

Hard Truths about Market Transparency

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In the wake of the LIBOR scandal, legislators have rushed through new rules intended to put a stop to market manipulation, purporting to improve market transparency.

The European Commission issued its latest proposal – for a regulation ‘on indices used as benchmarks in financial instruments and financial contracts’ – on 18 September 2013 (SWD(2013) 336/337).

The proposed regulation follows a report by the International Organization of Securities Commissions (IOSCO) issued in November 2012, which made recommendations about the oversight of activities by so-called Price Reporting Agencies (PRAs). However, the EU regulation goes far beyond the recommendations of the IOSCO report, despite claiming to be aligned with them.

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The proposed regulation opens a Pandora’s box of issues which include: the viability of implementation of the new rules; issues of extra-territoriality; press freedom and the right to express opinions; the possibility of reduced competition in energy pricing; and the potential for political interference in price-setting. While all of these issues are of concern, this article addresses only one of the many issues raised by the regulation: that of the transparency of the market.

The EU proposal suffers from a not uncommon delusion among regulators: ‘transparency’ can be mandated from above, by enforcing the disclosure of masses of documents and data, and putting in place an oversight procedure, with the threat of heavy penalties if the rules are not followed. This is not the case. Market transparency evolves, much as it does in any other walk of life, over

time, and through open and intelligent dialogue. This dialogue may be among professionals involved in the market – from industry, academia, and the press – all of whom have competing interests and goals. If the dialogue at times gets fractious, that is probably good rather than bad.

This article contends that oil markets in Europe have become less transparent in recent years as a result of regulatory meddling; that the oil market in Europe is now less transparent than similar markets in Asia which have traditionally been regarded as more opaque; and that price reporters, a main target of regulators’ zealous efforts, are likely to function less well as a result of the new rules being rushed through.

The EU does not define what it means by transparency in its recent legislative proposal, but it seems to have in mind a set of clear bureaucratic procedures that result in a mass of auditable data. The definition used here is much simpler, and is that provided in *Webster’s* dictionary: ‘transparent: characterized by visibility or accessibility of information especially concerning business practices’. Such a definition implies more than just the existence of masses of data. It implies that if you want to understand market activity, rather than just observe the stream of data it generates, you can do so with reasonable ease.

So there is a vertical as well as a horizontal dimension to transparency. The latter requires the disclosure of trade data, such as happens in the Platts window and on futures exchanges. The former is more subtle, requiring a dialogue about why the market is moving and what the consequences are – such a dialogue may include market participants and market observers. This explanatory role has been provided in the past by price reporters associated with price reporting firms and news agencies.

The evolution of these aspects of transparency is considered in the following section.

Evolution of Market Transparency

The evolution of oil market transparency has been a slow and often painful process. Price reporting firms and news agencies have played a key role in pushing it forward, their efforts often being resisted by market participants who by and large prefer anonymity.

1973–1985

During the period 1973–1985, oil markets lacked transparency, even in Europe. Oil traders at that time had a justifiably shadowy reputation. Many of the deals they did were private and confidential, and news about them leaked out to the market through a privileged network of well-connected oil traders. When writing his bestselling book about the major oil companies, *The Seven Sisters*, published in 1975, Antony Sampson had faced a wall of secrecy about their commercial activities.

This was an opaque market. The job of a price reporter in those days was to relate as much as they could risk reporting about the trades that were taking place. The ‘data gathering process’ involved intensive phone calls through the afternoon, but this was supplemented by long and often liquid lunches, meetings in IP Week and similar industry events, and even, on occasion, conversations while smoking on street corners in Mayfair where many of the traders had their offices. The names of the counterparties to physical oil transactions were known by those in the market, but were never published.

1986–1997

The period between 1986 and 1997 saw increasing transparency, as the move to formula-based pricing of crude oil boosted spot market activity. From 1985 onwards, electronic screens operated by price reporting firms such as Platts and Argus and news agencies such as Reuters and Dow Jones played a growing role in price discovery in the physical oil market.

The process of price discovery in this period was imperfect but reasonably efficient. In the 15-day Brent market as it then was, it was not uncommon to have around 50 full-size cargo deals (30 million bbl) reported over the course of a day. Many of the deals were 'leaked' to reporters within minutes of their being concluded. A high degree of liquidity existed in other forward markets such as open spec naphtha, non-EEC gasoil, and fuel oil cargoes for delivery to the CEGB.

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Physical markets which were not speculatively traded were often much less liquid. There was a significant difference between trade in northern Europe (particularly the reasonably liquid ARA hub), and trade in the Mediterranean region where very little fixed price business happened.

