American options, 178–182
   for pricing, 255–256
American/European vanilla options, 120
Analytic option pricing formulae, 105–113
Annualized standard deviation, 63
APX power exchange (APX), 192, 199
Arithmetic progressions, 293
Arrow–Debreu prices, 143

Basic Linear Algebra Subprograms (BLAS), 245
Basket options. See Multi-asset options
Battery storage, 214–217
BEGKR method, 169
Benchmark portfolio, 234–244
Binomial distribution, 284–289
   for large $n$ and low probability $p$, 285–286
   for large number, 286–288
      normalized binomial variates, 288–289
Binomial expansion, 294–295
Binomial lattice, 115
   techniques, 115
Binomial model, 171
Bivariate cumulative normal, 174
Black–Scholes equation, 146, 259
Black–Scholes model, 47
   formula, 52
   Girsanov’s theorem, 53
   Greeks, 60–61, 62
   historical and implied volatility, 61–67
   inclusion of continuous dividends, 57–60
   Microsoft Excel, 67–70
   multi-asset option pricing partial
differential equation, 50–52
   option pricing partial differential
equation, 47–50
   probability density function, 54
   univariate cumulative normal function, 55
Black–Scholes pricing framework, 163

Brownian Bridge, 15–17
Brownian motion, 1, 3
   model of asset price movements, 5
      with one source of randomness, 11–12
      properties, 3–5

C++, 1
   classes, 245
   option pricing, 254–256
   random number class, 250–254
   risk percentiles, 256–258
   vector class, 245–250
Call options on maximum and minimum
   of two assets, 174
Central Limit Theorem, 265–266
Confidence Intervals, 267–268
Continuous dividends, 46–47
   inclusion, 57–60
Contract risk distributions, 198–200
Contract valuation, 206–209
Correlation coefficient, 164
Correlation matrix, 9, 83, 223–224, 272
Covariance, 270–272
   covariance of $n$ variables, 271–272
      three variables, 271
      two variables, 270–271
Cox, Ross, and Rubinstein binomial
   lattice (CRR lattice), 118, 169
Crank–Nicolson method, 150
Cumulative distribution function (CDF),
   22, 39, 68, 193, 282, 289
Cumulative normal distribution function,
   292–293

Delta function, 60, 126–127, 261
Demand side response (DSR), 2
Dependent variables, 165
Doubly truncated Weibull distribution,
   98–102, 102–203
Downward branching node, 139,
   142–143, 145
Dual cash-out price method, 190–191
Early exercise, 155–159
Efficient frontier, 225, 226
with no transaction costs, 225–233
with transaction costs and benchmark portfolio, 234–244
Empirical CDFs, 193, 289–290
European options, 173
call options on maximum and minimum of two assets, 174
for pricing, 254–255
put options on maximum of two assets, 175–178
put options on minimum of two assets, 174–175
Excel Visual Basic code, 223
Exponential distribution, 34, 281–282
Fast response generation units, 206, 210
Financial risk distributions, 189
Finite difference
approximation, 146–150
lattices, 169
method, 160–162
Forward price, 76–77
Four-state Markov Chain, 195
Fubini’s theorem, 22–23, 297
Fully implicit method, 149–150
Gamma function, 60, 95, 127, 260–261
Gaussian Copula, 194
Gaussian distribution, 7, 16
GBP/EUR exchange rate, 34
GBP/USD exchange rate, 34
Geometric Brownian motion (GBM), 1, 5, 47, 115
Geometric progressions, 293
Girsanov’s theorem, 8
Greeks, 60–61, 125–129
Delta, 261
European call, 62
European put, 62
Gamma, 260–261
Rho, 263
Theta, 262–263
for Vanilla European options, 259–260
Vega, 263–264
Grid methods for Vanilla options, 145
log-transformed grids, 159–162
standard grids, 146–159
stochastic process, 145
Half hourly marginal system price benefit, 194
Half hourly power price, 42–44
simulation, 36
Historic portfolio volume forecast error distribution, 192–193
Imbalance risk, 189
benefit of including customer into portfolio, 194–195
contract risk distributions, 198–200
contracted energy, 190–191
MIP, 195–197
risk distribution, 192–193
SBP and SSP, 197–198
single cash-out price, 191–192
stand-alone cost, 193–194
Independent, identically distributed random variables (IID random variables), 265, 269–270, 273
IID lognormal distribution, 102
Intraday generation, 217–221
Intraday power storage and demand optionality, 210
battery storage, 214–217
import site with storage and solar PV, 212–213
storage connected to grid with/without solar PV generation, 211–212
swing contract, 213–214
Ito product rule, 11
Brownian Motion with one source of randomness, 11–12
in $n$ dimensions, 14–15
Ito quotient rule, 12–14
Ito’s formula. See Ito’s lemma
Ito’s isometry–correlated processes, 25–27
Ito’s isometry–single process, 23–25
Ito’s lemma, 5–8, 297
for multi-asset geometric Brownian motion, 9–11
Johnson binomial lattice, 133–137
Johnson distribution, 84
    option pricing formula, 84–88
    parameter estimation, 89–93
Jump diffusion process, 103

