In this edition of our regular quarterly newsletter, we discuss the practice of buying and selling the same amounts of electricity hourly in the NO2 Auction – the auction linking the UK and NO2 via the North Sea Link (NSL) interconnector. This practice has been described in several Urgent Market Messages (UMM) published on Nord Pool's UMM platform and was examined in a recent Montel article. Here we provide our analysis of this type of trading under the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) / forskrift om nettregulering og energimarkedet (NEM).

Background

Market Surveillance was contacted in advance by market participants who planned to place matching buy and sell volumes in the NO2 Auction. In connection to this, Market Surveillance assessed the practice under REMIT and analysed its potential impact. The NO2 Auction is different from the normal Single Day-Ahead Coupling (SDAC) auction in several respects, among them that bidding curves are not published. We therefore saw a need to assess this type of trading specifically for this auction.

It should be noted that this practice was only considered under REMIT/NEM. Nord Pool's Market Surveillance team has neither full information about other applicable legal frameworks, nor the mandate to monitor for breaches of those and, therefore, cannot assess this trading practice in that respect.

Categorising a wash trade

In Norway, REMIT is not implemented but similar regulations regarding market manipulation exist under the Energy Act (NEM-regulation)[1]. This legislation is implemented to align Norwegian regulations with REMIT[2]. Market Surveillance therefore uses the general ACER[3] Guidance and ACER Guidance Note on Wash Trades[4] (Guidance Note) to assess the trading behaviour observed in NO2.

According to section 6.3.2, of the ACER Guidance, a wash trade is a practice consisting of: '*entering into arrangements for the sale or purchase of a wholesale energy product, where there is no change in beneficial interests or market risk, or where beneficial interest or market risk is transferred between parties who are acting in concert or collusion*'.

Based on the Guidance Note, the trading behaviour in question can be categorised as a wash trade since:

[1] See NEM chapter 5

[2] This is stated by the Norwegian regulator on its website and mentioned explicitly in the comments to § 8-2 and § 8-3 in the Norwegian legislation (energilovforskriften) preceding the NEM-regulation.

[3] The EU Agency for the Cooperation of Energy Regulators

[4] https://documents.acer-remit.eu/guidance-on-remit-2/

- The behaviour involves only one entity;
- There is no change of market risk or beneficial interest[5], since the volumes are designed to match fully, without affecting the price.

However, this does not mean that all wash trades are problematic under REMIT. The wash trades in this specific case must therefore be further analysed. To do so, we use the Guidance Note to assess the behaviour being observed, under Article 5 of REMIT "Prohibition of market manipulation".

ACER Guidance Note on Wash Trades

Depending on the specifics of each case, based on the Guidance Note, wash trades considered to be manipulative will typically fall into one or both of two categories:

a) they give or are likely to give false or misleading signals to the market as to the supply, demand or price, and therefore fall under the category of market manipulation, or attempted market manipulation, through false/misleading signals according to Article 2(2)(a)i and Article 2(3)(a)i of REMIT;

b) they may secure or attempt to secure the price of a wholesale product at an artificial level, and therefore fall under the category of market manipulation through price positioning according to Article 2(2)(a)ii and Article 2(3)(a)ii of REMIT.

Since, in the trading patterns discussed here, volumes are designed to match fully, without affecting the price, we believe that category "b" is not, under normal circumstances, relevant (unless there is an erroneous order, for example, so that price may be affected). We therefore focus on category "a".

Among others, chapter 3.2 of the Guidance Note outlines the following misleading signals that are relevant to assess (our numbering):

(1) *Wash trades are transactions that can give, or can be likely to give, false or misleading signals to the market as to the supply, demand or price of a wholesale energy product. Indeed, by giving other market participants a misleading representation of the liquidity, price, price volatility or by creating an expectation about potential changes in the available demand or supply, a wash trade can lead (or can be likely to lead) other market participants to act in a way they would not have considered in the absence of the wash trade.*

(2) *Wash trades can create false or misleading signals regarding the liquidity of a given product. This false or misguided impression might then cause other market participants to take trading decisions based on misleading information. This practice also excludes other market participants from the opportunity of matching their orders, thereby reducing competition.*

(3) *Wash trades representing unusual volumes are likely to be interpreted by market participants as reflecting changes in market fundamentals (for example, changes in unavailability of generation units or on forecasts) that are not widely known by all market participants. This can create mistrust in the market and lead (or could be likely to lead) other market participants to act in a way they would not have considered in the absence of the wash trade(s).*

(4) *Moreover, wash trades, when perceived or suspected by other market participants, may create mistrust in the market integrity, leading investors to feel that the orders on the order book are not representative of the real market situation, thus negatively impacting liquidity.*

We evaluate each of signals (1)-(4) in the following section.

