

MIBEL BR public consultation
of wholesale electricity
market participants on
possible measures to improve
liquidity in the MIBEL forward
markets



Evaluation of the
responses received



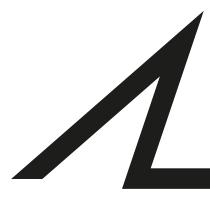


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Introduction

On 22 December 2020, the MIBEL Board of Regulators launched a public consultation, which was open until 29 January 2021, mainly addressed to participants in the wholesale electricity market.

The public consultation addressed various matters extracted from the conclusions of the "*Comparative study of the MIBEL prices (spot and forward) with other European markets and their relationship with the internal energy market*" (hereinafter, the MIBEL BR Study)¹, with the aim of obtaining the opinion of MIBEL stakeholders with regard to potential measures that could be proposed oriented to the better functioning and development of MIBEL.

Thirteen stakeholders responded to the consultation, which included electricity companies, consumers' associations, market operators and Central Counterparties (CCP).

The MIBEL Technical Committee (MIBEL TC) has analysed the replies received and these are summarised and assessed in this document.

Along with the publication of this document, the MIBEL TC has also made public the responses received to the consultation whose publication was not objected to.

Summary of the main responses to the questionnaire

The questionnaire included a series of questions related to certain aspects that affect the functioning of the market and particularly the liquidity of forward contracts. Below are the questions contained in the questionnaire, together with a summary of the responses received.

I. Market liquidity

1. Almost all of the respondents in the public consultation agree that liquidity is a key indicator of the proper functioning of the forward market.
2. However, as stated by an integrated group and an association of traders, the measures should be aimed at fostering the participation of a larger number (and a wider range) of participants, and should not be interventionist measures that could ultimately affect efficient price formation. Another integrated group also state that if the forward market is not attractive for stakeholders, liquidity will continue being low and, consequently, the spreads will be high.
3. Several stakeholders, including integrated groups, a traders association, a consumers association and a CCP, mention the direct relationship between regulatory stability and market liquidity, since it affects stakeholders' confidence to participate in such market.

¹https://www.cmc.es/sites/default/files/editor_contenidos/Energia/Mibel/190703%20Resumen%20Ejecutivo%20Estudio%20Precios_ES_PUB.pdf



Q1 - Do you consider that the injection of liquidity into the forward market is more necessary for the buy side or for the sell side?

All respondents agree that liquidity is a key indicator for the development of the forward market.

Various answers were received to the question posed:

4. On the one hand, vertically integrated groups are not keen on the idea of any type of market intervention, as they consider that it would generate perceptions of regulatory instability and would eventually have a negative impact on the liquidity being fostered. However, two integrated groups and a traders association affirm that if measures are finally adopted to inject liquidity into the market, these should affect the buy side and the sell side in the same way, in order not to interfere in the balance of prices or in the price formation process. Furthermore, an integrated group emphasises that the voluntary nature of the measures should be preserved in order to avoid an excessive intervention eventually discouraging stakeholders from participating in the market.
5. On the other hand, several respondents with demand profile state that the pressure on prices is on the buy side. Therefore, measures should be adopted to increase liquidity on the sell side.
6. Finally, the market operator proposes implementing measures to increase liquidity on the buy side.

Q2 - In your opinion, does physical bilateral trading, mainly carried out by vertically integrated groups, reduce or not the liquidity of the forward market?

Two types of answers were received to this question:

7. Integrated groups and also a traders association state that the physical bilateral trading they carry out is a natural hedge between generation and supply and it does not decrease the liquidity in the forward market, as their net positions are hedged on this market. An integrated group adds that this type of bilateral trading is also carried out in countries such as France or Germany, which have greater liquidity levels on their forward markets. Hence, in their opinion, this would demonstrate that the low liquidity level of the Spanish forward market is not a direct consequence of this type of trading.
8. Conversely, respondents with demand profile and the market operator answer “yes” to this question and claim that this type of trading not only withdraws liquidity from the forward market, but also results in a lack of transparency, since it hampers the disclosure of prices. A respondent with a demand profile also acknowledges that, to the extent permitted by legislation, this type of trading cannot be avoided, but greater transparency can be demanded.



II. The role of market makers with regard to contracts

9. In general, the respondents in the consultation agree on the importance of the role played by market makers to boost liquidity on the forward market, as a counterparty for both buyers and sellers.
10. A CCP indicates that the activity of market makers should not be limited to regulated markets. Hence, their services should also be provided to brokers.

