

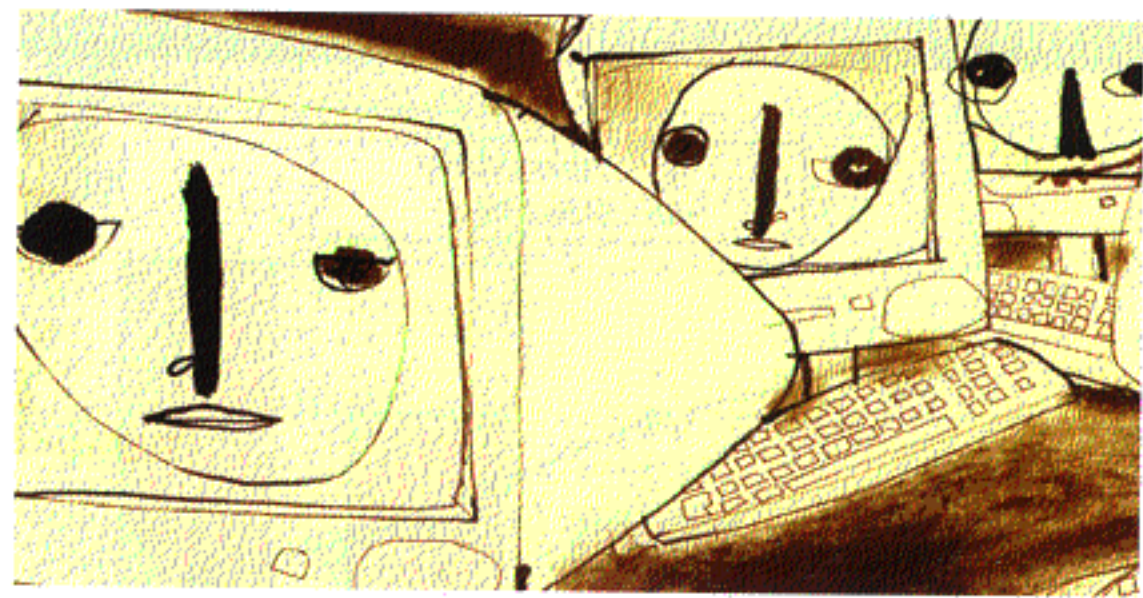
A man in a dark suit is shown in profile, looking down at a document he is holding. The scene is dimly lit, with several bright spotlights creating a dramatic, high-contrast atmosphere. The man's face is partially illuminated by the light from the spotlights. The document he is holding has the words 'Commodities Now' written on it in a stylized font.

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# Developing The 'Hybrid'



# Electricity Marketplace

The introduction of 'hybrid' electronic marketplaces for electricity trading heralds a new era for energy price risk management says **RAGNAR OTTOSEN**.

**IN THE** last 18 months electricity markets have witnessed the introduction of the electronic marketplace, making it possible to execute trades directly on screen via the Internet or direct telephone lines. One of the more advanced markets, in this respect, is the Nordic power market. In 2000, approximately 1500TWh were traded through brokers and exchanges. It has, therefore, not come as a surprise that the first example of an electronic marketplace with a large share of the market can be seen in the Nordic market. The power exchange NordPool already holds 25% of the market executed electronically. In addition, the smaller all-electronic marketplace ePower had about 5% of the market.

In April, SKM Energy Brokers, the largest broker in the Nordic market with a 20% market share, was sold to the electronic marketplace powerITS - a joint venture company between the German broker Pbi and the Swedish software supplier Univits. Other brokers have also announced that they intend to link up with electronic platforms,

tant new trend were brokers merge with companies providing the electronic platform. This will introduce a new marketplace which combines the technological excellence of the IT provider and the market skills and liquidity of the broker.

This can also be seen as another important step in the restructuring of broking business. The European power trading environment frequently states that it can only support a limited number of trading platforms with the necessary liquidity. Today, the number of alternatives is much higher than that which can conceivably be supported. Most agree that there will be perhaps five to six platforms which will survive the next development phase and that there has to be a restructuring of the business. There are many signs that this process is already underway in the Nordic market.

## Reduction In Transaction Costs

The reduction of transaction costs and of the fees paid to brokers or exchanges has fallen dramatically in the

in brokerage fees in the Nordic power market 1997-2000 compared with the increase in volumes.

## Introduction Of Electronic Trading

A relatively large share of the short term contracts are traded electronically - mainly because the value of each contract is too small to pay for the cost of labour intensive voice brokering services (together with speed). On the other hand, the high value of each longer term contract, typically millions of Euros, means that the value of market information is much higher. Most traders prefer to spend some time and money in acquiring market information through one or more brokers before taking the decision to buy or sell long term contracts and larger volumes of power.

