generation portfolio might change weather-induced patterns considerably and thus even render negative prices during peak hours more likely.

\(^\text{18}\)Unfortunately, there was a gap in hourly demand data from 2009 to mid 2012 on EEX [2016].
Figure 8: Supply curves for peak and offpeak hours
The figure shows the estimated supply curves for peak (black) and offpeak hours (red).

Table 1: Parameter estimates of supply curves

<table>
<thead>
<tr>
<th>A. Peak</th>
<th>$\alpha_0$</th>
<th>$\alpha_1$</th>
<th>$\alpha_2$</th>
<th>$\alpha_3$</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>-5.9380</td>
<td>-87.7721</td>
<td>388.3926</td>
<td>0.8544</td>
</tr>
<tr>
<td></td>
<td>(3.0837)</td>
<td>(37.7970)*</td>
<td>(46.6999)***</td>
<td>(0.0679)***</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Offpeak</th>
<th>$\beta_0$</th>
<th>$\beta_1$</th>
<th>$\beta_2$</th>
<th>$\beta_3$</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-6.8700</td>
<td>-203.4332</td>
<td>478.0203</td>
<td>0.8035</td>
</tr>
<tr>
<td></td>
<td>(0.9795)***</td>
<td>(9.4439)***</td>
<td>(63.2105)***</td>
<td>(0.0469)***</td>
</tr>
</tbody>
</table>

The table shows parameter estimates and standard errors (in parantheses) for the supply curve functions in peak hours (Panel A) as well as for offpeak hours (Panel B). Estimates are obtained by non-linear least-squares (least-squares) for wind power (solar power). ***, **, and * denotes statistical significance at the 0.1%, 1%, and 5% level.

It seems that in contrast to earlier studies differences between peak and offpeak hours have decreased considerably (e.g. Burger, Klar, Mueller, and Schindlmayr [2004]).

Since our model does not account for all fundamental factors (e.g. power plant outages) or other aspects (e.g. market psychology) an inspection of the residual process $\sigma_t := f(\tilde{\delta}_t) - \delta_t$ seems warranted. Very similar to Burger, Klar, Mueller, and Schindlmayr [2004] we find that this process is mostly unrelated to fundamentals such as weather variables or demand. In order to make use of the model in risk management applications such as hedging or Value-at-Risk calculations it makes sense to capture this additional uncertainty as well. For instance, if weather-related risk such as wind power generation at

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\(^{19}\)All time series correlations are below 20 percent (in absolute terms).
a specific location is to be hedged with spot price derivatives, neglecting this additional (independent) source of risk would potentially bias hedging efficiencies. We therefore follow the rather practical approach by Burger, Klar, Mueller, and Schindlmayr [2004] and model the residuals $\sigma_t$ by means of a parsimonious time series model. The inspection of the $\sigma_t$ reveals both serial correlation at various lags as well as heteroscedasticity prompting us to choose an ARIMA process with GARCH noise.20

4.2 Demand

Demand can be seen as the major driver of price changes. It exhibits pronounced seasonal patterns on a yearly, weekly, as well as intra-daily basis.21 Modeling demand has been investigated in numerous studies (e.g. Weron [2006], Burger, Klar, Mueller, and Schindlmayr [2004], Coulon and Howison [2009], or Wagner [2014]) and is quite well understood. It has been shown that besides the need for a flexible trend function in order to capture the pronounced seasonality patterns demand also requires to capture serial dependencies justifying the use of ARIMA-type modeling approaches. We once again follow Burger, Klar, Mueller, and Schindlmayr [2004] and use an ARIMA-type model to capture autocorrelation and a deterministic trend function with dummies for hours, weekends, holidays and months based on hourly demand data from EEX [2016]. As in the aforementioned studies, the model does a good job at capturing the characteristics of temperature-driven market-wide demand.

5 Discussion of Model Extensions

Our parsimonious structural modeling framework obviously carries its limitations. We will therefore shortly look at its most severe drawbacks, how one could approach these, and in which cases these might be of minor importance.

Obviously, the deterministic supply function could be modeled in a more involved fashion. Variations in the shape of the curve are primarily caused by two factors: (1) power plant availability and (2) power generation costs. Unexpected technical issues can result in sudden shutdowns of conventional generation assets resulting in potential changes in the shape of the supply curve. Note that such impacts might be very different conditional on which kind of asset is affected by the outage. For instance, an outage of a large nuclear

20A more detailed discussion of the model for the residual volatility process $\sigma_t$ can be found in Appendix C.

21Please refer to Appendix D for a more detailed discussion of the modeling details and statistical properties of market-wide demand in Germany.
baseload plant with low marginal costs usually results in a shift of the whole curve to the left, affecting the price formation for all hours within a day. In contrast, an outage of a flexible smaller natural gas power plant is more likely to make the supply curve steeper in the right part of the supply function, thereby having a stronger impact on prices during peak hours. Given detailed data on “default rates” of the generation fleet of conventional assets one could model the aggregate plant availability over time and construct the supply function based on available assets at a given point in time. This would then render the supply function stochastic.

As power plant owners usually offer to produce electricity for prices close to their marginal costs, fuel prices are another potentially important driver of time variation in the supply function. Note that different parts of the supply function are driven by different fuel costs as well. At the moment, we capture any variation, unexplained by our choice of fundamental factors, by a residual volatility process $\sigma_t$. Given the fact that this process is assumed to be stationary our model lacks any long-term risks such as permanent changes in fuel prices. A geopolitical event (e.g. trade-war, military conflict,..) could then shift part of the supply function up- or downwards and result in a long-term average price shift. In a similar way, fluctuating CO2 emission prices could have an impact on the supply function as well.\footnote{As CO2 emissions vary across electricity generation technologies, the impact of changes in CO2 prices is not the same for different parts of the supply function.}

The above extensions necessitate a lot of highly detailed data on the conventional generation portfolio which might not always be available. Also, although long-term risks in terms of changes in fuel prices are not captured, the residual volatility component should at least be capable of covering short-term deviations attributable to outages to some extent. We therefore regard the limitations primarily relevant for market participants concerned with long-term prospects of market dynamics. An ad-hoc approach to accommodate for a current permanent shift in the supply function could be partly captured by an additional parameter in the Model Component 1:

$$s_t = f_t(\hat{d}_t) + \sigma_t + \delta$$

If permanent, such a shock should be reflected in traded forward-looking instruments. As a result, $\delta$ could then be estimated by means of long-maturity electricity futures, somewhat similar to the practice of yield curve fitting for spot-price models of the fixed-income literature. The price of such a contract is its expected value under the risk neutral
\[ f_t^e = E_t^Q \left[ \sum_{t \in T} s_t \right] = E_t^Q \left[ \sum_{t \in T} f_t(\hat{d}_t) + \sigma_t + \delta \right] = E_t^Q \left[ \sum_{t \in T} f_t(\hat{d}_t) \right] + \hat{\delta} \]

The second equality follows from the fact that the residual volatility process \( \sum_{t \in T} \sigma_t \) is zero in expectation and independent from other sources of considered risk factors. Using a calibrated version of the model could in turn be used to match observed futures prices by adjusting \( \hat{\delta} = \sum_{t \in T} \delta \) accordingly. Nevertheless, care has to be taken in the estimation of \( \delta \). First, futures contracts incorporate risk premia which need to be estimated beforehand (e.g. based on historical fundamental data and quotes on futures). Second, one has to make sure that the shift in average prices is not attributable to forward-looking changes in fundamentals on the demand- or supply-side.