Q3 - What importance do you give to the role of market makers with regard to longer-term contracts?

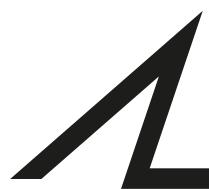
11. Most of the respondents stress the role played by market makers in longer-term contracts, since, among other reasons, they inspire confidence.
12. However, their long-term action raises doubts among some of the respondents. An integrated group comments that, in view of the low liquidity level in the long term, market makers' risk increases by not being able to renegotiate the positions as they are taken. Another integrated group says that, in the long term, market makers could increase counterparty risk in the CCP, as the margins required from stakeholders are valued according to the price of products and in the longer term, which are less liquid, calculating its volatility is more difficult.

Q4 - Do you consider that the existence of market makers will boost the forward market significantly, moderately or slightly?

13. Some integrated groups and a traders association consider that increasing the number of market makers as a measure to boost the forward market would have a small impact.
14. However, some suppliers and the market operator do consider that the existence of more market makers may boost the forward market significantly, but also identify as a key aspect the conditions under which market makers operate, such as bid-offer spreads, bid-offer volumes, quoted contracts or the periods of the trading session in which the market maker undertakes to enter bids.

Q5 - For what maturity dates do you consider that the figure of market maker would be more relevant?

15. Most of the respondents are in favour of products that draw greater interest among stakeholders who wish to hedge; specifically, those with maturities from M+1 to Cal+2. Some respondents, with both generation and demand profiles, and the market operator indicate that due to investments in renewables, the demand in longer-term trading has increased. Hence, it would be appropriate to increase the liquidity level in contracts between two to five years and up to ten years ahead.



Q6 - Do you consider that there is any type of stakeholder profile that should act as market maker?

16. Several respondents with a demand profile and an integrated group consider that the role of market maker is appropriate for stakeholders who are very active in trading. An integrated group, on the other hand, refers to financial institutions as suitable for the provision of the market maker service. Other integrated groups, a traders association and the market operator are of the opinion that market makers should respond to different risk profiles and should be able to take positions contrary to those of the hedgers. In addition, an integrated group and a traders association argue that the voluntary nature of market makers should be preserved. Finally, respondents with a demand profile or suppliers consider that the role of market maker should be played, in addition to other profiles, by vertically integrated groups or by operators qualified as dominant.

Q7 - What benefits should be associated with the market making activity?

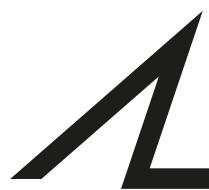
17. There is consensus in that there should be compensation for the service provided by market makers, which should be related to the risk assumed by these companies.
18. Some of the compensations or benefits indicated by the respondents are the exemption from the payment of fees for their participation in the market or a financial compensation in the form of an appropriate payment for the service provided.

Q8 - Do you consider that the remuneration for such activity should vary according to the profile of the stakeholder acting as market maker?

19. The majority of the respondents agree that discrimination among participants is a very sensitive issue. Accordingly, the general opinion is that the remuneration for this activity should not vary according to the profile of the stakeholder acting as market maker.
20. Only a respondent with a demand profile is in favour of the remuneration varying according to the agent profile and being conditional on the liquidity it brings to the market in terms of the number of transactions.

Q9 - If so, do you consider that a minimum trading volume should be required from market makers?

21. A traders association, an integrated group and the market operator consider that a minimum trading volume or number of transactions should not be required from market makers.
22. However, an agent with a demand profile and an integrated group do consider that a minimum volume of transactions should be required.



III. Integrated Group Auctions

23. There is a consensus among respondents in that they are not in favour of auctions for integrated groups, by considering that they involve, de facto, a regulatory intervention to artificially provide liquidity to the market, which could affect the efficient price formation.

Q10 - Would you consider it appropriate to establish a forward auction mechanism similar to the Virtual Power Plants(VPPs) type, where the energy would be sold by vertically integrated groups?

24. Despite acknowledging the importance of Virtual Power Plant auctions in the early stages of the liberalisation of the electricity market, almost all the respondents consider that it is not appropriate to re-establish a similar auction mechanism.

Q11 - If so, for what forward dates should the contracts be subject to auctions?

25. There were no answers to this question as there were no “yes” replies to the previous question.

Q12 - Should the settlement of auctioned products be physical or financial?

26. There are no answers to this question since respondents are not in favour of establishing VVP auctions. Only the market operator states that the physical settlement of auctioned products is only appropriate in cases where either the market or the liquidity of the underlying asset does not guarantee or require a sufficiently solid level for financial settlement.

