

Regulation and Reporting the Price of Oil

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The European Commission published a proposal for the regulation of benchmarks, including benchmarks used in oil pricing, on 18 September 2013. Unfortunately, the proposal fails to understand the nature of oil trading and threatens the industry's ability to provide affordable and reliable supply to Europe. The professional reporting of oil prices requires a deep understanding of markets, especially as the market for crude and petroleum products is vast and complex. Any attempt to regulate benchmarks in these complex markets requires a similar level of understanding. Without it, regulation jeopardizes the efficient trading of oil.

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PRA principles

The Commission's proposed regulation contrasts sharply with the work stream established by the G20 leaders to examine and make recommendations concerning price reporting agencies (PRAs). The final result of this work stream – an in-depth examination by the International Organization of Securities Commissions (IOSCO) and international agencies with an understanding of the physical oil market, such as OPEC, the IEA, and the IEF – was the document *Principles for Oil Price Reporting Agencies Final Report* (the PRA Principles), published in October 2012. IOSCO's PRA Principles were endorsed

by the G20 in November 2012. The PRA Principles are a proportionate set of recommendations for market authorities regarding oil benchmarks used in the pricing of financial instruments. IOSCO, together with the other international organizations, explicitly recommended that the principles should be applied by the PRAs to all their benchmarks used in the pricing of financial instruments, and not just to oil benchmarks.

One requirement of these principles is that PRAs publishing benchmark prices undergo an annual assurance review by an external auditor. UK-based privately owned Argus Media, one of three major PRAs – along with US-based Platts, which is part of McGraw Hill, and UK-based ICIS, a division of Reed Business Information, which is part of the Dutch-UK publisher Reed Elsevier – has successfully completed its requirement to undertake this year's review. Other PRAs include US-based Opis and the Japanese firm RIM. IOSCO and the other international organizations will review how the PRA Principles have been implemented in early 2014. Nothing in the G20 process so far has impeded the existing process of identifying oil prices. The European Commission, however, has introduced proposed legislation that poses serious risks to price identification in European energy and commodity markets.

European Commission Regulation of Benchmarks

An understanding of the physical constraints involved in the trading of oil is apparent in the IOSCO PRA Principles but is lacking in the proposed EU regulation. The proposed European regulation will produce energy benchmarks that are not representative,

reliable, or robust. Energy benchmarks will become unnecessarily volatile, as the market information allowed to be used to identify prices under the new law would be highly selective and restricted.

The Commission's benchmarks proposal has been drawn up on the assumption that the oil market, and all other commodity markets, are inherently like financial markets. It fails to recognize the more limited liquidity in oil markets, compared with financial markets. The buying and selling of oil ultimately takes place in a physical market that naturally operates with economies of scale, unlike financial markets that do not require the physical transportation of a commodity from producer to consumer. Financial markets trade in small volume lots, trade frequently in discrete units by simple electronic transfer, and do not trade within a physical infrastructure. The proposed European regulation for benchmarks is mainly designed for interest rate and other financial markets and is therefore not appropriate for the oil market, which is ultimately concerned with getting product to a consumer at the lowest possible cost.

The European Commission proposals have been formulated against a political backdrop intent on addressing the so-called 'financialization' of oil markets. But the debate about financialization has now settled on a consensus that stresses the importance of the convergence of derivatives with physical prices for the underlying assets, and the resulting fact that supply and demand are the key drivers of oil markets in all but the shortest term. The European regulation, on the other hand, does not address the physical aspects of oil benchmarks and focuses entirely on derivatives.

Physical Aspects of Oil Benchmarks

A commodity market such as oil emerges from and revolves around the physical infrastructure, which imposes constraints on trade such as limits on quantities, specific delivery times, breakdowns, and delays. European oil markets trade around shipping and storage facilities that result in the creation of large distinct units of purchase and sale – such as large cargoes of crude oil – that can only be transacted between appropriately equipped market participants. The size of trade and timing of delivery vary due to elements such as weather, port conditions, refinery operations, oil field maintenance, industrial action, and other unforeseen disruptions. Another factor that varies in oil markets is quality specification; there are hundreds of grades of crude and a vast range of refined products and blendstocks. Standardized contracts have evolved, but they require flexibility – elements such as quality, volume, and timing of delivery make allowance for operational tolerance.

