



The impact of financial regulation on energy markets

Andrew Tuson

Since the financial crisis, we have seen governments and regulators seek to introduce regulatory change to prevent the manipulation of financial markets and to protect consumers. Whilst the regulatory changes proposed may work well for financial markets, their application to energy markets in fact poses risks to the orderly operation of those markets. It appears that governments and regulators have failed properly to consider how their proposals will impact the energy markets in particular and how the price of physical commodities is generated.

.....

‘... GOVERNMENTS AND REGULATORS HAVE FAILED PROPERLY TO CONSIDER HOW THEIR PROPOSALS WILL IMPACT THE ENERGY MARKETS ...’

.....

In the UK, commodity markets have come more sharply into focus since the financial crisis. Press reports have suggested that the oil market may have been manipulated just as the LIBOR rate was manipulated. In the UK, HM Treasury, the Bank of England, and the Financial Conduct Authority (FCA) have conducted a year-long review into the fixed income, currency, and commodity markets through the ‘Fair and Effective Markets Review’ (the Review). The Review has published detailed recommendations on how markets, including the energy market, should be adapted in order to avoid the risk of market manipulation.

The Review found that prior to the financial crisis, regulatory focus centred on the operation of the equity markets and on ensuring that prices of equities and other products were not distorted. The Review identified that regulation of fixed income, currency, and commodity markets should be brought into line with that of equity markets, and that

regulatory regimes and focus relating to the equities markets should be extended to cover the commodity markets. As a result, the Review found that products traded within the fixed income, currency, and commodity energy markets should fall within the scope of the market abuse regime in the UK and that authorized firms should ensure that adequate surveillance is conducted across these markets in order to identify the risks of potential manipulation. Arising out of the Review, one key area in which regulation is developing in the UK, and also across the European Union, is in relation to the way in which benchmark prices are produced.

In the UK, as a result of the Review, the crude oil futures market’s principal financial benchmark, the ICE Brent Index, has become a regulated benchmark. This benchmark, along with seven others, has been determined as being of such importance to the UK financial system that the way it is produced is now subject to FCA rules which govern how the benchmark price is calculated. The other seven benchmarks now regulated in the UK as a result of the Review include financial rate benchmarks such as the LIBOR and the WM/Reuters London 4pm Closing Spot Rate.

At European level, the European Commission is proposing to introduce a regulation, referred to as the Benchmark Regulation, which will govern the way in which all benchmarks are used within the European Union. Benchmarks include indices used to set the price of financial instruments or certain financial products within the European Union. Negotiations regarding the terms of the Benchmark Regulation are on-going.

The main problem with the European Commission’s current proposals for the Benchmark Regulation is that they do not sufficiently address the difference between rate markets and physical markets. In the rate markets, such as foreign exchange, the benchmark price is derived from the details of trades conducted on exchange. In other words, there is no requirement on those who conduct the trades to decide whether their trading data should be used for the purpose of setting the FX benchmark rate. However, in the physical markets, such as the oil market, the benchmark price is set by price-reporting agencies who assess the volume and prices of transactions conducted in a particular window. Given that such transactions are conducted ‘over-the-counter’, rather than on exchange, in the physical markets there is no central repository of trading data. This means that price-reporting agencies in the physical markets are reliant on market participants speaking to them, providing market information, and voluntarily disclosing details of the transactions conducted. Unless this happens, price-reporting agencies will not have access to data enabling them to set their benchmark price.

Market participants

Through the proposed Benchmark Regulation, those who contribute data to price-reporting agencies would be subject to stringent regulatory criteria. These criteria include requirements that contributors should not provide any data where there is a conflict of interest and that they sign up to a code of conduct set by the price-reporting agency. The code of conduct would prescribe the issues which market participants would be

required to take into account in order to provide details of their trades to the price-reporting agency. If these criteria are not met, sanctions could follow, including the right for authorities such as the FCA to seize documents and information and to issue fines.