Other overlooked aspects in the model are wind direction and variations in irradiation angle. The direction a physical asset faces can have a considerable impact on the resulting power production both for wind as well as for solar. For wind power this is much less of a concern. This is due to the fact that so-called horizontal axis turbines, which represent the vast majority of commercial assets nowadays, can quickly adjust their rotor blades to variations in wind direction.\(^23\)

In contrast, the majority of commercial solar power plants are unable to adjust their orientation towards incoming irradiation which changes throughout the day. Therefore, a solar power plant’s individual configuration influences the resulting power generation. An extension of our model could incorporate information about each asset’s configuration within a weather cell. This could be captured by adjusting the local capacity weights when estimating the balancing-area-specific production curve \( g_{t,n}^{s,m} \) (see Section 3.2) according to the respective local orientations of solar power plants and be of help to capture local renewable generation dynamics more realistically.\(^24\) Furthermore, this would allow market participants to consider an additional strategic layer in their decisions making process.

\(^{23}\)Wind direction can become important for the detailed analysis of the power production profile of a specific wind park though (e.g. the exact placement of turbines next to each other and/or the consideration of obstacles such as hills). Given the spatial granularity of our weather model (weather cells of 100 km \( \times \) 100 km size) such a level of detail is beyond the scope of this study.

\(^{24}\)We actually attribute some of the unexplained variation by our solar production curves (see Section 3.2 Figure 6) to the neglection of solar panel orientation.
6 Empirical Analysis

Using the calibrated SLMS model we now address its performance in terms of reproducing wholesale power price dynamics. We then look into how our model can be applied in practice and in which cases it provides unique benefits for different stakeholders in the electricity sector.

In the following analysis, we make use of simulations to compare statistical properties such as observed and model-implied moments or quantiles. We found $N = 1000$ simulation scenarios to be reasonably robust in terms of the sampling error. To obtain one trajectory of wholesale power prices we have to simulate all state variables: (1) weather variables; (2) market-wide demand; (3) residual volatility. Our analysis also entails assessments of specific time frames in isolation (e.g. a specific month). If not stated otherwise, we create simulation scenarios in these cases by conditioning all state variables to equal their mean values at the beginning of the month.

6.1 Explaining Wholesale Power Prices

To underline the soundness of the proposed modeling framework we now shed light on its capability of reproducing salient statistical features of wholesale spot prices in the German electricity market. We start with a visual inspection of historical as well as simulated day-ahead spot prices. Figure 9 is an exemplary plot of $s_t$ from October to December 2012. It can be seen that the stylized features of observed day-ahead prices seem to be captured quite well. For instance, negative price spikes tend to occur more frequently during winter holidays when the demand from large industrial consumers is missing.

Next, we look at qq-plots of model-implied and observed spot prices. As a benchmark, we choose a standard reduced-form price model for electricity price dynamics used in Benth, Biegler-König, and Kiesel [2013] and calibrate it to the same time series of wholesale spot prices used for the SLSH model. The model features a flexible trend function, a mean-reversion component, as well as a spike process to capture heavy tails in the empirical distribution.\footnote{Please refer to Appendix E for a description of model specification and calibration.} Since reduced-form approaches are calibrated to the observed price distribution directly they serve well as a benchmark for our modeling framework. Figure 10 highlights the qq-plots between the observed price distribution and the corresponding modeling approaches. Both seem to be capable of capturing the majority of the empirical distribution although the extreme tails are not captured perfectly. This demonstrates that the SLMS model can compete with existing reduced-form approaches.
Next we have a look at how the model fares with capturing key properties of price volatility. Volatility is a key factor for important managerial decisions or risk management applications. For example, the scheduling of electricity production of highly flexible power plants is a complex path-dependent dynamic optimization problem. The asset derives much of its value from price volatility. Consequently, the decision to ramp up such an asset should then be based on the most relevant observable state variables influencing future volatility. As a result, we require a model in which the dependence between volatility and other variables of interest is captured accordingly.

To demonstrate the SLSH model’s capability in this regard we look at the relationship between residual demand $\hat{d}_t$ and price volatility. To set the corresponding variables into perspective, we calculate a daily average values for both variables of interest and inspect the relationship visually (see Figure 11). Although, the pattern is not captured perfectly, the model correctly predicts higher volatility levels for higher residual demand levels. Additionally, we also observe a slight reversal of this effect for very low levels of residual demand both for historical data as well as model-implied. This pattern can be attributed to the fact that for very low and high levels of residual demand $\hat{d}_t$ the supply function is relatively steep (see Figure 8), potentially causing larger price swings. Note that this

26 We actually depict splines fitted to the empirically observed relationships to facilitate the presentation.
effect is present in other electricity markets as well (e.g. see Eydeland and Wolyniec [2003]) and called “inverse leverage effect”.

Finally, we test the model’s capability to describe the joint distribution of the modeled (aggregate) drivers and the wholesale spot prices - a property that becomes very important for hedging practices. For instance, the owner of a wind park might be interested in using price-based derivative instruments (e.g. electricity futures) to reduce the volatility of his future cashflows. In order to make an assessment of the potential of such strategies he necessitates a model that correctly predicts the relationship between prices and wind power production. Table 2 depicts the time series correlations of renewable generation from solar, wind, demand, and residual demand with spot prices. As can be seen, the model-implied correlations are very close to what we actually observe.\footnote{We are well aware that correlations can be misleading for non-linear relationships. Nevertheless, the similarity of both empirical and model-implied moments is striking.} For instance, the link between residual demand and spot prices is stronger than for the case of raw demand and wind seems to have a stronger impact on spot prices than solar.

6.2 Managing Market Risks with the SLSH Model

Market participants in modern power markets are facing increasingly complex weather-dependent uncertainties. This section highlights how the SLSH model can help to better understand the associated risks.
Figure 11: Relationship between residual demand and price volatility

The figure shows the relationship between average daily residual demand $\hat{d}_t$ and average daily price volatility for historical data (blue line) and model-implied (red line).

