

Credit Committee Quarterly Report: July to September 2010

Date Published: 8 October 2010

Overview or Purpose of Document:

ELEXON produces this report on the Credit Assessment Price (CAP) review process every 3 months for the Credit Committee. This particular report covers July to September 2010. The purpose of these reports is to assist the Credit Committee in its obligation to keep the CAP Review process under review.

In summary:

- No CAP reviews were triggered during this Quarter, although a CAP value change from an earlier review was implemented on 28 July. CAP has been set at £50/MWh from that date.
- CAP underestimated outturn SBP in July but overestimated it in August and September.
- Looking into the future, October and beyond, on current forward prices an immediate CAP review looks to be unlikely.

Target Audience:

Credit Committee Members and BSC Parties

Contact Name and Details: steve.wilkin
Tel: 0207 380 4253
Email: stevewilkin@elexon.co.uk
Website address for document:

Contents

1	Why we produce the Quarterly Report	3
2	An overview of the CAP review process from July to September 2010.....	3
3	A more detailed analysis	3
4	Other comments on the CAP review process	7
5	Looking Forward	8
6	Conclusions	8

Intellectual Property Rights, Copyright and Disclaimer

The copyright and other intellectual property rights in this document are vested in ELEXON or appear with the consent of the copyright owner. These materials are made available for you for the purposes of your participation in the electricity industry. If you have an interest in the electricity industry, you may view, download, copy, distribute, modify, transmit, publish, sell or create derivative works (in whatever format) from this document or in other cases use for personal academic or other non-commercial purposes. All copyright and other proprietary notices contained in the document must be retained on any copy you make.

All other rights of the copyright owner not expressly dealt with above are reserved.

No representation, warranty or guarantee is made that the information in this document is accurate or complete. While care is taken in the collection and provision of this information, ELEXON Limited shall not be liable for any errors, omissions, misstatements or mistakes in any information or damages resulting from the use of this information or action taken in reliance on it.

1 Why we produce the Quarterly Report

ELEXON creates this report every 3 months to provide an overview of the performance of the CAP review process. We focus on the review process over the last Quarter (i.e. this report covers the months of July, August and September 2010). We assess the weekly trigger checks and the performance of CAP against outturn System Buy Price (SBP) and forward market prices.

The primary aims of these reports are to assist the Credit Committee:

- by indicating where a change in the trigger level may be necessary;
- in its task of keeping under review the suitability and availability of the forward price data and enabling the Committee, where appropriate, to recommend a change of provider(s) or additional provider(s) of forward price data to the Panel; and
- by providing a view on how well the methodology for reviewing CAP is working. The Committee can recommend a change to the standard methodology to the Panel if it believes it to be necessary or appropriate.

As these reports are primarily for the Committee, there is no explanation in these reports of how the CAP review process works or what CAP is used for. If you are reading this report out of interest and want to know about this background, there are documents that cover this on the Credit Committee web pages, which you can find at:

<http://www.elexon.co.uk/bscpanelandcommittees/panelcommittees/CreditCommittee/default.aspx>

2 An overview of the CAP review process from July to September 2010

The CAP trigger did not breach in this Quarter.

Following a trigger breach in the previous Quarter (on 21 June), the Credit Committee had decided to raise CAP to £50/MWh. This was effective from 28 July 2010.

