INTERCONTINENTAL EXCHANGE/TRAYPORT MERGER INQUIRY

Summary of hearing with RWE Supply & Trading on 10 June 2016

RWE on Trayport

1. RWE stated that Trayport was a software provider, and that a distinction should be drawn between Trayport as a software provider and the brokers that used the Trayport back-end software to host prices.

2. RWE said that in UK power and gas markets, all over the counter (OTC) brokers required Trayport to be able to host these prices correctly. Alongside the OTC brokers were exchanges, although there was really only one exchange active in UK power and UK gas – ICE. Although ICE had its own front-end screen, WebICE, RWE believed that the majority of traders accessed ICE products through Trayport's Trading Gateway. In UK power and UK gas, Trayport was therefore embedded as the main access point for traders dealing on exchanges and with brokers for OTC trades.

3. RWE said that in other markets there were other front-end screen choices, for example, in oil RWE said that it could use X-Trader, TT or EXXETA. However, RWE emphasised that these front ends still needed to utilise Trayport's Trading Gateway to access the UK power market.

RWE on trading OTC and on exchange

4. RWE stated that its decision to trade OTC or on exchange was driven by liquidity and price. It emphasised that the main factor was liquidity, as the narrower the bid-offer spread, the lower the total transaction cost. RWE said that in UK power and gas markets, the exchange and OTC products were interchangeable. OTC and exchanges offered two different routes to the same products. RWE said that most of the transactions were screen based – 95% of trades would be carried out electronically. RWE stated that it believed that there was no particular difference in liquidity between OTC and exchanges based on the size of transactions.

5. RWE said that there was also a variable cost per trade, whether this trade was made through an OTC broker, or an exchange. To cover the cost of the

full trade cycle a trader could pay: (i) a fee to a broker for carrying out the transaction; (ii) an exchange fee for registering the transaction; and (iii) a fee to the exchange for clearing the transaction. For companies who were not direct members of a clearing house, they would pay a clearing bank to do the transaction and then pay delivery fees to both the clearing bank and the exchange for delivering the trade.

6. RWE said that alternatively, a trader could do an OTC trade that was not cleared; a bilateral trade. In this case, the trader would only pay the OTC brokerage. There may be additional costs associated with this trade, such as credit fees within the organisation. The fee structure was transparent to the trader at the point of sale. However, RWE noted that relative to the size of the bid-offer spread, any transaction fees were likely to be small.

7. RWE stated that there were regulatory factors that could influence traders' decisions to trade OTC or on exchange. In particular, it stated that the OTC derivatives regulation on Central Counterparties and Trade Repositories, which obliged clearing for counterparties that were above a certain threshold volume of OTC transactions. This may affect a trader's decision to trade on exchange rather than OTC in order to avoid reaching that threshold. However, beyond that threshold, traders would be required to clear OTC transactions, so the relative cost of executing and clearing exchange versus OTC clearing may influence where brokers chose to carry out deals.

8. RWE also said that there was a boundary between the physical markets and the financial markets that was covered under the Markets in Financial Instruments Directive (MiFID). At the moment, the trading of physical products on multilateral trading facilities was not regulated under the directive. The proposed revisions to MiFID could result in a change in the boundaries of these products, so that physical power and gas traded on organised trading facilities (essentially broker platforms) may not fall within the boundaries of financial regulation. As a result of these revisions, there could be a shift from exchanges towards brokers.

RWE on shifting liquidity from OTC to on exchange

9. RWE said that there had been a significant shift in liquidity from OTC brokers to ICE in National Balancing Point (NBP) gas in recent years. RWE explained that a range of factors had contributed to the shift in liquidity from OTC brokers to exchanges, including banks exiting commodity markets resulting in a number of businesses, such as hedge funds, moving into commodities to fill the gap. Factors relevant to shifting liquidity included: the mix of counterparties in the market (such as financial players and hedge funds who

were often required to trade on exchange), price, anonymity (the trades carried out on exchange were anonymous versus the trades carried out bilaterally) and the governance framework. In addition, all exchange trades were recorded on Reuters, this would allow a trader to analyse the market which might make exchange trading preferable.

10. RWE said that liquidity was sticky once it had been established on a certain venue. RWE said that NASDAQ had tried to enter the UK power market a few years ago, and noted EEX was trying to break into the UK power market at the moment. However it had been very difficult to move liquidity in the UK power market. RWE noted that the product that NASDAQ offered to the UK power market was a different proposition as it was a 'Contract for Differences' as opposed to a physical contract, this meant that traders who needed to buy physical power could not do so using the NASDAQ contract, it would need to carry out a physical trade as well. RWE noted that NASDAQ failed to break into the UK power market.

11. [✂] RWE had tried to stimulate migration to exchanges – from the OTC market – by attracting new financial players to boost liquidity for the market and for the exchange. RWE had found that current market players were reluctant to move away from OTC platforms probably due to the familiarity of these traders with operating in the OTC market.