Market Surveillance's considerations under Article 5

Regarding (1) and (2), these types of wash trades may send false or misleading signals as to supply, demand or liquidity and/or represent a misleading representation of the liquidity of a wholesale energy product. There are some characteristics in the NO2 Auction that are different from the SDAC. Nord Pool does not publish

[5] An entity is considered to have a 'beneficial interest' in the arrangement for the sale or purchase of a wholesale energy product if it has the opportunity, directly or indirectly, to profit/loss or share any profit/loss derived from the arrangement for the sale or purchase of that wholesale energy product.

aggregated bidding curves for the NO2 Auction. As market participants cannot look at the bid curves, they cannot see how volumes are bid into the market. Also, the NO2 Auction provides an opportunity to trade based on price expectations in the SDAC.

We believe, given the way the market functions today, it is unlikely that the presence of wash trades makes other market participants act in a way they would not have considered in the absence of those trades, or that they take trading decisions based on misleading information about liquidity. The presence of wash trades in the market is unlikely to make market participants disregard the trading opportunity the NO2 Auction presents.

Regarding (3), we believe that it is unlikely that these wash trades would give signals concerning changes in fundamentals, as we do not believe market participants use traded volume in the NO2 Auction to identify such changes. No action is therefore taken based on false signals regarding fundamentals.

Regarding (4), there may be a potential to create misunderstanding, as other market participants may feel that orders in the order book might not be representative of the real market situation. Indeed, several market participants contacted Market Surveillance asking about the motivation for buying and selling the same volumes, as per the relevant UMMs. As a power exchange, Nord Pool does not comment on individual market participants' trading behaviour. However, we took note of the questions and the apparent potential for misunderstanding among market participants.

At the same time, we do not conclude, based on these questions, that market participants are taking trading decisions that they would not take in the absence of wash trades. As mentioned in (1), the presence of wash trades in the market is unlikely to make market participants disregard the trading opportunity the NO2 Auction presents – thereby negatively impacting liquidity.

Although other market participants, or members of the public, would not always be able to interpret the purpose of wash trades, we consider that no market participant has acted or taken trading decisions, nor are they likely to do so, due to these wash trades. We do not currently believe liquidity has been negatively impacted.

We looked into ways to reduce potential misunderstandings among market participants over wash trades and to prevent any misleading signals to the market.

Preventing misleading signals

The ACER Guidance Note outlines that providing the market with information about wash trades is the best practice for eliminating or limiting false or misleading signals: *"Providing the market with information about arrangements for the [wash trades] can have the effect of discouraging manipulative or fraudulent behaviour, but also dispelling some potential false or misleading signals."*

One measure recognised by the Guidance Note is pre-notification:

Pre-notification *– Consists of a notification issued by the Market Participant to the market (for example through an Urgent Market Message – UMM) prior to entering the orders into the trading system. The notification may appear on a message board available to all exchange members and detailing the product, the size and price of the transaction and the estimated timing of the trade.*

In this respect, UMMs published by market participants may fulfil this best practice requirement. The UMMs outline the product, size and timing of the trade. They also state that the company buys and sells the same amount, which means that the price of the auction should not be affected.

Conclusion

In this newsletter we used the Guidance Note from ACER to assess the practice of wash trades in the NO2 Auction under REMIT Article 5 and draw three conclusions.

Firstly, the Guidance Note recommends pre-notification of wash trades as a best practice measure to reduce the possibility of false or misleading signals. We put this forward as a clear recommendation for the trading practice discussed here. Nord Pool does not publish bidding curves for the NO2 Auction – so market participants will not be aware of how the traded volume is bid into the market. Thus, without pre-notification, there is a risk that these transactions may be misunderstood by some market participants. We therefore recommend always to publish a UMM before undertaking such wash trades.

Secondly, we conclude that if a market participant sends a UMM regarding their wash trades, potential false or misleading signals arising from these trades are dispelled. Thus, in our assessment, a breach of REMIT Article 5 is unlikely.

Thirdly, if a market participant does not send a UMM (which, as we have established, they should), it is relevant to consider the four points from the Guidance Note, as described earlier. Considering the speculative nature of the market, lack of indications of market participants having been misled and the persisting high level of liquidity, we currently consider that the risk is limited. At the same time, we do not know how regulatory authorities will assess this and our assessment may change depending on how market participants use this market. We believe that it is relevant to consider new examples of wash trades separately and follow this trading behaviour over time.

We welcome feedback and observations from stakeholders to help us improve our assessment.

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