With the introduction of Internet based trading, the unit cost of each transaction will be further reduced compared with traditional voice brokering. The fall in transaction costs caused by new technology and fierce competition has reduced the number of brokers/marketplaces in the Nordic

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among them the Norwegian broker M3 which was bought by the American company the Automated Power Exchange (APX). At present, as much as 80-90% of the total traded volume in the Nordic market is electronic or linked with an electronic platform - even if more than half of this volume is still voice-brokered. This shows an impor-

Nordic marketplace. Increased volumes and the introduction of electronic trading of standardised contracts is one of the main reasons for this decline. Today a power contract or set of contracts in the Nordic market can be traded with the use of brokers or exchanges with transaction costs a fraction of those ten years ago. Figure 1. shows the reduction

market from eighteen in the mid 1990s to six today. Moreover, profits have also been sharply reduced. Consequently, brokers or marketplaces are unlikely to survive without large volumes. The key to survival will therefore be to attract these necessary volumes, both to show liquidity and to reduce unit costs.

The question remains whether this

Fig 1. Illustration Of Traded Volumes & Broker Fees (Nordic)

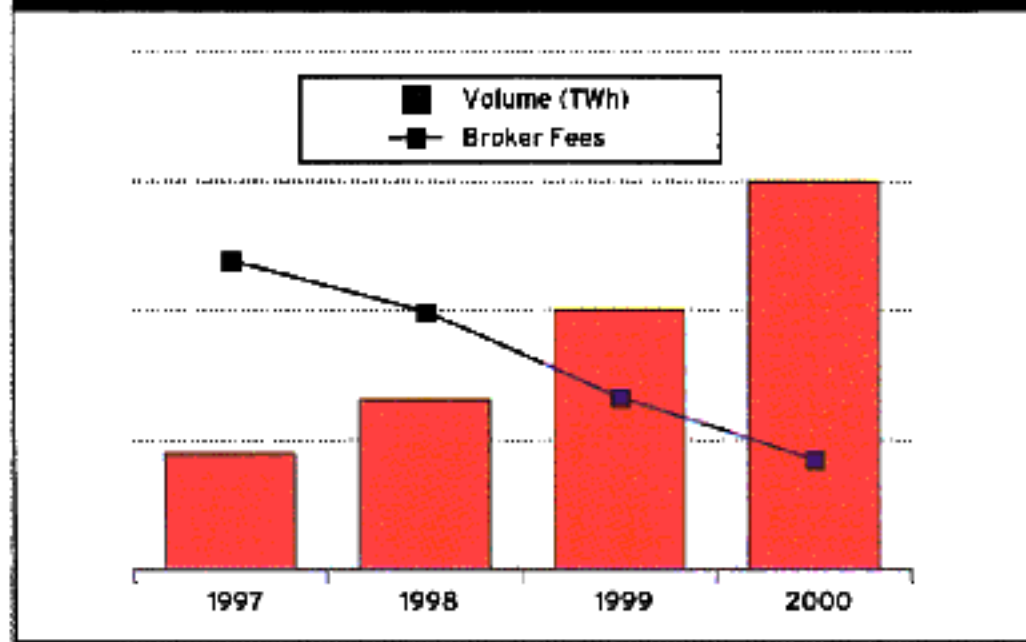
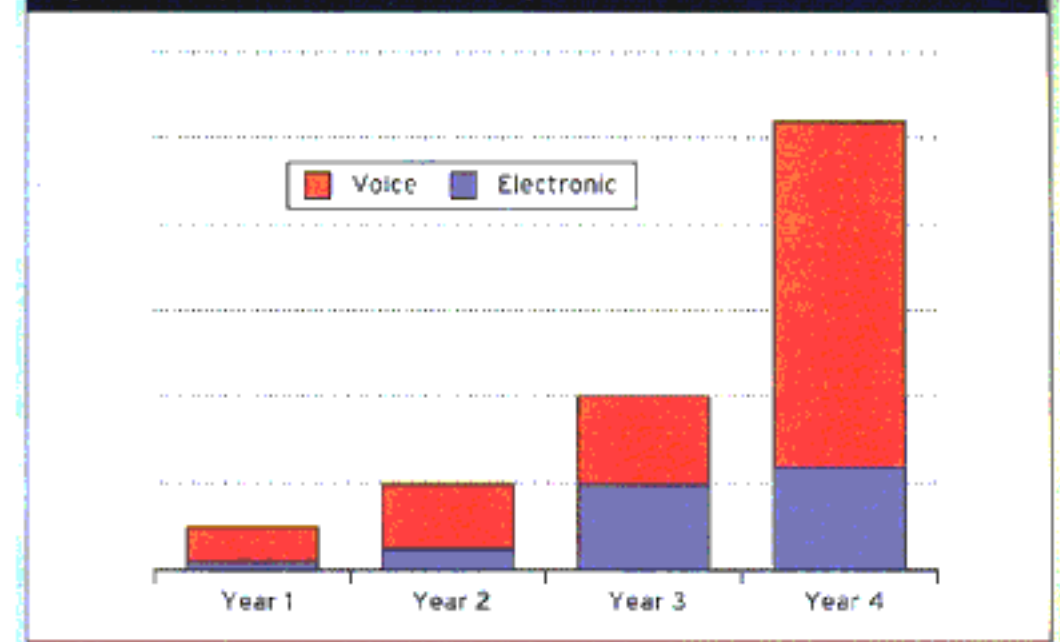