6.2.1 Setup of Risk Analysis

We take the renewable portfolio configuration from the start of 2013 as our base scenario and hold the installed capacity constant at first. Note that this differs from Section 6.1 where we reflect on our calibrated model’s capability of reproducing the observed electricity spot prices. This results in 31 (36) GW of installed wind (solar) power. We make use of simulations to deduce corresponding measures of interest and set the number of scenarios to $N = 1000$. One trajectory of wholesale power prices necessitates the simulation of all state variables: (1) weather variables; (2) market-wide demand; (3) residual volatility. In some cases, we analyze different time frames (e.g. months or years) in isolation. If not stated otherwise, we then compute the corresponding measure by conditioning the state variables to equal their mean values at the beginning of the respective time interval.

6.2.2 The Impact of Renewable Generation

As outlined in Section 3 the renewable generation portfolio is in constant change. Market participants need to understand how capacity additions impact their current commercial operations. This subsection will showcase two examples of important market players and how these might be affected.
Table 2: Correlations between spot prices and fundamental factors

<table>
<thead>
<tr>
<th></th>
<th>model</th>
<th>data</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\rho_{s_t, r_{w_t}}$</td>
<td>-0.30</td>
<td>-0.37</td>
</tr>
<tr>
<td>$\rho_{s_t, r_{e_{s_t}}}$</td>
<td>-0.04</td>
<td>-0.04</td>
</tr>
<tr>
<td>$\rho_{s_t, d_t}$</td>
<td>0.65</td>
<td>0.66</td>
</tr>
<tr>
<td>$\rho_{s_t, \hat{d}_t}$</td>
<td>0.82</td>
<td>0.85</td>
</tr>
</tbody>
</table>

This table compares correlations of several fundamental factors (demand $d_t$, residual demand $\hat{d}_t$, wind generation $r_{w_t}$, as well as solar generation $r_{e_{s_t}}$) with wholesale spot prices $s_t$ for the model (left column) as well as the historical data (right column) during 2012-2014.

Our first example consists of a merchant power plant which is not tied to any customer needs or long-term power purchase agreements. If one abstracts from technical restrictions as well as other fixed costs a conventional power plant can be seen as a strip of call options written on wholesale spot prices. A stylized profit margin of such a physical asset is given as follows:

$$rv_{T}^{pp}(c) = \sum_{t \in T} \max(s_t - c)^{+}$$  \hspace{1cm} (7)$$

where $T$ corresponds to the set of all hours within the respective time interval and $c$ to the variable cost required to produce the equivalent of 1 MWh of electricity. The variable costs are determined by the type of power plant considered.\textsuperscript{28} We focus on flexible peaking power plants that usually burn natural gas in order to produce electricity. Using a corresponding efficiency rate and fuel costs results in variable costs $c$ of about 60 EUR/MWh.\textsuperscript{29} Given the fact that $c$ is almost twice the price of average spot prices demonstrates that such an asset can thus be can basically be regarded as a strip of deep out-of-the money call option contracts.

In order to value the basket of option contracts one needs to calculate their expected value under the pricing measure $Q$:

$$v_{t_0}(c) = \mathbb{E}_{t_0}^Q [rv_T^{pp}(c)]$$  \hspace{1cm} (8)$$

\textsuperscript{28}In order for Eq.(7) to hold the power plant needs to be flexible enough such that it can be switched on and off with very short notice. Since coal and lignite power plants often times require several hours or even days to ramp up and down we focus on more flexible gas power plants for this example.

\textsuperscript{29}Efficiency rates of such physical assets usually range between about 20 - 30 % (see Eydeland and Wolyniec [2003]), thus for every MWh of electricity one necessitates the equivalent of 3 to 5 MWh of naturals gas. Prices of natural gas in Europe have not changed much during the last 5 years and averaged at about 20 EUR/MWh which is why we assume them to be constant for our analysis.
Figure 12: Peaking power plant

The left graph shows values of \( v_{t_0} \) of the peaking power plant as well as the average spot price for different months over the year, in which both time series have been normalized by their maximum value. The right graph shows the percentage reduction in the peaking plant’s value in different scenarios over the year.

We ignore risk premia and compute the above expectation under the physical measure \( \mathbb{P} \). Given the absence of a closed-form solution for (8) we resort to simulations. Option values are heavily driven by higher order price risks and our SLSM model allows us to price these risks accordingly.

The left graph of Figure 12 shows \( v_{t_0} \) as well as the average electricity price level for all months during a year. Clearly, there are seasonal patterns in both cases. The average price level is larger during winter season due to higher demand levels (see Section 4.2) and lower supply in terms of solar power production (see Section 3.3.1). However, in contrast to the average price level, the value of the peaking power plant rises tenfold during winter season. This aspect can be explained by the non-linear shape of the supply function \( f_t \). During winter, the intersection of supply and demand is much more likely to take place in the steeper part of \( f_t \) (see Section 4.1, Figure 8). The chances of positive price spikes therefore increases disproportionally. This increase of (positive) jump risk then has a very large impact on the on the value of the portfolio of deep out-of-the-money call option contracts (the peaking plant value \( v_{t_0} \)).

\[ \text{30} \]

In relation to the price of futures contracts ("average price level") or prices of at-the-money options, out-of-the money options prices increase disproportionally in value if jump risk increases which makes sense, since large jumps are usually the only events that causes these contracts to end up in-the-money.
larger discrepancies between values of $v_{t_0}$ during winter and summer season compared to average prices levels.\

Now suppose there is new wind or solar power capacity added to the supply-side. Given the heterogeneity in dependencies of local weather variables as well as the non-linearity of local production curves $g^{u,k}$, it is a non-trivial task to quantify how such capacity additions influence aggregate renewable generation. Existing approaches (Wagner [2014]) can at best account for a proportional growth of renewable capacities at all locations such that the relative contribution of all local constituents remains exactly the same. Of course, this is highly unrealistic. Our approach on the other hand captures these local aspects. We make use of this aspect in the following example.

To outline the varying impact of new renewable capacity additions we consider two scenarios in which a total amount of roughly 4 GW is installed (wind and solar power). This corresponds to realistic amounts of yearly changes in renewable generation capacities (BMWi [2016]). We then end up with 3300 MW of new wind power and 650 MW of solar power capacities and consider two schemes to allocate those across the \( K = 38 \) weather cells. The first one corresponds to an equally distributed scheme where each location is allocated an equal amount of wind power (Scenario Diversified). For the second scenario we assume that all wind power is clustered in a single northern location of Germany (Scenario Clustered).

