The Evolution of Exchanges: An OTC perspective

According to Phil Atkinson, Director of Corporate Development, ICAP Energy, the relationship between OTC broker, exchange and clearing house poses a transparency challenge for regulators and future providers of wholesale market liquidity.

Exchanges and liquidity

In a recent article published in the Financial Times, Clara Furse, CEO of the London Stock Exchange, expressed concern over the vertical silo model of exchanges, where an exchange has ownership of its own clearing operation. Such vertical silo models enable exchanges to control liquidity and both execution and clearing.

In European power markets both Nord Pool joined the EEX earlier this year in offering the German market products with the exact same specifications, the only difference being where the transaction was cleared.

OTC brokers have on numerous occasions been faced with the scenario where a deal could be matched between buyer and seller on a given product common to both exchanges, but the deal cannot complete due to the lack of inter-operability between the two clearing arms of Nord Pool (Nord Pool Clearing) and the European Energy Exchange (European Commodity Clearing).

Here we see two operations using the vertical silo model, i.e. "You trade in "my market" and you have to clear in "my clearing house." This has a negative effect on liquidity and transparency, as traders elect to do their trading for the same product with both exchanges.

Both markets (Nord Pool and Germany) have a number of features which connect the two markets. Most of the larger producers and financial institutions trade both markets. Strong price correlation between the Nord Pool and Germany and continued efforts to integrate the physical markets have strengthened this relationship. But, unfortunately with a lack of inter-operability between the two respective clearing houses, we are unlikely to see any major liquidity developments in the near future. In fact volume growth across all exchanges is forecasted to be negative for 2008.

The relationship between OTC broker, exchanges and clearing creates a market transparency challenge for the regulatory

Figure 1 – The European Landscape – OTC and Exchange Volumes

Estimated Volumes 2008	Volume Twh 2008	OTC Volume TWh	OTC Market Share
Nord Pool	2,200	1,100	50%
German Physical	4,000	4,000	100%
EEX	1,100	825	75%
Dutch Bilateral	320	320	100%
Endex	110	83	75%
French Bilateral	400	400	100%
Powernext	80	8	10%
Spanish Bilateral	140	140	100%
Total	**8,350**	**6,876**	**82%**
Total TWh Bilateral	4,860	4,860	100%
Total TWh Cleared	3,490	2,016	58%
Euro Markets Bilateral	4,860	4,860	100%
Euro Markets Cleared	1,290	916	71%
Euro Markets ex Nord Pool	6,150	5,776	94%

authorities and perhaps more importantly for the current and future liquidity providers in European energy markets.

It is clear that the OTC broking community is the major liquidity holder **(see Figure 1 on the next page).** If one extracts the volume traded on Nord Pool with its high levels of transparency, then the OTC broker community accounts for over 90% of the total traded volume and over 70% of the cleared volume.

Competing OTC platform

One should perhaps ask the question why markets such as the EEX, Endex and Powernext have been unable to achieve the same levels of market transparency as Nord Pool, especially in derivates.

The reason is simple. The electronic market places within the OTC community in combination with the application of Trayport's Trading Gateway technology provide the trading community with confident levels of electronic liquidity in combination with voice broking support – i.e. the hybrid broking model. All OTC brokers offer exchange look-a-like products on their electronic platforms (now regulated MTF's under MiFID) and trading firms using the Trading Gateway technology facilitate the viewing and execution of best prices across multiple markets/OTC brokers on a single screen.

This may be termed a synthetic exchange and does provide the trading community with transparency across multiple asset classes and brokers on a single platform. This also provides such users with more efficient post trade management.

Interestingly, we have seen Nord Pool, EEX and others link their existing exchange liquidity into the Trading Gateway to embrace broker liquidity into one big pool of prices.

Future role of exchanges

So what is the role of the exchanges and what is their future? We see that global players, such as NYSE, NASDAQ, EUREX and NYMEX, are all involved in various transactions/co-operative ventures etc. The belief is that their expertise and relationships will add value to the market and provide market players with new opportunities. But with a combination of financial and physical players all wanting to enter markets with high levels of transparency and clearing solutions that enable them to net cross border positions, one has to ask the question whether exchanges with their vertical silo approach will be able to provide such an offering.

With the OTC broking community offering valuable voice and electronic services and the trading community making use of Trayport's Trading Gateway, the exchanges to maintain an electronic exchange that can offer competitive levels of liquidity.

One may envisage greater co-operation between the exchanges and the OTC broker community such that the execution services are left with the broker and the exchange's prime function is to set the rules of the game. Is anonymity an issue? Anonymous trading exists already on OTC platforms and again with increasing regulation and a tightening of internal compliance procedures for OTC brokers the OTC option could provide as secure a trading environment for market participants as exchanges.

Transparency is a bigger issue in physical spot markets. Although only 20% of the European (excluding Nord Pool) power markets are cleared there is a high level of transparency amongst customers who trade the bilateral forward and cleared future markets. OTC brokers have access to all OTC clearing services and market participants seem satisfied with the present transactional possibilities. The key question for this year and beyond is: "Can clearing houses come forward with a solution that facilitates cross-market clearing without causing liquidity and transparency fragmentation?"