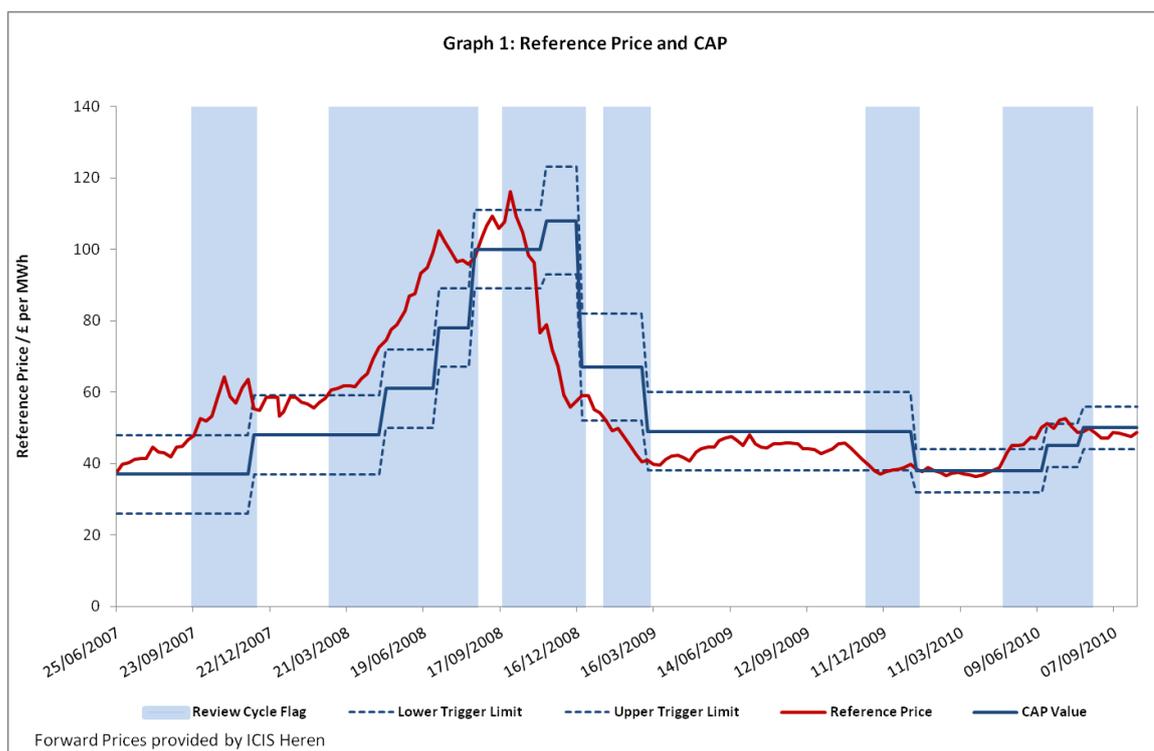
The trigger level remained at £6/MWh throughout the Quarter.

CAP values and reviews during the Quarter:

Date of Trigger Breach	Effective Dates	CAP Value actually implemented	CAP Value proposed in Consultation
10/05/2010	17/06/2010 to 27/07/2010	£45/MWh	£45/MWh
21/06/2010	28/07/2010 onwards	£50/MWh	£51/MWh

3 A more detailed analysis

A CAP review triggers if the Reference Price (which is derived from forward prices currently provided by ICIS Heren) breaches a band of current CAP +/- trigger level. So from 28 July 2010 when CAP was increased to £50/MWh, the new trigger limits became £56/MWh and £44/MWh.