Using our SLSH model, we assess changes in the peaking plant value due to changes in the renewable generation portfolio. We find that in both cases, price volatility rises but as can be seen from Table 3 there is a considerable negative impact on the value of the power plant ranging from -12 to -15 percent (on a yearly average). The reason for this is the fact that in both scenarios, the probability of higher price states is decreased and with it the profit margin of the peaking plant. The right graph in Figure 12 again visualizes the impact on the monthly values of the physical asset. As can be seen, the influence is felt the most during winter season. More importantly however, there is a difference between the two scenarios. Due to the fact that Scenario B situates new wind power capacities in northern more windy regions there is an even larger discount on the value of our basket of out-of-the-money options compared to the equally weighted capacity addition case. For the yearly value of an average sized peaking power plant (e.g. 500 MW) this results in a economically sizable difference in value of 500 MW $\times (0.38-0.36)$ EUR/MWh $\times 8760$ h

\[31\] Note that some existing structural models (e.g. Wagner [2014]) would have allowed to make a similar assessment. Keep in mind though, that we make use of a much longer time series of weather data, whereas, for example, Wagner [2014] is restricted to the few years of renewable production data currently available. This lack of data might result in less reliable parameter estimates for the market-wide renewable processes.
Table 3: Valuation of peaking power plant under different scenarios

This table summarizes values and relative changes of a stylized natural gas-fired power plant (1 MW) under 3 different scenarios. The base scenario corresponds to the current market environment whereas scenario A and B correspond to an equally weighted expansion and a clustered expansion respectively. The second line is the relative change in the respective scenario compared to the base case.

- $v_t(c = 60)\approx 50,000$ EUR. This shows that changes in the spatial distribution of the wind power generation portfolio have an economically important impact on conventional physical assets. Most importantly, this impact could not have been analyzed quantitatively by the help of existing reduced-form (e.g. Benth, Biegler-König, and Kiesel [2013]) or structural models (e.g. Wagner [2014]).

Interestingly, changes in the spatial distribution for solar power seem to matter much less compared to wind power. In unreported results we find that the impact of new solar capacity additions is extremely similar for both scenarios. This also holds if we artificially consider a larger amount of solar power.

Next, we look at the risk electricity suppliers face. In most electricity markets the majority of consumers enter some kind of load-serving contract in which the exact quantity of power is left unspecified while a fixed price for every consumed unit is set ex-ante. While very appealing for risk-averse consumers, this can potentially result in very risky non-linear exposures for the other party. These so-called Load-Serving Entities (LSEs) usually manage a large portfolio of such customers. A simplified version of the associated revenue stream arising from such a commitment is given as follows:

$$rv^{lse}_T(p) = \sum_{t \in T} \hat{q}_t(p - s_t)$$

where $\hat{q}_t$ corresponds to the consumer-specific demand in hour $t$ and $p$ is the contracted fixed price charged from the LSE for every quantity of electricity consumed. For electricity markets, quantity and price variables are usually positively related, resulting in non-linear payoff patterns. As $\hat{q}_t$ is not traded in the marketplace, contracts of this type are rather difficult to hedge.\(^{32}\) To visualize the problem, we now look at a simplified yearly load-

---

\(^{32}\)In other commodity markets, the supplying company can at least build buffer stocks by storing an adequate amount of the underlying good physically. Unfortunately, electricity is non-storable making the problem even more difficult.
Figure 13: Load-serving contract

The left graph shows the (hourly) payoff from the load-serving contract \( (\hat{q}_t(p - s_t)) \) relative to the prevailing spot price \( s_t \). The red vertical line corresponds to the contracted price \( p \). The right graph shows the correlation between spot prices \( s_t \) and market-wide demand \( d_t \) for every month of the year.

The load-serving contract for the German power market using our calibrated price model. For simplicity, we ignore the idiosyncratic part of the consumer demand and furthermore assume it to be perfectly correlated with market-wide power demand \( d_t \). We furthermore set the fixed price \( p \) such that the contract has a value of zero at initiation (\( \mathbb{E}_{t_0}^Q \mathbb{R}_T^{LSE}(p) = 0 \)).

Given the concave payoff structure of the load-serving contract, the fixed price is larger than the average electricity spot price (\( \mathbb{E}_{t_0}^Q s_t < p = 39.2 \) EUR/MWh).

The left graph in Figure 13 shows the relationship between hourly payoffs and the spot price in the load-serving contract. The non-linear pattern is clearly visible: Consumers tend to ask less for lower price states and ask for more in higher price states.\(^{33}\)

Before analyzing the impact of potential changes in the renewable generation portfolio, it is insightful to shed some light on how renewables affect the LSE’s business. The right graph in Figure 13 shows the monthly correlations of spot prices \( s_t \) and market-wide demand \( d_t \) (which is perfectly correlated with the above custmer demand \( \hat{q}_t \)).\(^{34}\) As can be

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\(^{33}\) Although not central to our analysis, this demonstrates the hedging dilemma the LSE faces. A linear hedge using futures contracts will consequently not be capable of completely protecting the company from adverse payoffs in high- and low price states. Unfortunately, non-linear instruments, such as options, are not liquid. As a result, LSEs usually adjust the fixed price to compensate for the unhedgable risks they bear.

\(^{34}\) To arrive at a representative correlation coefficient, we take the average correlation across \( N = 1000 \) simulated scenarios of a month.
seen, there is a pronounced seasonal pattern with a significant drop of dependencies arising throughout the summer months. This shows how the increasing presence of renewables introduces new sources of risks into wholesale market prices. As shown in Section 3.3 solar irradiation is at extremely low levels during the winter season making wind power a much more important contributor to market-wide power generation. During summer, solar power production rises about ten-fold whereas wind production drops by about 30 - 50 percent. Overall, aggregated market-wide renewable generation is much higher and more volatile during summer. As a result, the link between market-wide demand $d_t$ and the resulting spot price $s_t$ is decreased. This has important implications for the LSE. First, if the dependencies between spot prices and the uncertain quantity variable change so does the amount of the non-linear exposure in the payoff function, potentially even decreasing the risk of extreme losses for the LSE. On the other hand, a weaker link between wholesale prices and demand means that the hedging efficiency of electricity futures is lower during some periods during the year.$^{35}$ LSEs are consequently more and more affected by the growing share of weather-dependent electricity production.

Suppose now, it is publicly known that new renewable capacities are added to the generation portfolio next year (as was the case for the peaking plant example). The consumer now wants to re-assess whether the fixed price $p$ he is charged is still “fair” in this regard. To do so he can compute $p$ such that $\mathbb{E}_t r^{tar} (p) = 0$ holds. The fixed price under scenario A (diversified wind power expansion) is larger than under scenario B (clustered wind power expansion). We obtain $p \approx 38$ EUR/MWh for Scenario Diversified and only $p \approx 37.5$ EUR/MWh for Scenario Clustered. So, if one is not charged accordingly this can easily result in large discrepancies in the resulting electricity costs. Even for just a medium-sized commercial business (e.g. 150 MW per hour) the difference is economically significant ($150 \text{ MW} \times (38-37.5) \text{ EUR/MWh} \times 8760 \text{ h} = 657,000.00 \text{ EUR}$) and is much larger than for the case of the power plant outlined in the last section as well.

Overall, the above two examples demonstrate the impact of the steady increasing amount of renewables on commercial activities of market participants. It is shown that even if one is not directly invested in local renewable production assets it can be important to incorporate the spatial distribution of renewable generation capacities within a power price model.