Kalman filter, 82

Lattice methods, 145
    constructing and using standard
    binomial lattice, 121–129
    Johnson binomial lattice, 133–137
    log transformed binomial lattice,
    129–133
    standard binomial lattice, 115–121
    trinomial lattice, 137–145
    for Vanilla options, 115
Least squares Monte Carlo optimization,
    211–212, 213
Lithium ion batteries, 210
Load management, 35
Log transformed binomial lattice,
    129–133
Log-transformed grids, 159
    derivation of equation, 159–160
    finite difference method, 160–162
    see also Standard grids
Lognormal distribution, 117, 280–281
Longstaff Schwartz regression
    approach, 2
    see also Least squares Monte Carlo
    optimization
Marginal power price, 33
Market index price (MIP), 190, 195–197
Markov process, 3
Markowitz efficient frontier, 225
Markowitz mean–variance portfolio
    selection problem, 223
Markowitz portfolio optimization, 1
Martingale measure, pricing derivatives
    using, 45–46
Martingale process, 3
Mathematical reference
    arithmetic and geometric progressions,
    293
    cumulative normal distribution
    function, 292–293
    series expansions, 294–295
    standard integrals, 291–292
    Mersenne Twister uniform random
    number generator, 250, 252
    Merton jump diffusion model, 102, 255
    analytic option pricing formulae,
    105–113
    jump diffusion process, 103
    Monte Carlo simulation, 104–105
    parameter estimation, 113–114
    Microsoft Excel, 67–70
    Microsoft Excel VBA code, 1, 90–93,
    223, 230, 240–242
    Mixed integer linear programming
    (MILP), 211
Moment generating functions, 272–273
Monte Carlo
    fundamental power stack model, 2
    lattice approach, 165
    methods, 163
    simulation, 33, 104–105, 192, 250
Multi-asset
    Black–Scholes equation, 163–164
    derivative, 50
    geometric Brownian motion, 1, 9–11
    Multi-asset options, 165
    multidimensional lattice methods, 163,
    169–171
    multidimensional Monte Carlo
    methods, 165–169
    pricing partial differential equation,
    50–52
    three asset options, 183–187
    two asset options, 171–182
    see also Single asset American style
    options; Single asset European
    options
Multifactor forward curve model, 82–83