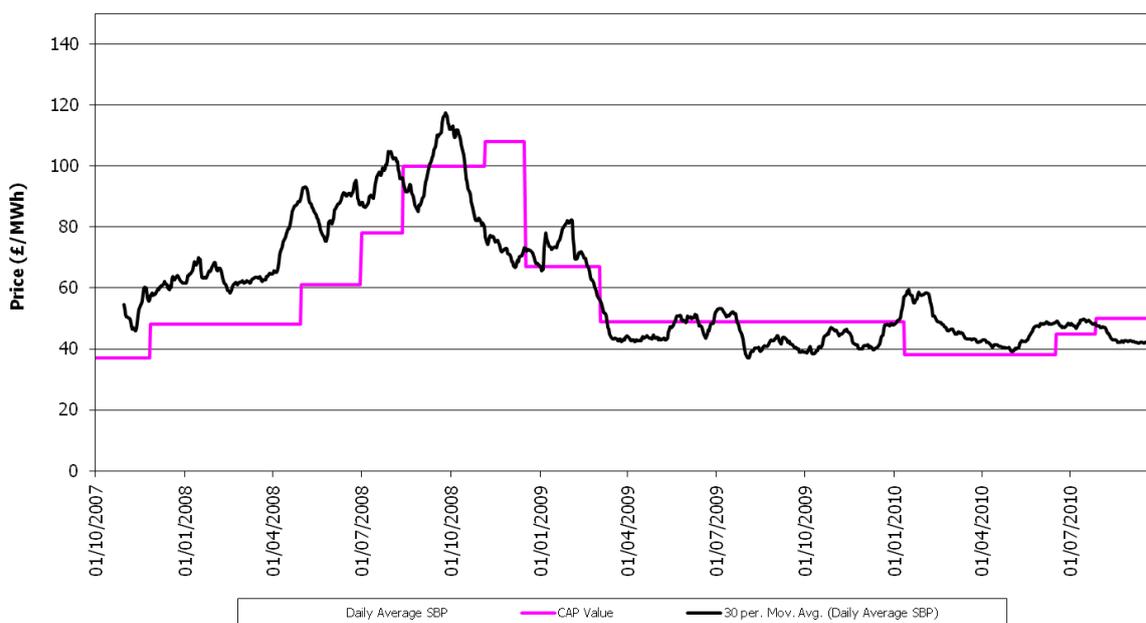


In Graph 1 you can see how the Reference Price has varied and what the CAP value has been set at over time. The new CAP review process was introduced in October 2007. On the graph you can also see the upper and lower limits of the trigger level and the shaded areas indicate periods where the value of CAP was under review.

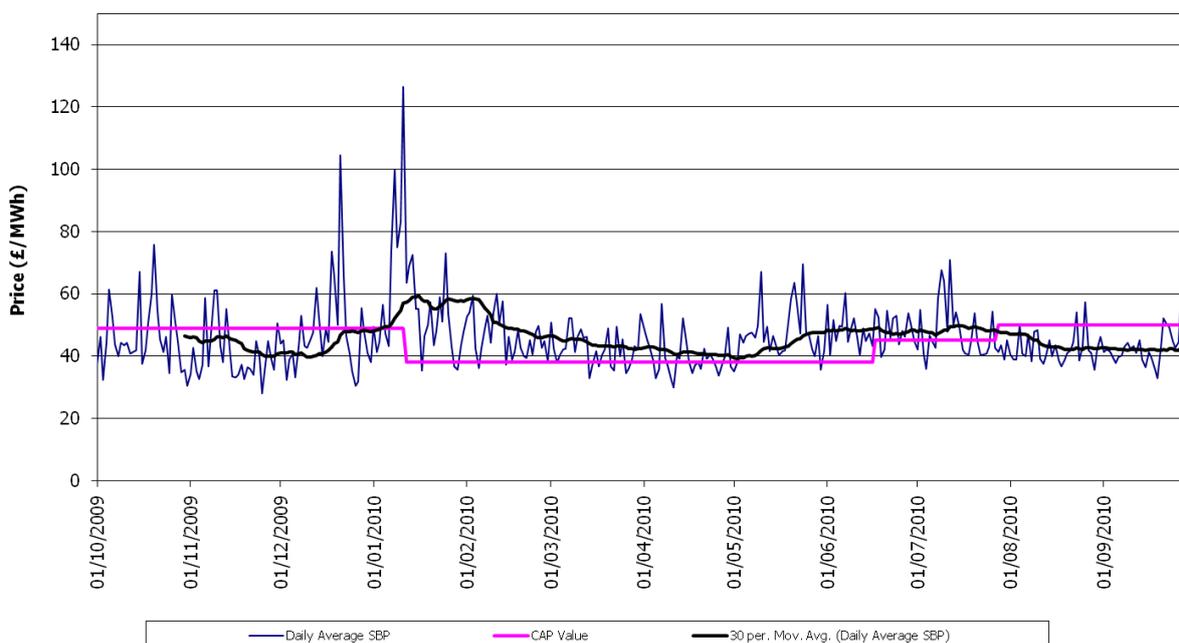
During this last Quarter, the Reference Price peaked on 12 July 2010 at £52.70/MWh, having risen almost continually from early April (when it stood at approximately £37/MWh). However, since that peak the Reference Price has dropped back somewhat to average at £48.25/MWh during August and September. The rising Reference Price from April to July had triggered two successive CAP reviews, but the more recent decline in Reference Price has not been sufficiently strong to trigger a downwards CAP value review.