Fig 2. Anticipated Future Development Of Traded Volumes (Nordic)



development will pave the way for an all electronic trading environment. The first real example of the value and benefit of electronic trading occurred in 1999 in the Nordic market when NordPool, the power exchange, handled over 20TWh in one day - equivalent to 10% of the total annual volume of NordPool. It was told that the 'pling' signal at NordPool's desk indicating the matching of a trade made was activated continuously for several hours. However, on other occasions voice

into the platform would then act both as brokers attracting volume and as a help desk - a 'hybrid' exchange, bringing together the advantages of the human relation factor of the voice broker and the technology and cost advantages of the electronic platform.

At present several electronic platforms have been introduced into the European power market and some have already attracted relatively large volumes, while others will struggle to achieve market share. Experience so far

place. The NordPool help desk therefore could operate as a voice broker attracting liquidity to the electronic marketplace. Even if this was not done openly, it is quite clear that this was an important measure in attracting liquidity. NordPool can actually be regarded as the first successful implementation of the combination of electronic trading in combination with elements of voice brokering.

#### Hybrid Marketplaces vs. Institutional Exchanges

One of the things that distinguishes these hybrid marketplaces from what we shall call institutionalised exchanges, like the EEX and APX (Amsterdam Power Exchange) is that they are not generally regulated and therefore able to take a very flexible approach to the rules and regulations governing the institutional exchanges. Normally an institutional exchange will not be allowed to have an internal voice brokering operation. On the other hand, these hybrid marketplaces generally cannot pretend to be the same type of official marketplaces, acting as an official price reference. This is generally very important in the spot market, i.e. the market for physical short term delivery which is used as the reference price in financial contracts. We can therefore expect institutional exchanges to exist side by side with the non-institutional exchanges, as the latter can give users a more flexible product. This co-existence will benefit the user, as the institutional exchange will have to try and attain a very high level of flexibility within the regulatory framework at the same time as the non-institutional exchange will have to meet the highest business quality standards ■

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broking also proved its value. In 2001, the Nordic market went through a period of very high volatility and market uncertainty. In this period voice brokering increased its market share. One of the more obvious explanations for this increase in voice brokers' market share is the need for traders to continuously monitor and check market trends. For this purpose voice brokers were the preferred choice.

Figure 2. illustrates the expected development of electronic and voice brokering volumes over coming years in the European power market.

#### The Hybrid Electricity Marketplace

Today, one can see the emergence of two types of electronic platforms. One is the pure platform, designed to compete with brokers, exchanges and bilateral trade by having very low costs and lower fees than voice brokering. The other is to merge the two methods of trade matching - voice brokering and electronic trading, into one integrated platform. The voice brokers integrated

seems to indicate that marketplaces integrating voice brokering and electronic communication will have a clear advantage. Examples of such marketplaces are GFinet, Spectron and the new powerITS. (EnronOnline is probably the most successful platform measured in volume, but in this context not regarded as a marketplace competing with brokers and exchanges).

So far, the only example of an electronic marketplace which has attracted high volumes is NordPool. Since its establishment in the early 1990s, the exchange has been in competition with the brokers. It was not until 2000 that NordPool attracted a larger volume than the largest Nordic broker SKM Energy Brokers. It is also important to understand that NordPool did not entirely base its operation on electronic trading. NordPool is a combined futures and forward exchange, spot exchange and clearinghouse. To attract volume to its electronic marketplace, NordPool used the clearinghouse help desk to actively motivate clients to use the NordPool market-



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