$^{35}$Although the perspective is slightly different, we analyze seasonal patterns in hedging efficiencies in more detail for the case of renewable power producers in Chapter 4.
The intermittent nature of renewable electricity production has changed the landscape of many liberalized power markets. New weather related risks arise for the stakeholders. Aggregate (market-wide) renewable production is itself determined by the sum of local (renewable) production facilities across a given market area. As local output is highly sensitive to local weather conditions, the spatial distribution of installed renewable generation capacities is therefore a potentially interesting characteristic that should be captured by a meaningful risk management tool. We propose a flexible modeling framework for wholesale power prices capable of incorporating the local aspect of renewables for the case of the German power market. We recursively adopt the basic idea behind hybrid structural models by not only looking at the drivers of wholesale prices (e.g. temperature-driven demand, aggregate solar or wind production,...) but also at the (local) drivers of renewable production itself.

In a nutshell, we disentangle the modeling of weather conditions, the mapping to (local) renewable production, and the amount of (local) installed capacity. This is advantageous since it allows us to calibrate part of our model to a rich history of weather data instead of having to rely on the (relatively) short time frame of renewable production. Our results show that the SLSM-model is well capable of reproducing the statistical properties in the time series of renewable production and wholesale power prices and can consequently be regarded as a valid tool for risk management purposes.

We furthermore outline how market participants can make use of our flexible modeling framework. It is shown that changes in the renewable generation portfolio have a considerable impact on the commercial business activities of market participants such as power plant owners as well as suppliers. More importantly, and in contrast to existing approaches, the SLSM-model is capable of quantifying the distinct impact of changes in the renewable generation portfolio on wholesale market prices. This makes it clear that market participants, facing the challenges in renewable-dominant power markets, require a modeling approach like ours.

Given the fact our model captures local risks it lends itself well to manage production risks of renewable energy projects. Local weather conditions across distant locations can be very different (see Appendix B). Consequently, we also expect a similar degree of heterogeneity for local renewable production. A methodology that is only capable of capturing the aggregate market-wide renewable generation is thus insufficient to assess idiosyncratic production risks of specific locations. For instance, investors might want to weight risk and reward for new renewable energy projects. Also, to manage production...
risks, producers might be interested in the potential of risk transfer by the use of derivative instruments whose payoff is often times tied to market-wide aggregate variables, such as wholesale spot prices or weather-related indices. A meaningful assessment consequently necessitates a model which incorporates the joint distribution of local weather conditions and important market variables such as spot prices. The SLSH model is a suitable tool to address these challenges.

References


Anemos, 2016, Wind Atlas and Production Index Europe: Commercial Supplier of Weather Data for Wind Power Applications, Anemos Gesellschaft fuer Umweltmeteorologie mbH.


A Estimation of Production Curves

Given observed patterns regarding dependencies between renewable power production and its corresponding weather variable we choose a 3-parameter logistic function for wind and a second-order polynomial for solar:

$$g^{w,k}(y^{w,k}_{t}) = \frac{\alpha_0^k}{1 + e^{-\gamma_1^k(y^{w,k}_t - \gamma_2^k)}}$$

$$g^{s,k}(y^{s,k}_t) = \alpha_0^k + \alpha_1^k y_t + \alpha_2^k (y_t)^2$$

Parameters are obtained by non-linear least squares (least-squares) for wind power (solar power). Table 4 shows estimated coefficients along with standard errors.
The table shows parameter estimates and standard errors (in parentheses) for production curves of wind power (Panel A) as well as for solar power (Panel B) in all four balancing-areas. Estimates are obtained by non-linear least-squares (least-squares) for wind power (solar power). Note that parameter estimates are very small for the case of solar due to the fact that the weather variable (solar irradiation) takes relatively large values (between 0 and 1000) compared to wind speed (between 0 and 20). *** (***) denotes statistical significance at the 0.1% (1%) level.

### A. Wind power

<table>
<thead>
<tr>
<th>Parameter</th>
<th>50Hertz</th>
<th>TenneT</th>
<th>Amprion</th>
<th>TransnetBW</th>
</tr>
</thead>
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<td>$\gamma_0^k$</td>
<td>0.8026 (0.0051)***</td>
<td>0.5483 (0.0034)***</td>
<td>0.8829 (0.0068)***</td>
<td>0.9769 (0.0100)***</td>
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<td>$\gamma_1^k$</td>
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<td>0.4254 (0.0020)***</td>
<td>0.4171 (0.0029)***</td>
<td>0.4352 (0.0038)***</td>
</tr>
<tr>
<td>$\gamma_2^k$</td>
<td>10.4716 (0.0326)***</td>
<td>10.5792 (0.0324)***</td>
<td>9.7561 (0.0425)***</td>
<td>10.1843 (0.0553)***</td>
</tr>
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</table>

### B. Solar power

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<th>Value</th>
<th>Value</th>
<th>Value</th>
</tr>
</thead>
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<td>$1.98 \times 10^{-4}$</td>
<td>$1.82 \times 10^{-3}$</td>
<td>$1.20 \times 10^{-3}$</td>
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<tr>
<td></td>
<td>($3.6 \times 10^{-4}$)***</td>
<td>($3.05 \times 10^{-4}$)***</td>
<td>($3.71 \times 10^{-4}$)***</td>
<td>($4.53 \times 10^{-4}$)***</td>
</tr>
<tr>
<td>$\pi_1^k$</td>
<td>$4.35 \times 10^{-4}$</td>
<td>$4.69 \times 10^{-4}$</td>
<td>$6.42 \times 10^{-6}$</td>
<td>$5.72 \times 10^{-4}$</td>
</tr>
<tr>
<td></td>
<td>($4.3 \times 10^{-6}$)***</td>
<td>($3.49 \times 10^{-6}$)***</td>
<td>($4.22 \times 10^{-6}$)***</td>
<td>($4.89 \times 10^{-6}$)***</td>
</tr>
<tr>
<td>$\pi_2^k$</td>
<td>$-0.53 \times 10^{-8}$</td>
<td>$-1.09 \times 10^{-7}$</td>
<td>$-1.65 \times 10^{-7}$</td>
<td>$-1.31 \times 10^{-7}$</td>
</tr>
<tr>
<td></td>
<td>($6.4 \times 10^{-9}$)***</td>
<td>($5.03 \times 10^{-9}$)***</td>
<td>($6.1 \times 10^{-9}$)***</td>
<td>($6.72 \times 10^{-9}$)***</td>
</tr>
</tbody>
</table>
Figure 14: Wind speed time series in southern Germany in 2000-2005
The figure depicts hourly wind speed for the years 2000-2005 (top) and for a week in June, 2002 (bottom) in a weather cell located in the southern part of Germany (Baden-Wuerttemberg).

