# Annual Credit Assessment Price (CAP) Process Review

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| **Meeting Name** | BSC Panel |
| **Meeting Date** | 10 March 2011 |
| **Purpose of paper** | For information |
| **Summary** | This is the annual review of the CAP process by the Credit Committee. The view of the Credit Committee is that the CAP review process has worked well during 2010 and no changes are currently necessary to that process. The BSC Panel is invited to note the views of the Credit Committee. |

## 1. Why are we providing this review?

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The last review of the Credit Assessment Price (CAP) process was presented to the BSC Panel in March 2010. It has previously been agreed that such a review should be carried out at least annually, therefore we are presenting this review for your information.

The aim of the review is to report how well the process that monitors and amends the CAP value worked throughout 2010. This review is provided by the Credit Committee, which is the Panel Committee charged with operating the CAP review process, including determining changes to the value of CAP.

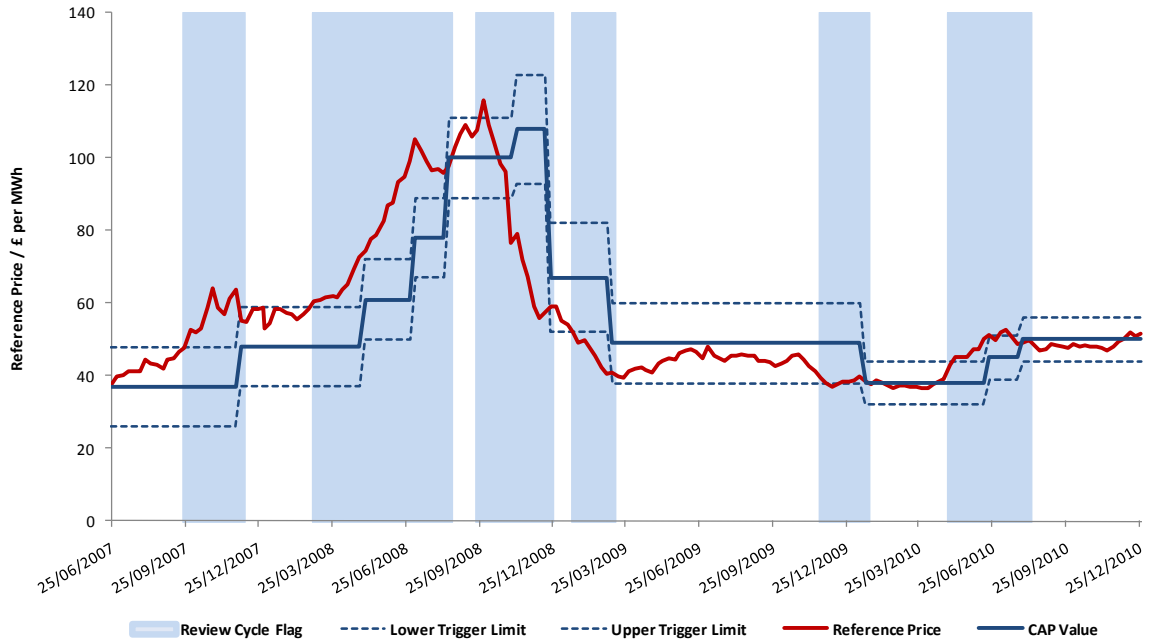
The main text of this paper assumes that the reader is familiar with CAP, what it is used for, and how its value is reviewed. Background information on these areas is set out in the Appendix to this paper.

## 2. What happened in 2010?

### CAP values reviews and changes

The monitoring and review process works by comparing the current value of CAP with a Reference Price derived from average quarterly forward market prices. This forward price data is currently provided by ICIS Heren. Where the absolute difference between the two values exceeds a preset trigger level, a CAP review is triggered. Graph 1 shows the values of CAP and the Reference Price since 2007.

Graph 1: Reference Price and CAP




Forward Prices provided by ICIS Heren

There were two reviews of CAP triggered in 2010, both in quick succession, which looks like one review period on the graph. A new value of CAP was implemented on 12 January 2010, following a breach at the end of 2009. This had reduced the CAP value from £49 to £38. A trigger event then occurred in May 2010, and CAP increased to £45. As soon as the review period ended, another breach occurred, resulting in CAP being increased to £50 in July, a value at which it remains at the date of this paper's publication.