12. RWE commented that it was too early to judge whether EEX would be successful or not in its attempt to enter UK power. RWE explained that EEX's strategy was to try to expand the market for UK power by attracting European players who currently traded EEX German power, for instance, to trade UK power on EEX's exchange. EEX was trying to attract these players to EEX's UK power products as they could gain netting benefits from positions they held on other EEX products. RWE commented that in order to move the liquidity in UK power EEX was going to have to persuade some market makers to see the long-term benefit of the increase in liquidity for new entrants and move their business, and hence liquidity, onto a new exchange. RWE emphasised that it was difficult to gain sufficient traction to shift liquidity to a new exchange.

13. RWE explained that if it agreed to shifting liquidity to a different exchange, it could risk splitting the liquidity pool without necessarily stimulating further liquidity from new entrants. This could result in diluting the liquidity pool amongst a number of exchanges which would widen the bid-offer spread.

14. RWE explained that in order to persuade traders to move liquidity from an exchange once liquidity had settled then changes in factors, such as price, would need to be extreme.

15. RWE said that in order for liquidity to shift from OTC to exchange in markets one factor could be that new trading firms could have a natural preference to trade exchange products, which could result in liquidity emerging on exchanges. Other factors could be changes in regulation.

RWE on clearing venues

16. RWE stated that it used clearing banks. It indicated that generally the choice of clearing house was based on one-to-one relationships with the exchanges ie if a trade was made on ICE, then ICE would clear that trade. RWE stated that if it were to trade through a broker, the choice of clearing venue would depend on the market. In some markets, for example UK power and UK gas, there was only ICE. In other markets, for example coal, you could select from a number of different exchanges.

17. RWE stated that when it traded OTC, the choice of exchange venue and clearing house could take place at different stages. Some brokers offered cleared trades on screen, so at the point of transaction, a trader would know whether the trade was an ICE-cleared trade. On other occasions where a trader was tying up a deal a particular counterparty may not be available, for example, because you may not have a credit relationship with that counterparty. In this case, the trade could be given to an exchange and at that point the two counterparties would agree where it would be given up to for clearing, instructing an OTC broker.

18. RWE said that if it wanted to do a cleared trade and there was an equivalent price on an OTC broker firm or direct on an exchange, it would always trade on exchange because the total cost of trading was cheaper. However, RWE explained that there were circumstances where they could use a broker to carry out a bilateral transaction that ended up not being cleared as the transaction costs may be cheaper. However, if there were an equivalent price on OTC and exchange, and the trader wanted to clear the trade, then RWE would use the exchange.

19. RWE said that OTC cleared trades were infrequent in both the UK power and gas markets. RWE explained that, in UK power, the majority of liquidity was with OTC brokers, whereas in UK gas, the liquidity was split between OTC brokers and ICE. In the UK gas market trade would be typically done directly on ICE or directly through an OTC platform without the necessity to clear.

20. RWE stated that the availability of Trayport's straight through processing (STP) was a factor that may affect the choice of where the trade was to clear as STP affected the operational risk and efficiency of processing transactions. RWE explained that STP avoided layers of manual processing and minimised the risk of errors. RWE said that this risk was higher in high volume markets, which were typically the markets that RWE operated in.

21. RWE said that it had moved from manual clearing to STP clearing and that if its clearing house of choice was no longer available through the STP link and connecting to Trayport's back-end, this could affect its decision to use that clearing house due to the increased operating burden. RWE explained that the cost of the transaction and netting effects were also factors which drove its choice of clearing house. RWE acknowledged that there may be other traders where the hierarchy of factors influencing their choice of clearing house was different.

RWE on Trayport

22. RWE said that Trayport hosted the broker's back-end or matching engines, which was the software that matched prices and hosted the brokers credit matrices. The exchange matching engine was a different engine. RWE was concerned that ICE could make it more difficult and more expensive for brokers to run their business, which relied on the Trayport back-end systems.

23. RWE said that an attempt to launch an alternative execution venue would more than likely fail if its prices were not consolidated into the Trayport system. Historically, EEX did not have a Trayport link and the EUREX system was deemed to be quite difficult to access. In response, EEX put a lot of effort into working with Trayport to provide this translator. Now, it was seamless. It was possible for companies to set up a service, as long as it was connected to a Trayport service.

24. RWE said that these links required quite a lot of maintenance. EEX's software provider, EUREX, would require software upgrades and technical changes. Trayport and EUREX had to maintain the software together, and RWE said that under ICE's ownership such upgrades may not be top of Trayport's list.

RWE on 'market making'

25. RWE said that as a designated market maker, RWE was required to provide prices for an agreed amount of time per day under the Ofgem imposed 'Secure and Promote' obligation. In UK power, RWE was obliged to make markets on behalf of other generation businesses.