B Empirical Analysis of Weather Models

B.1 Wind speed dynamics

Figure 14 visualizes the hourly wind speed in the southern part of Germany for 2005-2008 as well as for a week in June 2002. Clearly, wind speed is highly volatile and can change dramatically just within a few hours. Its levels also tend to be lower during summer than winter.\textsuperscript{36} On top of that, volatility tends to be a lot higher during autumn and winter months. In a similar fashion, higher moments such as skewness and excess kurtosis also vary and seem to rise during autumn and winter season. For most locations, the wind speed distributions’ shape thus seems to exhibit considerable seasonality. Wind speed furthermore exhibits considerable evidence for non-Gaussian behavior with a positive skewness and significant positive autocorrelation (see Figure 15). Unsurprisingly, these characteristics are not homogeneous across locations. Figure 16 depicts the time series

\textsuperscript{36}We also observe a weak day- and night pattern.
Figure 15: Wind speed distribution and autocorrelation function

The left graph shows the histogram of wind speed in a weather cell located in southern Germany (Baden-Wuerttemberg) along with the density of a normal distribution with identical mean and standard deviation (red dotted line). The right graph depicts the corresponding autocorrelation function.

of wind speed at two different weather cells and clearly demonstrates that although key characteristics such as trends in level and volatility prevail, differences do exist.

In addition to the general specification outlined in Section 3.3.1, we therefore incorporate a time-dependent and location-specific volatility function $\sigma_{w,k}^t$ and distribution function $F_{w,k}^t$ to capture seasonal time-variation in the symmetry of the distribution. This is achieved by normalizing the wind speed times series both by its trend as well as by its (seasonal) standard deviation:

$$y_{w,k}^t = \left( y_{w,k}^t - \mu_{w,k}^t \right) \left( \sigma_{w,k}^t \right)^{-1}$$

where $\sigma_{w,k}^t$ is estimated on a monthly basis. We then group $\bar{y}_{w,k}^t$ by quarters and estimate a corresponding distribution function. Since skewness and kurtosis are highly sensitive to outliers we choose a quarterly time frame to increase the number of observations in each case.

Dependencies between regions also vary and are largely determined by distance. For instance, exemplary adjacent regions located in the of south Germany (state of Baden-Wuerttemberg) exhibit a correlation of over 90\% (after removing trends in levels and volatility) while the relationship to a third region situated in the north-eastern part of Germany is much lower (30 and 40 percent respectively).
Figure 16: Time series of wind speed at different locations

The figure shows time series of wind speed for a weather cell in southern Germany (top) as well as for a weather cell located in the North Sea (bottom) for the years 2000-2005.

To demonstrate the overall fit of our modeling approach we compare empirical and (model-implied) simulated values. Figure 17 shows the trajectory of wind speed for a region in north-western Germany over the years 2000-2004 along with its simulated correspondent indicating that the approach seems to be capable of reproducing the prominent statistical characteristics. This can also be seen by inspecting qq-plots of simulated vs. observed wind speed values (Figure 18). The model-implied autocorrelation functions also come very close to their observed counterparts (Figure 19). This is also apparent by having a look at model residuals which mostly void of any significant autocorrelation (Figure 20). Similarly, the modeling approach does a good job at capturing the cross-sectional dependencies between locations. We obtain a close fit to the observed crosscorrelation function (Figure 19) and model residuals show hardly any evidence of dependencies across locations (Figure 22). Overall, this results suggest that our approach is capable of capturing both locations-specific characteristics and cross-sectional dependencies.
Figure 17: Observed vs. simulated wind speed

The figure shows observed (top) as well as simulated (bottom) wind speed for a weather cell located in southern Germany.
Figure 18: qq-plots of simulated vs. observed wind speed

The figure depicts qq-plots of simulated (x-axis) vs. observed (y-axis) wind speed of 9 random locations throughout the German market area.
Figure 19: ACFs of observed and simulated wind speed

The figure visualizes the actual (blue) as well as the simulated (red) autocorrelation function of de-trended and transformed wind speed $\hat{y}_t^{\mu}$ for 9 randomly selected locations throughout Germany.
Figure 20: ACFs wind speed and model residuals

The top 3 graphs visualize the actual (blue) as well as the simulated (red) autocorrelation function of de-trended and transformed wind speed $\hat{y}_w^t$ for 3 exemplary locations in Germany. The bottom 3 graphs show the autocorrelation function of the corresponding model residuals with 5% confidence bounds.
Figure 21: CCFs of observed and simulated wind speed
The figure visualizes the actual (blue) as well as the simulated (red) crosscorrelation function of de-trended and transformed wind speed $\hat{y}_w$ for 9 pairs of randomly selected locations throughout Germany.
Figure 22: CCFs of wind speed and model residuals

The top 3 graphs visualize the actual (blue) as well as the simulated (red) cross-correlation function of de-trended and transformed wind speed $\hat{y}_w^t$ between 3 pairs of exemplary locations in Germany. The bottom 3 graphs show the crosscorrelation function of the corresponding model residuals with 5% confidence bounds.
B.2 Solar Irradiation Dynamics

Solar irradiation shows a very pronounced intraday pattern (see left graph in Figure 23) due to the fact that there is no sunshine during night time. This pattern gradually changes throughout the year, that is, the sun rises earlier and sets later in the evening during the summer months. However, the peak is happening at noon regardless of the current season. The absolute level of daily peaks also changes seasonally indicated by the right graph in Figure 23. Apart from the above deterministic day- and night pattern, cloud formations can lead to unexpected drops in irradiation levels. Figure 24 shows hourly irradiation in the southern part of Germany for a week in April. Sudden strong decreases thus regularly happen. However, we noticed that most of the time, days tend to be either sunny or rather cloudy overall. Thus, consecutive extreme drops and rises throughout the same day are rather rare.

Cloud formations thus have a considerable impact on the resulting levels of solar irradiation and one is incapable of observing these during night time. Consequently, we are blind for any larger cloud formations that have been built up in the hours just before sunrise and which heavily affect the weather variables during the early morning hours. We therefore adjust the general methodology and loosely follow Wagner [2014]. Motivated by the fact that extreme intraday volatility is rather uncommon for our data set, we model...
The figure shows a typical pattern of the variation of solar irradiation within a month (April, 2000). The weather cell is located in southern Germany (Baden-Wuerttemberg).

The daily maximum irradiation level $\tilde{y}_{s,k}^j$ and capture any variation throughout the day by means of a deterministic pattern function. To formalize the notion of the daily maximum irradiation level, we introduce the day count function that maps all hours in the data set of length $T$ to its respective day of the year

$$d : [0, T] \mapsto \mathbb{N}_0$$

$d$ thus takes values between 1 and 365$^{37}$ depending on which day a respective hour $t$ belongs to. The daily maximum process of local hourly solar irradiation levels then reads as follows:

$$\tilde{y}_{j}^{s,k} = \max_{t:d_t = j} \left( y_{t}^{s,k} \right), \ j = 1, \ldots, d_T$$

(10)

To account for seasonal variations over the year we de-trend the data ($\tilde{y}_{j}^{s,k} := y_{j}^{s,k} - \mu_{j}^{s,k}$). The resulting process shows serial and spatial correlation as well as non-normality. The latter issue can be dealt with the transformation-approach outlined in Section 3.3.1 to arrive at an approximately normally distributed time series that preserves the original covariance structure as usual. The resulting multivariate time series of (daily) maxima of solar irradiation is then once again captured by means of a VAR model as usual. We

$^{37}$For simplicity, we map the 29th of February in leap years to the 28th of February.
furthermore assume solar irradiation and wind speed to be independent from each other since time series correlations of the corresponding de-trended weather variables are smaller than 25% (in absolute terms) and cluster near 0.