The details of the 2010 CAP values and reviews are set out in the table below.

| Date of CAP Trigger Breach | Effective Dates of CAP | CAP Value implemented | CAP Value proposed in Consultation |
|---|---|---|---|
| 10 May 2010 | 12 January 2010 to 17 June 2010 | £45 | £45 |
| 21 June 2010 | 28 July 2010 onwards | £50 | £51 |

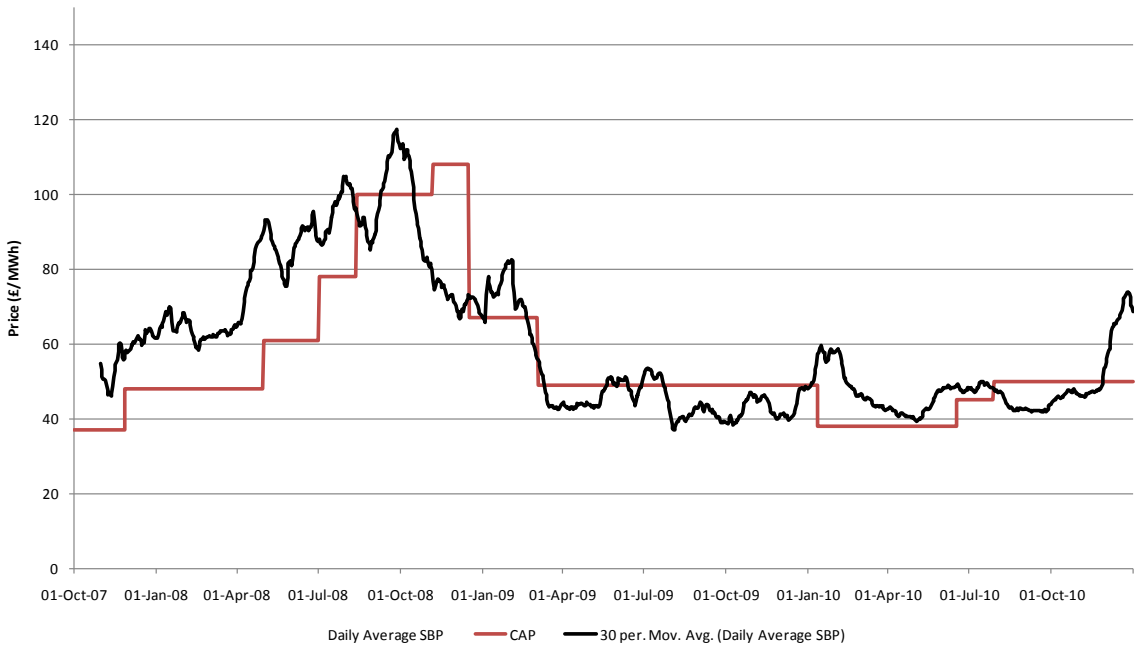
## How well did CAP reflect out-turn System Buy Price?

CAP is intended to be a proxy for System Buy Price (SBP). The underlying reason for the CAP review process is to set CAP so that it always gives an accurate reflection of what we expect SBP to be. Because of the time taken to review and change CAP, we set CAP based on the industry expectation of general electricity price levels in 2 - 6

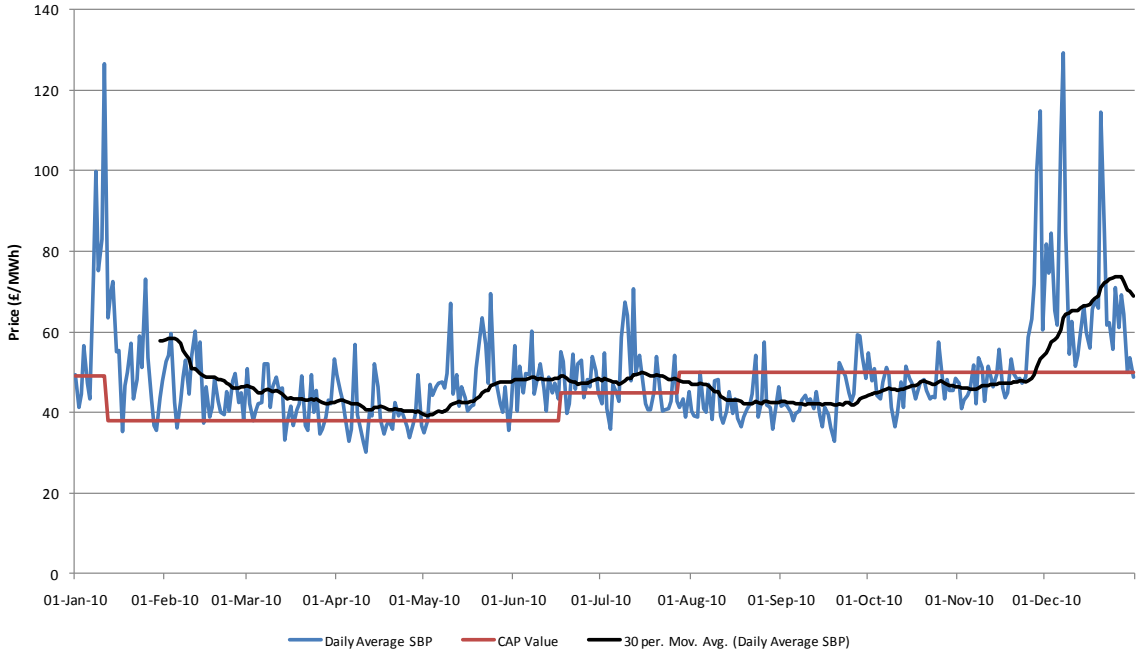
months' time. So the way to measure how well this review process is working is primarily to see how well the CAP value that we set matches the actual SBP.