IV. Mechanisms specifically targeted at renewables

27. Various stakeholders, with different profiles – demand profile, integrated group, market operator and a CCP– believe that, nowadays, with a high penetration of renewable energy, it would be reasonable to consider mechanisms that are complementary to auctions, which in turn enable boosting liquidity on the forward market.
28. On the offer side, there is a new generation of independent producers of renewable energy who are interested in having hedging instruments to reduce their exposure to the market price, thus stabilising their income over a time horizon.
29. Likewise, on the bid side, large consumers also demand long-term products to reduce uncertainties in their procurement costs to ensure their competitiveness.

Q13 – In a complementary way to the auction mechanisms set out in Spanish and Portuguese legislation, would you consider it beneficial to establish a competitive mechanism, perhaps for more mature technologies, in which both the offer, articulated via renewable facilities, and bid participate?

30. The majority of respondents do not object to the establishment of competitive mechanisms. However, an integrated group considers that a measure or action of this type would have a low level of acceptance while there is a regulatory risk associated with price formation on the markets (e.g., taxes on electricity production).

Q14 - If your answer to the previous question is “yes”:

What maturity dates should the products have (5, 7, 10 years or other maturity dates)?

Should the settlement of the contracts be physical or financial?

In the mechanisms to be put in place, do you consider it would be beneficial if the guarantees of origin (GoOs) were linked to the energy at stake and these were transferred to the awardees? Or, could the products of such GoOs be decoupled?

31. The respondents state that the 5-, 7- and 10-year maturities are the most appropriate. Nevertheless, they also highlight that renewable energy producers are currently more interested in trading in periods exceeding 10 years, in particular, in maturities of 15 years.
32. With regard to the type of settlement, there is no consensus among the answers received to this question; while an integrated group is in favour of financial settlement, another two respondents with demand profile favour physical settlement. The market operator considers that the decision should be made by stakeholders, except where a product has GoO-related aspects associated, in which case the settlement should be physical.
33. With regard to the GoOs, given that European legislation envisages the possibility of a total decoupling of energy and GoOs, this should be left to the stakeholders' discretion.

V. Participation of smaller stakeholders in the forward market

34. Even though two integrated groups and a CCP consider that there is no real problem in small stakeholders accessing the forward market, the majority of respondents indicate that a lower participation of these is due to the numerous barriers to access which they face. These barriers include, among others, the lack of knowledge of the forward market, the applicable financial regulation, the levels of solvency and margins required to participate, as well as the lack of qualified resources to manage this activity.

Q15 - How could the participation of smaller stakeholders (suppliers, producers or consumers) in the forward market be facilitated or promoted?

35. To foster the participation of smaller stakeholders in forward markets, the respondents consider that the actions should be aimed at mitigating the access barriers mentioned above. They say such actions include, among others, simplifying the burdens of compliance or reducing financial costs associated with accessing and trading on forward markets.

Q16 - Do you consider it necessary, for example, to establish contracts of a smaller size or with other profiles?

36. All the answers indicate that the minimum size of the contract does not appear to be an important element in the participation or not of these types of stakeholders.

Q17 - Do you consider that the creation of the figure of independent aggregator is important to foster the participation of smaller stakeholders?

37. All stakeholders, except the market operator, do not consider that the creation of the figure of independent aggregator is important, as there are market stakeholders and traders that already permit the aggregation of smaller stakeholders.
38. In addition, a consumer association also indicates that this figure would not be viable as the management of forward market margins is complex.

Q18 - How could the figure of independent aggregator be implemented in the forward market?

39. Several integrated groups and a traders association state that independent aggregators should be subject to the same rights and obligations as any other market participant.
40. For its part, the market operator stresses the regulatory obstacle, under financial legislation, that this figure would have to face, since its role would be considered a financial service.

Q19 - What mechanisms could be implemented to foster the participation of more financial institutions in the forward market, in order to promote the participation of smaller stakeholders?

41. All respondents highlight the need for greater regulatory stability as this creates an atmosphere of trust, not only in Spain and Portugal, but also at the EU level, which is essential for attracting more financial institutions to boost liquidity and competition.
42. In addition, a respondent with demand profile states that "*formulas or incentives should be sought for financial institutions already acting as clearing members to accept new stakeholders, eliminating restrictions based on the size*". Furthermore, the market operator indicates that access to the forward market could be facilitated for a greater number of smaller players with a greater number of financial institutions offering the service of clearing member to access the CCP, and also points out "*a key element to increase or facilitate the participation of smaller entities, which is the possibility of using bank guarantees as a collateral instrument against CCPs*".