To capture (local) intraday-variations we make use of a deterministic time-dependent and site-specific function \( \delta^k_j \) mapping the daily maximum to hourly values as follows:

\[
y_s^k(t, y_{d_t}^k) = \delta^k_d(t, y_{d_t}^k) = x \sum_{k=1}^{24} \alpha_k \mathbf{1}_{(k\text{-th hour of the day})}
\]

where \( \delta^k_j \) is estimated for every day of the year and every weather cell separately. We find that, similarly to the case of wind speed, our modeling approach seems to be capable of reproducing the salient features of solar irradiation (see Figure 25, Figure 26, Figure 27, Figure 28, and Figure 29 respectively).

**C Modeling Residual Volatility \( \sigma_t \)**

We consider various model specifications to model the residual volatility process \( \sigma_t = s_t - f_t(\hat{d}_t) \). After experimenting with different lags and specifications we found a SARIMA(2,0,2) \( \times (1,0,1)_{24} \) model to be the superior one (in terms of AIC). Likewise Gaussian GARCH noise was incapable of capturing the tails of the distribution appropriately causing us to instead opt for student-t distributed error terms.

The formal description of the model for the residual volatility process \( \sigma_t \) thus reads as follows:

\[
\phi(B)\Phi(B^{24})\sigma_t = \theta(B)\Theta(B^{24})\varepsilon_t \\
\varepsilon_t = \eta_t \xi_t \\
\xi_t^2 = \omega_0 + \omega_1 \xi_{t-1}^2 + \omega_2 \xi_{t-1}^2, \omega_i \in \mathbb{R}^+, i = 0,1,2
\]

where \( \omega_0 \geq 0, \omega_1 > 0, \omega_2 > 0, \omega_1 + \omega_2 < 1, \phi(z) = 1 - \phi_1 z - \phi_2 z^2, \Phi(z) = 1 - \Phi_1(z), \theta(z) = 1 - \theta_1(z) - \theta_2 z^2, \Theta(z) = 1 - \Theta_1(z) \), \( \phi_1, \phi_2, \Phi_1, \theta_1, \theta_2, \Theta_1 \in \mathbb{R} \), \( B \) corresponds to the backshift operator \( (B^j x_t = x_{t-j}) \), and \( \eta_t \) is student-t distributed random variable with \( v \) degrees of freedom. We can write (11) explicitly

\[
\sigma_t = \phi_1 \sigma_{t-1} + \phi_2 \sigma_{t-2} + \Phi_1 \sigma_{t-24} - \Phi_1 (\phi_1 \sigma_{t-25} + \phi_2 \sigma_{t-26}) \\
+ \varepsilon_t - \theta_1 \varepsilon_{t-1} - \theta_2 \varepsilon_{t-1} - \Theta_1 \varepsilon_{t-24} + \Theta_1 (\theta_1 \varepsilon_{t-25} + \theta_2 \varepsilon_{t-26})
\]
Table 5: Parameter estimates of the residual volatility model

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<th></th>
<th>φ₁</th>
<th>φ₂</th>
<th>Φ₁</th>
<th>θ₁</th>
<th>θ₂</th>
<th>Θ₁</th>
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<td>-0.1085</td>
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<td></td>
<td>(0.0141)***</td>
<td>(0.0131)***</td>
<td>(0.0021)***</td>
<td>(0.0158)***</td>
<td>(0.0092)***</td>
<td>(0.0040)***</td>
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<tr>
<td>B. GARCH</td>
<td>ω₀</td>
<td>ω₁</td>
<td>ω₂</td>
<td>υ</td>
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<td>(0.0261)***</td>
<td>(0.0192)***</td>
<td>(0.0998)***</td>
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The table shows parameter estimates and standard errors (in parentheses) for SARIMA(2,0,2) × (1,0,1)₂⁴-GARCH(1,1) model. Estimates are obtained by maximum likelihood. ***, **, and * denotes statistical significance at the 0.1%, 1%, and 5% level.

making it more clear how lagged and contemporaneous values are related to each other. The model is estimated by maximum likelihood and results are shown in Table 5.

D Market-Wide Demand in Germany

As expected, demand in Germany exhibits pronounced seasonal patterns. Figure 30 shows the hourly time series of demand for Germany from late 2012 until 2014 revealing several salient patterns and features. First, demand tends to be considerably higher during winter seasons, which can mainly be attributed to an increased demand for electrical light. Also note that sharp drops in consumption levels for winter holidays (24th of December until about the 4-6th of January) caused by the seasonal shutdown of major production facilities in the car manufacturing business as well as of steel mills and aluminum smelters.

The left graph of Figure 31 offers a more detailed look at the weekly seasonality. Demand usually peaks in the first half of the week and drops considerably on the weekend with Sunday generally having the lowest demand levels overall. The intraday variation of electricity consumption is very large with changes of almost 60% during the day (see right graph of Figure 31). Consumption usually rises significantly in the morning hours when people get up and prepare for work and peaks during lunch time and later in the evening (rush hour).

Following Burger, Klar, Mueller, and Schindlmayr [2004] we model demand with a flexible trend function paired with a SARIMA(2,0,2) × (1,0,1)₂⁴ component. This results in the
Table 6: Parameter estimates of the demand model

<table>
<thead>
<tr>
<th>(\hat{\phi}_1)</th>
<th>(\hat{\phi}_2)</th>
<th>(\hat{\Phi}_1)</th>
<th>(\hat{\theta}_1)</th>
<th>(\hat{\theta}_2)</th>
<th>(\hat{\Theta}_1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.6997</td>
<td>0.0975</td>
<td>-0.2345</td>
<td>0.4634</td>
<td>0.1237</td>
<td>0.3682</td>
</tr>
<tr>
<td>(0.0689)***</td>
<td>(0.0584)***</td>
<td>(0.0719)***</td>
<td>(0.0686)***</td>
<td>(0.0224)***</td>
<td>(0.0691)***</td>
</tr>
</tbody>
</table>

The table shows parameter estimates and standard errors (in parentheses) for SARIMA(2, 0, 2) × (1, 0, 1)\(_{24}\) model. Estimates are obtained by maximum likelihood. ***, **, and * denotes statistical significance at the 0.1%, 1%, and 5% level.