In Graphs 2 and 2a you can see the relationship between CAP and daily average SBP. Graph 2 shows the period from October 2007 to the end of 2010, while Graph 2a shows the data for 2010 only. To provide clarity over the longer time period in Graph 2, we have removed the daily average SBP but kept the 30 day moving average of daily SBPs.

**Graph 2 Daily Average System Buy Price and CAP**

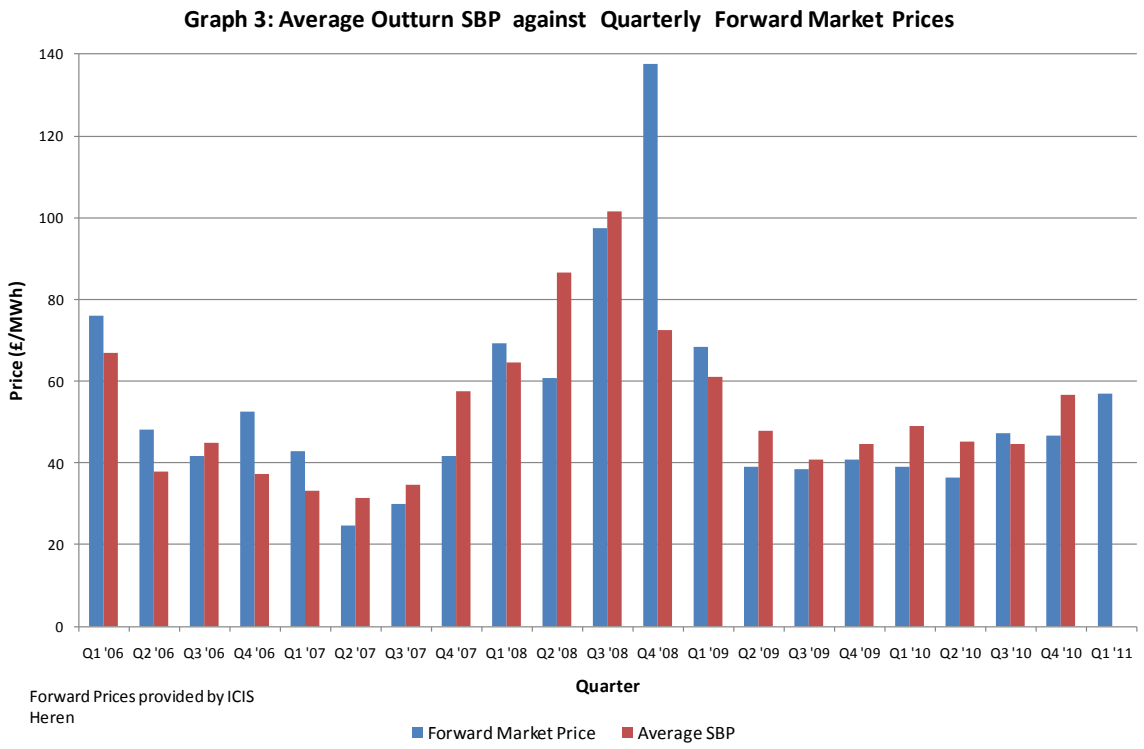


**Graph 2a: Daily Average System Buy Price and CAP**




For 2010, with the exception of January and December where high imbalance prices coincided with the extreme weather conditions, there was a reasonable match between CAP and SBP.

In Graph 3 you can see the average outturn System Buy Price (SBP) over each Quarter against the forward price for that Quarter. We have based this forward price on the last available Quarterly forward market price before the Quarter actually began. This is another measure of how good the CAP review process is overall. This is because if the forward price does not predict outturn future price movements well, then with our current methodology, CAP will not reflect future prices well either.




In Q4 of 2010, CAP was quite a large under-estimate of SBP, although this is by no means the largest discrepancy we have witnessed. This is mainly because of the large spike in prices in December – for the rest of the quarter, the forward prices much more closely matched SBP. A similar impact was noted in Q1, where another extreme cold spell was experienced and resulted in large imbalance prices. Again, Q3 showed the closest correlation between forward prices and SBP, as this will be the quarter where demand is most predictable.