In Graphs 2 and 2a you can see the relationship between CAP and daily average SBP. We believe that this is the real measure of how good the current CAP review process is at predicting outturn SBP. Graph 2 shows the period from October 2007 to date, while Graph 2a shows the data for the last 12 months 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



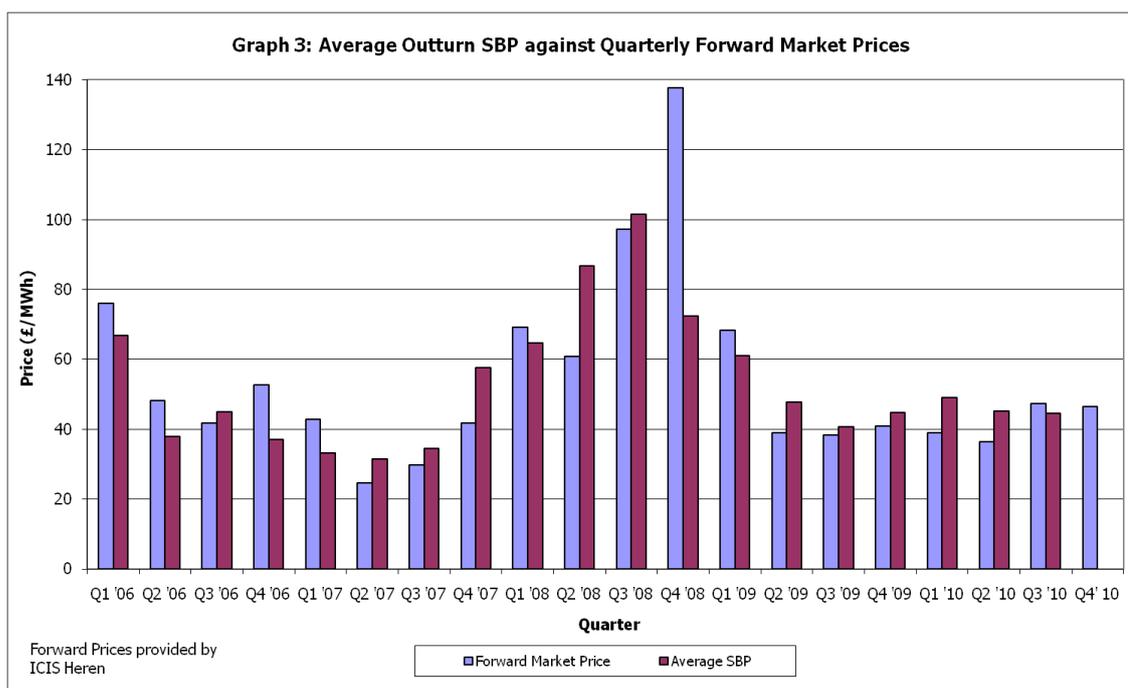
Graph 2a: Daily average System Buy Price and CAP



You can see from the graphs and the table below that CAP underestimated SBP in July, but from August onwards SBP dropped by almost £6/MWh from its average in July. The upwards CAP change on 28 July in combination with this drop in SBP meant that CAP overestimated SBP in both August and September.

	July 2010 (up to 27 July)	August 2010 (including 28 to 31 July)	September 2010
Average Outturn SBP	£48.14/MWh	£42.48/MWh	£43.84/MWh
Average Outturn SBP - CAP	+ £3.14/MWh	-£7.52/MWh	-£6.16/MWh

Graph 3 shows 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 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 SBP movements well, then with our current methodology, CAP will not reflect future SBP well either. Of course, we should make the point that forward prices are not necessarily used by the markets as predictors of SBP, but we have previously found that they are generally a good basis for this purpose, as can be seen over the years in Graph 3. Hence they have proved a good basis for use in the CAP review process.