following formal model specification:

\[
d_t = \mu^d_t + \psi_t
\]

\[
\hat{\phi}(B)\hat{\Phi}(B^{24})\psi_t = \hat{\theta}(B)\hat{\Theta}(B^{24})\epsilon_t
\]

where \(\mu^d_t\) corresponds to the trend-function with dummy-variables for hourly-, weekly-, monthly-, and holiday-patterns, \(\hat{\phi}(z) = 1 - \hat{\phi}_1 z - \hat{\phi}_2 z^2\), \(\hat{\Phi}(z) = 1 - \hat{\Phi}_1(z), \hat{\theta}(z) = 1 - \hat{\theta}_1(z) - \hat{\theta}_2 z^2\), \(\hat{\Theta}(z) = 1 - \hat{\Theta}_1(z), \hat{\phi}_1, \hat{\phi}_2, \hat{\Phi}_1, \hat{\theta}_1, \hat{\theta}_2, \hat{\Theta}_1 \in \mathbb{R}\), \(B\) corresponds to the backshift operator \((B^j x_t = x_{t-j})\), and \(\epsilon_t\) is a normally distributed random variable. The model is estimated by maximum likelihood and results can be found in Table 6.

E Reduced-Form Model Specification and Calibration

Given the occurrence of negative prices for the case of electricity, arithmetic spot price models have gained wide acceptance during recent years. We follow Benth, Kallsen, and Meyer-Brandis [2007], Meyer-Brandis and Tankov [2008], and Benth, Biegler-König, and Kiesel [2013] and model hourly day-ahead spot prices by means of a multi-factor spike model specified as follows:

\[
s_t = \mu^s_t + x_t + y_t \tag{12}
\]

\[
dx_t = -\kappa_x x_t dt + \sigma_x dw_t, \kappa_x, \sigma_x \in \mathbb{R}^+
\]

\[
dy_t = -\kappa_y y_t dt + dn_t, \kappa_y \in \mathbb{R}^+
\]

where \(\mu^s_t\) corresponds to the deterministic seasonality function which accounts for trends over the year, weekday- and holiday-effects, as well as for the pronounced intraday-
Table 7: Parameter estimates of the reduced-form power price model

<table>
<thead>
<tr>
<th>$\kappa_x$</th>
<th>$\sigma_x$</th>
<th>$\kappa_y$</th>
<th>$\lambda$</th>
<th>$p$</th>
<th>$\beta_1$</th>
<th>$\beta_2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1711</td>
<td>9.8826</td>
<td>0.4364</td>
<td>0.0081</td>
<td>0.5231</td>
<td>0.0266</td>
<td>0.0172</td>
</tr>
</tbody>
</table>

The table shows parameter estimates for the reduced-form power price model given by (12).

pattern. $x_t$ is a standard Vasicek mean-reversion process capturing “normal” price variations whereas $y_t$ is a spike process to account for rare price spikes. $dw_t$ is a standard brownian motion and $dn_t$ a compound Poisson process with constant jump intensity $\lambda$ and double-exponentially distributed jump sizes $z_t$, i.e. exponentially distributed negative as well as positive jumps with density:

$$f_z(x) = p\beta_1 e^{-\beta_1 x}1_{x<0} + (1-p)\beta_2 e^{-\beta_2 x}1_{x>0}, \ p, \beta_1, \beta_2 \in \mathbb{R}^+$$

where $\beta_1, \beta_2 > 0$ and $p \in [0,1]$. $\beta_1$ ($\beta_2$) controls the shape of the positive (negative) jump size distribution whereas $p$ determines the fraction of positive and negative spikes respectively.

The calibration of the above model specification necessitates the identification of latent state variables $x_t$ and $y_t$ as well as model parameters governing the Gaussian and non-Gaussian mean-reversion process. Following Cartea and Figueroa [2005], Benth, Kallsen, and Meyer-Brandis [2007], and Bieger-König [2013] we identify spikes by a recursive filtering algorithm which simultaneously estimates the trend function $\mu_s t$ as well as the time series of $y_t$. Given the values of $y_t$ and $\mu_s t$ we can infer the time series of the gaussian mean-reversion process $x_t$. Model parameters can then be estimated by means of standard econometric techniques.

Figure 32 shows the time series of filtered state variables whereas Table 7 summarize the parameter estimates. The distribution of $x_t$ exhibits skewness and excess kurtosis close to zero. The filtering algorithm thus works quite well in identifying heavy tailed price movements allowing the disentanglement of both processes and estimation of parameter values afterwards. We find an hourly spike intensity of 0.8 percent which corresponds to roughly 70 spikes annually on average. Furthermore, negative as well as positive spikes are almost equally likely $p \approx 0.5$ but negative ones are of larger magnitude ($-58$ EUR/MWh vs. +37 EUR/MWh on average). This stands in contrast to studies using data before 2010. For instance, Bieger-König [2013] finds that positive spikes are slightly larger and almost 3 times as frequent. An effect which we attribute to the growing presence of renewable generation.
Figure 25: qq-plots of simulated vs. observed solar irradiation

This figure shows qq-plots of randomly selected weather cells of solar irradiation levels.
Figure 26: ACFs of observed and simulated solar irradiation

The figure visualizes the actual (blue) as well as the simulated (red) autocorrelation function of de-trended and transformed daily maximum of solar irradiation $\hat{y}_{t}^{s,k}$ for 9 randomly selected locations throughout Germany.
Figure 27: ACFs of solar irradiation and model residuals

The top 3 graphs visualize the actual (blue) as well as the simulated (red) autocorrelation function of de-trended and transformed daily maximum of solar irradiation $\hat{y}_{t}^{s,k}$ for 3 exemplary locations in Germany. The bottom 3 graphs show the autocorrelation function of the corresponding model residuals with 5% confidence bounds.
Figure 28: CCFs of observed and simulated solar irradiation

The figure visualizes the actual (blue) as well as the simulated (red) crosscorrelation function of de-trended and transformed daily maximum of solar irradiation $\hat{y}_{s,k}^i$ for 9 randomly selected pairs of locations throughout Germany.
Figure 29: CCFs of solar irradiation and model residuals

The top 3 graphs visualize the actual (blue) as well as the simulated (red) crosscorrelation function of de-trended and transformed daily maximum of solar irradiation $\hat{y}_{t}^{s,k}$ between 3 pairs of exemplary locations in Germany. The bottom 3 graphs show the crosscorrelation function of the corresponding model residuals with 5% confidence bounds.
The Figure exhibits the hourly times series of (expected) load in the day-ahead market from 16.10.2012 to 31.12.2014.

The left graph shows a detailed view of (expected) load in March 2013 whereas the right graph depicts the timeseries of load for the 4th of March, 2013.
Figure 32: Filtered state variables

The top graph shows the filtered Non-Gaussian process whereas the bottom graph depicts the Gaussian counterpart.
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