VI. Courses and Seminars on forward markets

43. The respondents unanimously agree on the positive effects of educational measures.

Q20 - Do you consider that it is necessary to hold specific courses or seminars on forward markets (functioning, purpose, contracts available, risks, etc.)?

44. There is also a strong consensus among respondents on highlighting the advantages of financial education and holding courses and seminars.

Q21 - What are your greatest doubts relating to forward trading or the participation of non-financial institutions in these markets?

45. In the opinion of the majority of respondents, the lack of regulatory stability in the sector and the potential interventions in the markets, not envisaged by stakeholders, increase uncertainty in forward trading.

46. Some of the most common doubts mentioned are the application of financial regulations, the use of margins and the bureaucratic processes involved in participating in the forward market.

47. Conversely, an integrated group states that "*the participation of non-financial entities in forward markets does not raise relevant doubts as long as it is done in compliance with current regulations*". In turn, another integrated group suggests that "*information on the processes for agents to join the markets should be made available in a clearer and more transparent manner, in order to facilitate the whole bureaucratic process inherent to trading in the forward markets*".



MIBEL BR comments

This section contains the feedback and opinion, by blocks of subjects, of the MIBEL BR to the answers received via the public consultation.

I. Market liquidity

48. One of the conclusions drawn from the MIBEL BR Study, which analyses the evolution of the forward market during the 2010-2018 period, is that the ex-post risk premium of forward contracts is, on average, positive (which means that short positions are settled, on average, with profit).
49. The liquidity of a market is affected, among other factors, by the diversity of stakeholders who participate on it. The diversity depends on both the profile of the stakeholders intervening (hedgers, and/or speculators, and arbitrageurs), and their hedging needs (on the buy side or on the sell side), as well as on the volume or size of these. The MIBEL BR considers that these aspects are fundamental and should be borne in mind when analysing possible actions aimed at boosting the liquidity of the forward market.
50. Likewise, the MIBEL BR Study highlights the negative impact that the perception of regulatory risk has on the participation, and therefore, on the liquidity of the forward market, as stated by various respondents in the public consultation.
51. The lack of incentive for vertically integrated groups to participate in forward markets, as the risk of daily market prices is naturally hedged through forward bilateral contracts between their generation and their supply, is another aspect that is also reflected in the MIBEL BR Study. As indicated above, the answers received in this regard from integrated groups state that they participate in the forward market in order to hedge their net position.

II. The role of market makers with regard to contracts

52. The MIBEL BR shares the view of the majority of respondents in the public consultation in acknowledging the importance of market makers in fostering the forward electricity market. As these entities are on the market offering bid and offer prices on an ongoing basis, they offer stakeholders, which go to the market to hedge their risks, the possibility of accessing the liquidity required to meet their needs. In turn, market makers must be compensated for this service provided to the market, either via rebates or financial compensation offered by the trading venue or via traded spreads.
53. The compensation to market makers mentioned in the previous paragraph, in addition to being a common practice, is also included in a generic manner in the internal rules of the OMIP market.

54. However, given the characteristics of these financial instruments, the market making activity is more expensive. Therefore, a more attractive compensation is necessary for the activity of injecting liquidity carried on by stakeholders providing this service to these markets, compared with other more conventional markets. In fact, the risk assumed by market makers in these types of markets is greater the longer the contracts' maturity. In the absence of other incentive mechanisms, it is natural to see wide spreads for contracts with longer maturities.
55. In the opinion of the MIBEL BR, the higher the number of market makers, the greater the market efficiency. In fact, a higher level of competition among members providing this type of service would tend to minimise the excess remuneration that these members can absorb from the market, either via spreads or a direct financial compensation.
56. However, the MIBEL BR acknowledges that as the number of market makers increases, the profit for the market deriving from the activity of new market makers will progressively decrease.
57. The MIBEL BR agrees with the respondents to the public consultation in acknowledging that the intrinsic characteristics of market members should not, *per se*, be an obstacle to access the market making activity. The MIBEL BR also shares the views of the majority of respondents with regard to the need of maintaining the voluntary nature of this activity on the MIBEL forward market.
58. Bearing in mind the characteristics of the forward electricity market, in particular with regard to the risks assumed by market makers, the MIBEL BR also considers that the incentive mechanisms for this activity should include direct benefits for market operators, either via rebates or reductions in trading fees, as already reflected in OMIP's internal market regulations.
59. In the opinion of the MIBEL BR, the market making activity should not be conditional on the formal characteristics of the stakeholder that provides liquidity to the market. However, the incentive system can and must compensate market makers that provide more liquidity. That is to say, those members that reduce the spread and provide greater market depth should be compensated. Therefore, the remuneration system of the market making activity must incentivise in an effective manner boosting the liquidity in the market via more and better offers.
60. The MIBEL BR considers that the risks to which market makers are exposed are dynamic, and therefore, the level of liquidity provided to the market should also be dynamic. Hence, market makers should not be required to provide the same level of liquidity at all times. However, the price risk incurred by this activity can be covered by widening the spreads, without the amount offered necessarily decreasing or even expiring. In situations of volatility, which are already considered in the OMIP's internal market regulations, it is acceptable for market makers to be able to cover their risk positions and, therefore, they are permitted not to be exposed to the market.
61. In the opinion of the MIBEL BR, market makers should follow clear market exposure rules in terms of amount and minimum times of exposure, safeguarding exceptional situations of market turmoil. It is also important that these rules be transparent and that all market participants be aware of the minimum times of exposure of market makers and the respective amounts.