For the third Quarter of 2010, you can see that the last forward price was above the outturn average SBP. Although this is a snapshot view on the last day of the second Quarter, it is consistent with the CAP value set by the June 2010 review overestimating out-turn SBP during August and September 2010.

4 Other comments on the CAP review process

4.1 *Effect of Modification P217*

ELEXON has monitored the impact of pricing modification P217, implemented on 5 November 2009. Reports are now included as routine in the monthly Trading Operations Report.

The evidence from this monitoring is that P217 can impact the prices in individual half hours but has no significant impact on the level of average daily prices. So there is still no reason to suggest that the current CAP review process needs to be revised as a result.

4.2 *Liquidity concerns*

During the summer, there was little trade on Quarterly forward products (although this has picked up somewhat in September trading). The Reference Price is of course calculated from the prices of these Quarterly forward products, although under the ICIS Heren methodology they are end of day indicative spot prices based on prices which traders have said they would trade at, not the actual traded prices during the day (if any).

In the light of the lack of actual trades in Quarterly forward products, we sought ICIS Heren's view on whether Quarterly forward prices might be withdrawn but were assured that this was very unlikely, particular with the forthcoming closer interconnections with continental Europe where these products are widely traded.

However, as a precaution we started to investigate potential alternative ICIS Heren product prices on which to base the Reference Price, e.g. monthly or seasonal products. The first stage of this is collecting the data and comparing a reference price calculated using these products with the current formal Reference Price. The evidence to date suggests that we can largely replicate the current Reference Price track using a combination of Monthly and Seasonal forward product prices in place of Quarterly forward prices should we ever need to do so.

Should we ever believe that we need to change the formula by which the Reference Price is calculated, we would seek Credit Committee views on a recommendation to the BSC Panel. Any change would be implemented by a change to the formula in the CAP Review Guidance Document.

4.3 *Credit Committee Membership Changes*

We have had changes of membership of the Credit Committee as a result of Panel membership changes at the end of September. (Members of the Credit Committee are required by its terms of reference to be members of one of the Panel, ISG or SVG.) Four members, Nick Durlacher who was Chairman, John Sykes who was Acting (deputy) Chairman, James Nixon and Sebastian Eyre have stood down. We thank them all for their work supporting the Committee.

As a result of these changes we will be seeking new Credit Committee members and the appointment of a new Credit Committee Chairman, at the October meeting of the BSC Panel.

5 Looking Forward

5.1 *Will there be another CAP Review soon?*

A CAP review would trigger if the Reference Price rose above £56/MWh or dropped below £44/MWh.

With each change of month in the coming Quarter, we include less of the first Quarter of 2011 forward prices and more of the second Quarter prices in calculating the Reference Price.

In October, the Reference Price is based purely on first Quarter 2011 prices. For November and December, the Reference Price would tend to drop all other things being equal. This coupled with a slight downward trend in Quarterly prices during September suggests that a CAP review with a view to increasing the value of CAP is unlikely.

But how likely is a CAP review with a view to decreasing the value of CAP?

On the last day of September, the first and second Quarter 2011 prices both stood above the £44/MWh lower trigger level. This suggests that despite the recent slight downward trend in Quarterly prices an immediate downwards CAP review is also unlikely.

As always, any sudden market movements could undermine these predictions very quickly, particularly as we are currently operating with a narrower trigger band than historically (+/- £6/MWh as opposed to the +/-£11/MWh we have operated with in the past). This means it takes a smaller movement in Reference Price to trigger a CAP review.

6 Conclusions

- No CAP reviews were triggered during this Quarter, although a CAP value change from an earlier review was implemented on 28 July. CAP has been set at £50/MWh from that date.
- CAP underestimated outturn SBP in July but overestimated it in August and September.
- Looking into the future, October and beyond, on current forward prices an immediate CAP review looks to be unlikely.