In conclusion, we believe that the CAP review process has worked well over 2010; i.e. it has produced CAP values that match well with the outturn SBP.

Therefore, we can see no pressing need to change the CAP review process at the moment.

## CAP process changes during 2010

No changes were made to the CAP process last year. The Credit committee reviewed the trigger level at its meeting in June, but decided that it should remain at £6/MWh, a level that was set during the second review in 2009, and became effective in January 2010.

## Impact of Modification P217

At the end of 2009, Modification P217 was introduced which altered the methodology by which the Main Energy Imbalance Price was calculated. At the time of the last annual CAP review, there was insufficient pricing data to categorically state that the impact of these changes on SBP would not require changes in the CAP process. Since

the implementation of the Modification, ELEXON has included monthly analysis on its impact on prices in the Trading Operations Report. This has shown that while individual Settlement Periods have been affected, the impact on average daily prices has not been significant. Therefore there is nothing to suggest that the CAP process needs to be modified as a result of the new Imbalance Pricing methodology.

### Credit Committee membership changes

There were several changes to the membership of the Credit Committee during 2010. Nick Durlacher - the Credit Committee Chairman - and John Sykes the Acting (deputy) Chairman resigned from the Committee, as did James Nixon, Sebastian Eyre and Man Kwong Liu. Andrew Pinder, the new ELEXON and BSC Panel Chairman was elected as the Credit Committee Chair, and Andrew Colley elected as the Acting Chairman. Stuart Cotten also joined the Committee.

The membership of the committee now stands at seven. Members of the Credit Committee are required by its terms of reference to be members of one of the Panel, ISG or SVG.

## 3. Possible CAP review process changes

As we believe the CAP review is working well within the constraints of the current BSC, we are not recommending any changes this year.

However, each year we draw attention to aspects of the BSC that constrain the speed of change of CAP. Most of the associated changes could only be made if a BSC Party raised a Modification Proposal, as they are set within the BSC. To date, no Party has done so.

Any change to the following would require a Modification to be implemented:

- **A minimum 20 business day notice period of any CAP change must be given to Trading Parties and affected BSC Agents.** Shortening this period might allow CAP to be more responsive to rapid changes in prices. However, the long notice period may be of value to Parties at times of increasing CAP, and the current CAP review process may need to be amended by the Panel concurrently with any change of notice period as the review process was designed with the 20 business day period in mind.
- **There is a requirement to consult on CAP changes with Trading Parties.** It has been suggested in the past is that if the CAP review process is working well, the process should be automated to the extent that CAP should simply be set to equal the Reference Price after a given notice period. This would remove the need for the BSC obligations to consult Trading Parties and on the BSC Panel (delegated to Credit Committee) to review and determine values of CAP. This suggestion relies on the continuing satisfactory operation of the automated CAP review process. The CAP consultation period has already been reduced

over the years to 5 Working Days, and it does not seem appropriate to shorten the consultation period any further.

- **There is no ability to postpone or withdraw a decision to change CAP, if circumstances change during the notice period.** If a price trend is suddenly reversed, it can take a while for the CAP value to "catch up". This is evident in Graph 1 above for September/October 2008, where CAP was raised as a result of increasing forward prices, immediately prior to the credit crunch hit. This meant that by the time the higher value of CAP was implemented, market sentiment was very different from when the CAP value was determined. The Credit Committee was aware during the notice period that the value of CAP to be implemented was no longer appropriate, but nothing could be done about it. Shortening the notice period would also mean the next CAP review could commence earlier, taking account of new information.

One change that could be made without a Modification is to amend the CAP Review Guidance Document, which is owned by the Panel. This could allow another CAP review to commence during the notice period before a CAP change arising from a previous review has been implemented. The original CAP change would still be made, but a further CAP change could be implemented more quickly than at present, allowing a faster response in times of rapidly changing forward prices.

However, theoretically, this could result in two further CAP reviews triggered during the notice period before the first CAP change was implemented. This has the potential for causing confusion, and is why overlapping CAP reviews were explicitly prevented in the CAP Review Guidance Document when we originally put this process together in 2007.

## 4. Recommendations

The Panel is invited to:

a) **NOTE** the view of the Credit Committee that no changes are currently necessary to the CAP review process;

b) **NOTE** that the Credit Committee will continue to monitor the accuracy and efficiency of this process;

c) **NOTE** that the Credit Committee will recommend changes to the BSC Panel should it believe changes are appropriate in future; and

d) **NOTE** the potential changes identified in this paper that could be made to the CAP review process.