The price discovery process – which was pioneered by price reporters such as Platts, Argus, ICIS, and others, often to the intense irritation of oil companies – was boosted greatly by real-time price reporting by the news agencies such as Reuters and Dow Jones. A further leap forward came with the advent of oil futures in Europe, notably the IPE gasoil contract (1981) and IPE Brent contract (1988) which made the outright price highly visible. By the end of the 1980s, also, the so-called Wall Street refiners had entered the physical market and were making markets in Over the Counter (OTC) swaps and options, so the size of the derivatives market burgeoned and prices gradually became more visible.

By 1993, when Paul Horsnell and Robert Mabro published *Oil Markets and Prices*, the oil market's transparency had developed enormously:

'Before the mid 1960s, the major oil companies were their own price assessors, calling out prices unilaterally, a role taken up by OPEC through to the end of the 1970s. The growth of spot

markets for crude oil created a need for price assessment, at first simply as a contribution to transparency. ... However, the assessed prices ... began to be used in trade rather than merely as an aid to trade.'

This period is characterized by a growing level of physical market transparency. For instance, reporters who monitored the Transworld squeeze of the Brent market at the end of 1987 published the key deals on electronic screens, and the oil market story rapidly became front-page news. The names of those companies involved in the squeeze were published, whereas 'naming names' had hitherto been off limits.

Asia at that time, in contrast to Europe, had among the least liquid and least transparent markets. Deals were almost invariably done on a Platts-related basis, but there was no obligation to disclose them to Platts. The pool of fixed price transactions was limited, and with the bulk of deals done on a Private and Confidential basis, subjective judgement was often used when verifiable information was unavailable.

The emergence of the Platts window in Singapore in the early 1990s provided a solution to this. The advent of the window coincided with a push by investment banks to sell derivatives, such as swaps, to oil market participants in Asia where demand was burgeoning. By forcing traders to objectify their opinions, and by using the increasingly visible swaps prices in the assessments, Platts brought transparency to what had been a failing assessment process.

1997–2001

In the period 1997–2001, futures markets gradually became the locus of outright price discovery in real time, and price reporters used their electronic screens to communicate physical oil market information, if not in real time, on at least an hourly basis. Swap market liquidity grew exponentially and market transparency was enhanced by growing competition among the news agencies and the price reporting agencies.

As markets became more liquid and more volatile, however, assessment methodologies in Europe lagged behind.

In the 1980s and 1990s, when

markets were typically less volatile, Platts had used a 'representative' trading range over the day in most of its oil products assessments. In this system, traders reported deals through the day, and by the close reporters would compile comprehensive lists of deals done over the whole trading day. This involved subjective assessment, as the ranges published did not represent the highs or lows of the day, but were typical ranges traded with outliers removed. If a deal smelt bad, it was tossed out of the basket without remorse.

In such a system, it was often in traders' interests to widen the spread of trades over a working day. Also, as long as deals were reported retrospectively, it was impossible to track at exactly what time of day they were done transparently, and therefore whether they made sense in light of the prevailing crack spread and timing structure of the market.

With physical crude oil prices dropping to all-time lows below \$10/bbl in 1986 and 1998, regulatory scrutiny of the physical market was virtually non-existent. Such investigations as did occur were performed by competition authorities looking at the link between the wholesale and retail price. All this changed in 2001, however, when the Enron scandal revealed false reporting of deals in the gas market, diminishing regulatory confidence in the price reporting firms – if indeed it had ever existed. Meanwhile, the inexorable rise in oil prices between 1998, and the all-time highs reached in 2008, catapulted the oil market to the top of regulators' priorities.

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In response to Enron and other scandals, regulators introduced a series of regulations aimed at reducing the risk of market abuse, and upping the penalties if it were identified. Simultaneously, the main PRAs took decisive steps to make their assessment procedures

more robust and transparent. These included: putting in place auditable systems such as the Platts window, to diminish the risk of subjectivity in an assessment; formal compliance regimes that ensured best practices were being followed; and more rigorous procedures for correcting, re-specifying, and phasing out assessments. Similar steps were taken by other price reporting firms such as Argus, resulting in an assessment regime that was arguably more rigorous than that for any other commodity.

2002 onwards

The period from 2002 to the present is characterized, therefore, by increased rigour in assessment procedures, mounting regulatory scrutiny, but a very uneven development of market transparency. Horizontal transparency has increased greatly. With the advent of assessment windows, deals worth tens of millions of dollars were conducted in the plain light of day, with the names of counterparties in physical transactions revealed to the market at large. However, vertical transparency of the market – the dialogue that allows an understanding of the activity of market players – has deteriorated.