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The agreement of purchase or sale is only one small element in a complicated physical transaction that may take weeks to complete. The spot sale is negotiated several weeks before loading, while delivery may be several weeks after loading. Between loading and delivery, transportation must be chartered, quality checked and confirmed, loading or injection must take place, and offtake or delivery must be completed.

All of this makes a European regulation that is designed for financial market benchmarks inappropriate in physical energy markets.

Physical spot commodity markets provide energy to consumers throughout the globe efficiently, allocating products to provide the best value for buyers and the best returns for sellers. The spot

price is the element that clears shortfalls and surpluses in each market, mitigating inefficiencies. Spot prices are the outcome of negotiations between buyers and sellers of each commodity in each location, as both sides to a deal seek to maximize value. Transparency in open market pricing allows non-spot transactions, such as longer-term contracts, to settle on agreed prices that represent fair value. The provision of this transparency is the role of PRAs, which identify prices in the open spot market where sellers and buyers discover the price through negotiation. Prices reported by PRAs are for the marginal supplies that are crucial indicators to balance the energy markets.

Impact on Reporting of Energy Prices

The regulation proposed by the Commission would distort the prices published by PRAs, damaging the efficiency of energy markets themselves. Distortion would occur because the reporting of energy prices requires information on transactions and on bids, offers, and other market intelligence underlying the transactional data. PRAs specialize in gathering and reporting this information, but the European regulation would undermine this process.

The regulation would impose extensive legal obligations on the providers of market information to anyone who publishes a benchmark price. Companies involved in producing, supplying, and consuming energy would react to these new obligations, many of which are onerous and costly, by stopping the supply of information to PRAs. This would enable such companies to avoid risks, costs, and administrative burdens while allowing them to continue with their main function – energy production, supply, trading, and consumption. All the information gathered by PRAs is supplied voluntarily by companies in the energy sector, so ending this supply would be the easiest choice for most companies. Companies that trade in physical energy, but do not deal in financial derivatives traded within the EU, would have no incentive to continue supplying information to the providers of benchmarks used to settle the

financial instruments, even though these benchmarks are also used in physical trading.

One key obligation that companies would avoid by opting out would be the legally binding codes of conduct with PRAs. Other provisions in the European regulation would impose new internal controls on any company that contributes price information to the provider of a price benchmark. The obligations in the regulation would result in high costs for each company contributing market information, and companies would be unlikely to accept the intrusive nature of the rules. The onerous nature of the obligations on providers of market information could even prevent the production of benchmarks in a timely manner because companies would need to implement so many controls on contributors that information may reach the benchmark provider outside the required timescale for daily publication.

The EU and the International Energy Market

The international nature of energy markets makes the obligations imposed by the European regulation even more inappropriate – many market participants are based outside the EU and would have no incentive to agree to operate under the terms of the new legislation, with all of the obligations it entails. It would not be feasible for a PRA based in Europe to demand that non-EU companies – such as Middle East state-owned producers, Russian trading firms or Indian refiners – sign legally binding codes of conduct under EU law if any of their employees is to be a source of information.

For example, a Russian trading company that acquires diesel from a Russian refinery and supplies it to the structurally short European market would no longer wish to contribute information to PRAs. Such a withdrawal would have far-reaching implications because the company may be selling at the lowest marginal price, thereby helping to determine the clearing or open market price. The PRA would be unable to utilize this price in its benchmark assessment if the Russian company, understandably,

had opted out as it was not prepared to take on costly and onerous obligations such as a legally binding code of conduct and new internal controls. The PRA would then face the prospect of publishing a benchmark price based on selective information (that is, information limited to sources that are prepared to accept the costly and onerous obligations of price identification in a heavily regulated environment). This benchmark would thus be distorted by the absence of information from companies such as the Russian trading firm, as well as others as diverse as state-owned companies from north Africa and the Middle East that sell refined products to Europe, state-controlled Chinese trading firms, and Indian or South Korean refiners that export their products to Europe.