N2EX, 192
National Grid, 210
Newton’s method, 64, 66
Normal (Gaussian) distribution, 277–280
Normal cumulative distribution, 67
Normalized binomial variates, 133,
    288–289
NORMDIST function, 67
Numeraires, 45
Object-based programming languages, 248
Objective Function, 1, 230, 233, 244
One factor forward curve model, 72, 137
exponential factor, 72
forward price and spot price, 76–77
option pricing formula, 77–80
spot price process, 73–76
One-factor spot model, 70–72
Option payoff at terminal nodes, 123–124
Option pricing, 254–256
American options, 255–256
European options, 254–255
formula, 77–80, 84–88
partial differential equation, 47–50
Option values computation at given time
instant, 151–155
Ornstein–Uhlenbeck process, 1, 17
mean, 18
variance, 19–21
Payoff, 45, 46, 54, 123–124, 172, 213
Poisson distribution, 282–283
Poisson process, 21–22, 34, 102
Poisson random number generator
functions, 253
Portfolio optimization, 224
covariance matrix, 223–224
efficient frontier with no transaction
costs, 225–233
efficient frontier with transaction costs
and benchmark portfolio, 234–244
optimum asset allocation, 224–225
Portfolio volume forecast error
distributions, 194
Power contracts
imbalance risk, 189–200
intraday generation, 217–221
intraday power storage and demand
optionality, 210–217
wind contracts, 200–209
Power price model
modeling wind and solar generation,
36–42
power stack model, 33–36
simulated half hourly power price,
42–44
Power spot price, stochastic process for,
205–206
Power stack model, 33–36
Price European exchange options, 171
Probability
density function, 23, 54, 58, 275, 277
distribution, 15
measure, 53
Problems, 27–32
answers to, 297–313
Put options
on maximum of two assets, 175–178
on minimum of two assets, 174–175
Put–call parity, 46–47
Radon–Nikodym derivative, 8
Random number class, 250–254
Random walk, 3
Reasonable approximation, 119
Relative contract maturities, 83
Renewable energy, 2
generators, 189
Risk percentiles, 256–258
Simulation, 204–205
Monte Carlo simulation, 33, 104–105,
192, 250
Single asset American style options
Grid methods for Vanilla options, 145
lattice methods for Vanilla options,
115–145
see also Multi-asset options
Single asset European options
Johnson distribution, 84–93
Merton jump diffusion model,
102–114
multifactor forward curve model,
82–83
one factor forward curve model, 72–80
one-factor spot model, 70–72
pricing derivatives using martingale
measure, 45–46
put–call parity, 46–47
two-factor spot model, 81–82
Vanilla options and Black–Scholes
model, 47–70
Weibull distribution, 93–102
see also Multi-asset options
Single cash-out price method, 190–192
Single-factor forward curve model, 82
Solar generation, 35, 36
  actual half hourly UK summer solar PV generation, 41
  actual half hourly UK winter solar PV generation, 42
  current and previous daily average UK solar PV generation, 38
  current and previous half hour UK solar PV generation, 38
  simulated half hourly UK summer solar PV generation, 41
  simulated half hourly UK winter solar PV generation, 42
Solar PV generation
  import site with storage and, 212–213
  storage connected to grid with/without, 211–212
Spot price process, 73–77
Standard Binomial lattice, 115
  asset values to lattice nodes, 122–123
  computing Greeks, 125–129
  constructing and using, 121
  iterate backwards through lattice, 124–125
  lognormal mean, 116
  lognormal variance, 116–121
  option payoff at terminal nodes, 123–124
  values of constants by lattice, 122
Standard Brownian motion, 4
Standard grids, 146
  backwards iteration and early exercise, 155–159
  boundary conditions, 150–151
  computation of option values at given time instant, 151–155
  finite difference approximation, 146–150
  see also Log-transformed grids
Standard integrals, 291–292
Standard normal distribution, 4
Standard statistical results, 265–273
  Central Limit Theorem, 265–266
  Confidence Intervals, 267–268
  covariance, 270–272
  covariance matrix, 272
law of large numbers, 265
  moment generating functions, 272–273
  variance, 268–270
Standard Template Library (STL), 245
Standard Weibull distribution, 93–98
Statistical distribution functions
  Binomial distribution, 284–289
  empirical CDF, 289–290
  exponential distribution, 281–282
  lognormal distribution, 280–281
  normal (Gaussian) distribution, 277–280
  Poisson distribution, 282–283
  uniform distribution, 275–277
Stochastic integral expectation, 27
Stochastic integrals, 22
  expectation of stochastic integral, 27
  Fubini’s theorem, 22–23
  Ito’s isometry–correlated processes, 25–27
  Ito’s isometry–single process, 23–25
Stochastic processes, 1, 8, 145
  for power spot price, 205–206
Swing contract, 213–214
System buy price (SBP), 190, 197–198
System long, 190
System price, 189
System sell price (SSP), 190, 197–198
System short, 190
Taylor Series, 294
Terminal nodes, option payoff at, 123–124
Tesla, 210
Three asset options, 183–187
Tidal power, 2
Time varying drift and volatility, 8
Time-varying mean, 76
Trinomial lattice, 137–145
  branching types for nodes in trinomial lattice, 139
  downward branching node, 142–143, 145
  mean reverting trinomial lattice, 138
  normal branching node, 140–141, 145
  pricing using lattice, 144
  upward branching node, 141–142, 144–145
Two asset options, 171
- American options, 178–182
- European exchange options, 171–173
- European options on maximum or minimum, 173–178

Two dimensions, Ito product and quotient rules in, 11–14

Two-factor spot model, 81–82

Uniform distribution, 275–277

Uniform grid, 156

Univariate cumulative normal function, 55

Value at risk (VAR), 192

Vanilla European options, Greeks for, 259–264

Vanilla options, 47–70

Vanilla options, grid methods for, 145
- log-transformed grids, 159–162
- standard grids, 146–159
- stochastic process, 145

Vanilla options, lattice methods for, 115
- constructing and using standard binomial lattice, 121–129
- Johnson binomial lattice, 133–137
- log transformed binomial lattice, 129–133
- standard binomial lattice, 115–121
- trinomial lattice, 137–145

Variance, 268
- of $n$ variables, 269–270
- one variable, 268

Ornstein–Uhlenbeck process, 19–21
- three variables, 269
- two variables, 268–269

Vector class, 245–250

Vega function, 60, 128–129, 263–264

Visual Basic, 67

Volatility, 5
- historical, 61–64
- implied, 61, 64–67
- smile, 64

Weibull distribution, 93, 202–204
- doubly truncated Weibull distribution, 98–102
- standard Weibull distribution, 93–98

Wind contracts, 200
- contract valuation, 206–209
- simulation and calibration, 204–205
- stochastic process for power spot price, 205–206

Weibull distribution, 202–204

Wind generation, 35–36
- actual half hourly UK, 39
- actual half hourly UK summer, 40
- actual half hourly UK winter, 40
- current and previous day wind generation load factors, 37
- current and previous half hour wind generation load factors, 37
- simulated half hourly UK, 40