26. [✂] RWE explained that its goal as a market maker was not to take business away from the OTC market, but to attract new players into the market increasing the overall liquidity.

27. RWE gave the example of the initial stages of the carbon market where three different exchanges – NASDAQ, EEX and ICE – competed for business by incentivising market makers. Individual market participants and major players had preferred venues according to where they traded energy which would have allowed them to reduce clearing costs. The liquidity in the carbon market eventually settled on ICE and market making here and elsewhere ceased as there was no competing liquidity on NASDAQ or EEX. Trades on ICE typically ended up in the ICE clearing house.

RWE on market data services

28. RWE said there were two issues with ICE having access to Trayport data. The first, was the strategic use of the data to see what was being traded, where it was being traded and who was carrying out the trade. ICE could use that data to its commercial advantage. The second, was data services as a product in its own right. Currently RWE received its own trade data (products/volume/price, but not counterparty) from Trayport, and also everybody else's trade data on an anonymised basis through Trayport.

29. With respect to the first concern, RWE said that in markets where it was not particularly strong and its market share was not high, ICE would be able to see which counterparties were active. That would enable it to go and target those counterparties. Access to this information was currently protected by contractual restrictions. RWE said that contractual restrictions were not necessarily strong enough to give them comfort. ICE could be able to see more data than it could at the moment even if the counterparties were still anonymous to it. For example, ICE would understand a lot more about market shares and how much of the market it was missing, and would be better placed to plan how much to target markets it was not in. ICE would have a huge amount of additional price information and be able to produce a history of prices much more readily and potentially be able to have leverage off that to provide its own services.

30. On the second, RWE said that the data allowed RWE to track prices and could be used for modelling purposes but also in risk management systems and so it had a value. This was part of the service RWE received from Trayport. The data could be commercialised and sold as an additional product. As a result of the merger, RWE could find that data services were no longer supplied as part of a bundled service, but would need to approach ICE

on a commercial basis. RWE said that, in addition, the data could be sold to market participants who were transacting and to other parties who were looking to build other services off that, whether journalistic services or the like.

31. RWE said that it had tried to persuade market participants to freely publish anonymised transaction data as this would increase transparency in the market.

RWE's concerns with the merger

32. RWE's said that its concern was that ICE may use its ownership to degrade Trayport's service or make access to the broker market more expensive. RWE said that it had similar concerns about GFI when it used to own Trayport, although RWE said that GFI undertook to operate Trayport on an independent basis and had largely done so.

33. RWE said that this concern was directly linked to the closed access programming interface (API) strategy used by Trayport, which created an inability for traders to plug other front-end and back-end systems into Trayport. As a result, Trayport exclusively controlled access to broker venues.

34. RWE also explained that ICE was involved at other stages of the trade life cycle: the front-end; execution; trade confirmation; clearing; reporting services; and the provision of market data services. RWE explained that ICE offered a number of vertical services associated with trades and was concerned that the acquisition would result in Trayport's closed system becoming even more closed, and that the available alternative services would deteriorate and become more expensive.

35. RWE said that it was possible that, post-acquisition, ICE could increase the cost that it required the brokers to pay for Trayport's service. This could then be passed-through as an increase in brokerage fees to traders. RWE said that, at that point, ICE's execution service would become more competitive or ICE would be able to increase its execution fee thereby increasing the cost of trading for the whole market.

36. RWE noted that for UK power and UK gas, where the only alternatives were ICE or OTC brokers that required Trayport, if prices went up then traders would have no alternative.

37. RWE said that a significant price increase could have an effect on the available liquidity. Price increases were bound to impact the bid-offer spread available in the market. If the bid-offer spread widened, the cost of transacting

for a financial player increased and the attractiveness of that market, say relative to another market, would fall. Therefore, traders choosing, for example, between deploying their risk capital in oil, coal and NBP gas, who found that the NBP gas bid-offer spread increased, may choose to deploy less risk capital into that market and to deploy it somewhere else. This would result in a decrease in liquidity in NBP gas.

38. RWE said that this might be a disincentive for ICE to increase prices as it would not want to see a decrease in total liquidity in the market. RWE said there was a balance where ICE started to lose business as a result of a drop in total liquidity. RWE said that, alternatively, ICE could not put its brokerage fees up, following a price increase in Trayport, resulting in liquidity shifts from the OTC brokers to ICE.

39. RWE said that there was also a risk that ICE could gain information about markets where it was not currently active, giving it an advantage over other exchanges. RWE said that this could put it into a position that was advantageous compared to its exchange rivals.

40. RWE said that Trayport also hosted other exchanges, for example EEX in German power. RWE said that the link with EEX and Trayport currently worked very well, but RWE was concerned that following the acquisition, the link could get degraded or not even be offered.