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These companies would soon have a low degree of confidence in benchmarks published in the EU because the benchmarks would only reflect market data contributed by the shrinking group of firms prepared to accept the onerous obligations involved in providing information to the benchmark publishers. Companies that had withdrawn from supplying information to benchmark providers would realize that regulation had resulted in either artificially high benchmarks that reflected mainly price data from higher-cost EU suppliers, or artificially low benchmarks that were biased to buyers' price data. They would become wary of using such distorted benchmarks as indexes in physical transactions. Adding to this wariness, many non-EU state-controlled energy suppliers would mistrust benchmarks that they perceived to be under the control of a large energy consumer – the EU. It would be no different if the tables were turned – EU member states would be uncomfortable if energy benchmarks came under the direct supervision of government

agencies in exporting countries. Policy makers in EU member states and the European Parliament should be aware of the political sensitivities of energy pricing.

The Creation of EU and Non-EU Benchmarks

PRA and market participants would be aware of other prices in the open market that were not reflected in the distorted benchmarks created under the direct supervision of regulators in the EU (involving, as noted above, many costly and onerous regulations on publishers and sources of market data). PRAs would then find themselves in the bizarre situation of having to report two price assessments for the same commodity: a EU benchmark based on information from a small self-selecting group of approved sources operating under EU rules and direct supervision by regulators in the EU, and a non-EU benchmark representative of the open market price, but which the PRA states must not be used as a benchmark except outside the EU.

A two-tiered market of this type – with EU and non-EU benchmarks – would be inefficient, particularly for Europe. Trading and hedging in the EU would be based on benchmarks that did not represent costs and value at the margin. Price discovery and transparency in the EU under the proposed regulation would be inefficient. And, in the end, inefficiency is always paid for by the consumer.

If regulation makes benchmarks unviable and therefore destroys the relationship between derivatives and underlying physical markets, hedging as it is now practised becomes impossible. This would have far-reaching implications for the industry, its corporate energy users (such as manufacturers and other industrial users of energy), and consumers in the real economy in Europe.

Hedging is necessary in energy and other commodity markets because these commodities are delivered in large lots that take time to move between locations that are subject to differing infrastructure constraints. Exposure to time and location must be mitigated, or risk becomes

unmanageable for buyers and sellers. Mitigation is carried out through hedging floating costs against fixed benchmark prices. Without hedging, uncertainty and volatility in energy markets are costs that would be passed on to consumers in the EU.

The European regulation applies to benchmarks used in financial instruments in the EU. It asks other jurisdictions to have 'equivalent' systems, but these need not be imposed through legislation, so the EU regulation is almost certain to be out of step with regulatory frameworks in other parts of the global energy markets. This would result in a dysfunctional energy market in which, for example, a physical price index – which does not seek to comply with the EU regulation – could be used to price physical energy transactions within the EU by all companies, but could only be used to hedge price risk by non-EU companies hedging in non-EU venues.

EU-based companies would be forced to use a benchmark for price risk management purposes which was based on the European regulation, even though this index did not represent the open market price and was not used for physical indexation. Non-EU companies selling in Europe would thus be better able to manage their price risk than their EU-based competitors. This would give non-EU companies a competitive advantage and could result in relocations or greater European dependence on non-EU suppliers, to the detriment of Europe's energy security.

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The EU would, perversely, end up worse off as a result of one of its own pieces of legislation, if the member states and European Parliament do indeed decide to enact a regulation on benchmarks that may be suitable for financial markets but not for the physical commodity trading sector.

Conclusion

The regulation proposal as it stands will result in confusion in the market. EU companies may be severely disadvantaged compared with non-EU companies. Benchmarks fulfilling the obligations of this regulation will be unrepresentative, unreliable, and not robust. Any benchmarks produced under this regulation will have fewer sources of

information than existing benchmarks, with the result that transparency will be reduced. The consequence will be more volatile benchmarks. Other price series are likely to be used as benchmarks to index physical energy, even within the EU, but only non-EU companies will be able to manage price risk using these non-EU benchmarks. In other words, the proposed European regulation, by misunderstanding the nature of the oil

market, risks achieving exactly the opposite of its intent. Fortunately, the solution to the conundrum created by this proposed regulation already exists and has been developed and agreed internationally, with input from acknowledged expert agencies in the field. Europe should give its full weight to supporting the implementation of the PRA Principles for oil and all other commodity benchmarks. ■