III. Integrated Group Auctions

62. The MIBEL BR takes note of the view of the participants in the public consultation who commented that the establishment of energy auctions for integrated groups would affect the liquidity of the forward market's trading on the continuous market of organised market trading venues. Furthermore, they consider that the establishment of this instrument as a regulatory measure can, artificially, affect efficient price formation.

IV. Mechanisms specifically targeted at renewables

63. From the meetings held by the MIBEL BR during 2020, both with associations of renewable producers as well as with associations of large consumers and industrial consumers, it has been concluded that on the bid side and on the offer side, hedging is needed to mitigate risks. The dispute arises, among both profiles, with regard to the ideal maturity for such hedging (between 5 and 15 years on the offer side, and between 2 and 5 years on the bid side). Furthermore, the current regulatory environment of installing new renewable generation, with ambitious targets, both at European level and at that of each of the national plans developing EU legislation, as well as the boost of forward trading of electro-intensive consumers by Spanish regulations, favours and fosters forward trading. Therefore, this environment helps to adopt measures aimed at facilitating the confluence of interests in hedging the bid and offer.

V. Participation of smaller stakeholders in the forward market

64. The MIBEL BR acknowledges that the costs of accessing the forward market, specifically with regard to regulatory requirements, in the field of financial regulation, are too burdensome for smaller stakeholders, and do not outweigh the benefits offered by participating in these markets, especially in terms of risk management. However, the regulatory framework of the financial intermediation activity on the electricity forward markets derives, mainly, from EU legislation on markets of financial instruments, which precludes the MIBEL BR from proposing improvements in the near future.
65. The MIBEL BR shares the opinion of the majority of respondents on the participation of smaller stakeholders on the market. Specifically, the MIBEL BR considers that the low participation of smaller stakeholders is due to issues that go beyond the costs of accessing the market or the range of products offered.
66. The MIBEL BR understands that the financial regulatory framework, especially in respect of prudential and organisational requirements, can be an obstacle for the participation of smaller stakeholders, even via an aggregator². However, the existence of solid prudential requirements is a fundamental part of an efficient and safe market. Even more so when it is a market whose economic exposure is leveraged by nature.

² A natural or legal person who, in compliance with the requirements established in financial regulations and market rules, aggregates the buying/selling interests of its clients to operate in the forward market. This figure, although similar, is not equivalent to that set out in the energy regulations.



67. Current market participants on the forward market may act in accordance with the rules of the forward market, as aggregators for smaller stakeholders, via the service of reception and transmission of orders provided, on a non-discriminatory basis, to their clients.
68. The MIBEL BR shares the opinion of the majority of respondents in that if a new type of market stakeholder is created with the aim of aggregating trading interests of smaller stakeholders on the forward market, it should have a regulatory framework similar to that of other stakeholders.
69. The MIBEL BR acknowledges that the forward electricity market's regulatory environment has been subjected to several substantial changes in the past few years, in particular on the occasion of the transposition of MiFID II, and the implementing regulations thereof. Even though the majority of the most profound regulatory changes stem from European legislation, the MIBEL BR takes note of stakeholders' opinions on regulatory stability.

VI. Courses and Seminars on forward markets

70. The MIBEL BR shares the view of the respondents on the importance of fostering educational and training measures on forward markets.

