Expanding Role Envisaged for Energy Exchanges

According to Moffatt Associates' latest quarterly survey, the majority of market participants consider that energy exchanges have stimulated market liquidity in both gas and power. Further expansion in both exchange and OTC trading is expected in the next three years.

This issue of Energy Viewpoints focuses on the future role of exchanges and the relative merits of exchange and OTC trading.

More liquidity in power than gas

Between 70% and 80% of survey respondents believe that energy exchanges have increased market liquidity, particularly in the wholesale power markets.

Below are some typical comments from traders:

"For power definitely, if you have an exchange you get new entrants to the market, e.g. the financial institutions that don't need to know much about the market. Also there is easy access and easier credit."

"(a) Yes (in power), but only moderately due to high fragmentation (one or more exchanges per country) and consequent high costs and lack of efficient margins, (b) No (in gas) as underlying physical spot markets in Continental Europe have yet to develop sufficiently (which in turn is due to lack of proper TPA to gas grids and transmission)."

"Yes (in power), they have increased liquidity because they provide a consistent and reliable long-term benchmark and guarantee the existence of the markets. You need exchanges to make sure you can get rid of risk or take it on. They are a sign of stability."

"Yes (in power), due to the fact that we can balance our position through the exchanges. In fact, the liquidity of the power exchanges will affect the development of the forward power market."

"Not in gas, but yes in power. Exchanges have helped new entrants in gas but I don't see exchanges as vital. They are necessary for balancing but I don't see the volumes. In power they have helped, especially the smaller players e.g. in Germany."

Trading opportunities and limitations

Respondents were asked to say whether they agreed or disagreed with certain specific statements relating to the relative merits of exchange and OTC trading in power and gas.

A summary of responses is set out in the table below:

Scenario	Agree	Disagree	Don't Know
Exchanges provide a level of price transparency which is lacking in the OTC market	62%	34%	3%
In gas trading, exchanges (where they operate) provide reliable spot market prices	34%	38%	28%
In power trading, exchanges (where they operate) provide reliable spot market prices	79%	11%	11%
Exchanges should offer more opportunities for purely paper/financial trading	61%	7%	32%
Exchanges offer the most efficient platform for cross-border trading (e.g. market coupling)	54%	32%	14%
Currently trading on exchanges is prohibitively expensive relative to the OTC market	50%	39%	11%
The value of contract clearing via an exchange offsets the additional cost of trading	18%	50%	32%
Exchanges and not TSOs should be responsible for publishing market data on capacity, flows and storage	34%	59%	7%
Regulators should encourage more trading via energy exchanges	25%	64%	11%
More trading via exchanges would reduce the role of excessive financial speculation in energy markets	14%	75%	11%
Currently there are too many exchanges in Europe	50%	36%	14%
There should be one exchange for each regional energy market (as defined by ERGEG)	52%	41%	7%
There should be only one exchange platform for gas, power and CO_2 trading for the whole of the EU	34%	59%	7%
Exchanges should be independent of Government and/or TSOs if they are trading financial (paper) contracts	83%	10%	7%
Exchanges can be owned by a Government and/or TSOs if they are only trading spot (physical) contracts	48%	38%	14%

Advantages of OTC trading

Generally market traders consider that exchanges offer significant advantages in terms of transparency, spot power price reliability, reduced credit risk and market coupling **(see previous table).**

But the market is opposed to regulators forcing more trading via exchange platforms because at the moment OTC trading is more flexible, cheaper and offers more specialised products.

Below are some typical comments from traders:

"Lower costs of OTC and the ability to design tailor-made products that are not available on the exchanges."

"The main benefit of OTC trading is the cost advantage and to an extent it is less strict on rules and regulations so there is more flexibility."

"OTC trading is important as a complement because traders have much better customer contacts and there are tailor-made and specialised products."

"The ability on the OTC market to negotiate prices."

"In gas, traded volumes are set to grow strongly but this will largely be OTC. Exchanges will only get significant volumes if they offer interesting products that are not available OTC – e.g. a day-ahead cleared price for gas."

Expanding role of exchanges

Traders believe that trading on both exchange and OTC platforms will increase significantly in the next three years.

Below are some typical comments:

"Yes, I think the main issue is the credit issue. Trading on exchanges is safer and that is why people get involved e.g. financial institutions will come to the exchanges."

"Yes, trading via exchanges will probably increase, but not necessarily stronger than brokered OTC trading (as far as forward trading is concerned)."

"Yes, it's an idea whose time has come. It has been slow to develop but there will be pressure in the market to see exchanges operate better."

"Yes, because credit is moving the focus – most energy companies are less credit-worthy than financial institutions."

"Yes, because I think there will be a greater focus on credit, people will take credit more seriously and I think the increase could be very significant."

"Yes, if there are more consolidated exchanges with more products, with incentives to trade on exchanges rather than OTC. At the moment there are no incentives to trade."

"Yes on some. Some exchanges may disappear and the trade will be taken up by others, where trading will take off. It won't increase in 12 months, but it should in 5 years, so it probably will increase in the next 3 years."

"Yes, because it is a natural development of the market, more players are involved in it and these won't want to have the infrastructure that is needed for trading OTC."

Moffatt Associates
MAY 2008