No Comment

Nowadays, traders at major oil companies who are asked by price reporters about why prices are moving will probably decline to comment, and will direct further requests to a compliance officer or the Press Office. Most of the majors now will only allow approved disclosures about their trading activities – such as those made in ‘the window’ where bids, offers, and deals are communicated, or in their end-of-day deal summaries which cannot be further checked to evaluate the significance of the deals. The opinions of individual employees in relation to the direction of prices are not allowed, as this may be construed as ‘signalling’ by the company, although a senior trader may sometimes be assigned the job of managing the dialogue between trading desk and the media.

This lack of dialogue limits the ‘visibility and accessibility of information’. Reporters are resourceful

people, however, and it is likely that valuable information is exchanged anyway – whether on mobile phones or in face-to-face meetings – and of course the diligent reporter will disseminate this to the market at large. However, the open dialogue between market participants and reporters that used to be habitual has been curbed by regulators’ concern to stop selective disclosures.

The end result is that, while a segment of the physical market is made highly transparent by the Platts window and equivalent systems offered by other vendors, this transparency is confined to a small portion of the trading day and to the relatively small number of grades of oil that are reasonably liquid. That is not to say, of course, that the window is anything but a boon to market transparency; indeed, the ‘naming of names’ in real time provides a degree of transparency that is unavailable for other commodities.

But the reporting of physical oil transactions outside these assessment ‘windows’ has become less transparent than it was a decade ago. Companies faced with severe penalties for misreporting deals, and with no penalties for non-reporting of deals, have taken the easy course. The number of deals reported outside the assessment windows has declined. The ready flow of information between traders about their deals, the circumstances of the deals, the peculiarities of the oils traded, all that rich vein of information that price reporters gathered throughout the 1980s and 1990s to understand and contextualize the deals, has become less available.

There is a profound irony here. While the horizontal transparency of the market has been improved by the efforts of price reporters, regulators remain antipathetic to their efforts; meanwhile, diminution in the market’s vertical transparency is the unintended consequence of regulators’ efforts.

Regulators who were rattled by the LIBOR scandal and who are now trying to rush through a generic fix for ‘benchmarks’ in markets (including commodities) seem not at all bothered by this reality. They should be. Commodities are not standardized financial instruments, but are highly

differentiated in terms of quality, logistics, and fungibility with other grades. Vertical transparency is necessary. It is not just a question of averaging masses of data, but of understanding what the data means.

The EU benchmark proposal is likely to harm the transparency of the market rather than improve it. The threat of massive fines for ‘misassessment’ can only deter rather than encourage competition among the price reporting firms.

Meanwhile, there is a risk that regulatory scrutiny will reduce market liquidity, or displace it to regions outside Europe with laxer regulatory and compliance regimes. Trading activity in Singapore has burgeoned in the last decade, and market activity in the trading windows and outside has become more liquid and more visible.

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This is unsurprising. When the risks of getting involved in discussing market activity outweigh the rewards, market participants are likely to retreat into their shells. When the risks of engaging in market activity outweigh the potential rewards, those involved are likely to vote with their feet and move to other markets. Price reporters already comment anecdotally that financial institutions are providing less deal data in Europe. Industry sources have described the new EU regulation on benchmarks as ‘draconian’ and ‘unworkable’.

Conclusions

No-one would disagree with the regulators’ goals of stopping manipulation, averting collusion, and improving transparency in the oil market.

The EU benchmark proposal will not achieve these goals, however. The urgency of the new legislation appears to be predicated on a loss of public confidence in the functioning of the markets, and the assumption that

widespread manipulation of the energy markets has actually occurred. After the EU raids on oil companies and Platts in May 2013, a senior EU official was quoted in the press as saying: 'We are witnessing more alleged and potential manipulation of benchmarks in energy markets'.

This statement is breath-taking because it is the EU itself that has

generated these allegations of manipulation. Meanwhile, the new regulations are being pushed through even before it has been established whether Shell, BP, Statoil, or Platts have a case to answer.

In this overcharged atmosphere, the cause of market transparency is suffering. Nothing in the EU's proposed benchmarks regulation will

allow the increasingly opaque European oil market to function better.

The hard truth is that regulators, in trying to make things better, have made them much worse. The proposed legislation on benchmarks indicates another wrong turn that is about to be taken by the EU juggernaut. ■