As a result of these proposed regulatory changes, market participants may become concerned about the risks of breaching the requirements of the Benchmark Regulation. Market participants may therefore decide that they should cease to speak to price-reporting agencies and give details of their trades, in order to avoid potentially breaching the Benchmark Regulation. Uncertainty over how regulators are likely to interpret the proposed regulation and impose sanctions could again make it less likely that market participants would be willing to continue to provide details of their transactions to price-reporting agencies. If fewer market participants speak to price-reporting agencies and disclose details of their transactions, this in turn would reduce the amount of data available which price-reporting agencies could use in order to set the benchmark price of energy commodities.

These difficulties do not apply in the same way in the rate markets. For example, a market participant who enters into a transaction in the FX market will not have a choice over whether the details of that transaction are taken into account for the purpose of WM / Reuters calculating their London 4 p.m. Closing Spot Rate. Such data will automatically be provided by the exchange to the price-reporting agency when the daily benchmark price is calculated.

Price-reporting agencies

Concerns over the effect of the proposed Benchmark Regulation extend beyond the issue of market

.....

‘CURRENTLY, PRICE-REPORTING AGENCIES USE THEIR EXPERT MARKET KNOWLEDGE FREELY, TO ADJUST FOR ABNORMAL MARKET CONDITIONS.’

.....

participants disclosing details of their transactions to price-reporting agencies. Price-reporting agencies themselves are also facing additional regulatory burdens. Two concerns arise in particular, discussed below.

The first concern is that the approach taken by the proposed Benchmark Regulation is that price-reporting agencies should produce their benchmark price based on an average price of the trades conducted on any one day, or in any particular trading window. If price-reporting agencies derogate from this approach and apply their own analysis to trades conducted, they are taking the risk that regulators may determine that they are not using an appropriate methodology. This risk does not apply in the rate markets, where an average price of trades conducted on any one day may be applied in order to create an accurate benchmark price. However, in the physical energy markets, simply taking an average of transaction prices conducted on any one day could in fact lead to distorted and unreliable pricings. Given the vagaries of supply and demand in the physical markets, the number of transactions conducted on any one particular day may be unusually low, or traded at an unusually high price. Where this happens, simply taking an average of the transaction prices made on any one particular day could lead to benchmark prices becoming dislocated and volatile. Currently, price-reporting agencies are able to use their expert market knowledge freely, in order to adjust for abnormal market conditions. If price-reporting agencies felt constrained from applying their expertise to adjust transaction prices to take account

of unreliable market data, this would be likely to damage the accuracy of benchmark pricings.

A further concern for price-reporting agencies in the energy market is that those who act as price-reporting agencies are not generally set up specifically for that purpose, but rather act as journalists reporting on market developments in the industries they cover. Often, the benchmark price they produce is a by-product of their principal activity. However, as a result of the requirements currently in the Benchmark Regulation, price-reporting agencies will need to become authorized firms and be regulated by their local regulators, such as the FCA in the UK. As a result of this regulatory scrutiny and the potential sanctions where regulators may seize documents and information belonging to a price-reporting agency in the event of a suspected breach of the Benchmark Regulation, there is a risk that some price-reporting agencies may consider that their ability to conduct their primary function – acting as journalists – is constrained. Under the proposals, journalists would not be able to refuse to disclose the source of their data and would have to hand over their source data if required. If some price-reporting agencies determine that they do not wish to be regulated in the way proposed by the Benchmark Regulation, this could adversely impact the market, as there would be fewer price-reporting agencies competing with each other to produce the most accurate and reliable benchmark price in the market.

Reform of energy markets

Whilst the European Commission has acknowledged that there are some differences between the rate markets and the physical commodity markets, and whilst they have sought to draft some derogations from their



.....
'... THE DEROGATIONS DO NOT GO FAR ENOUGH IN ADDRESSING THE FUNDAMENTAL DIFFERENCES BETWEEN RATE AND ENERGY MARKETS.'
.....

requirements in relation to rate markets, the derogations do not go far enough in addressing the fundamental differences between rate and energy markets.

Given the risk of damage to the energy markets which could be caused through proposed regulatory reform in this area, it is perhaps surprising that regulators have not fully considered the implications of their proposals. Whilst there is an understandable political driver to introduce regulatory reform which addresses the causes of the financial crisis, the energy markets cannot be said to have been involved in the causes of the financial crisis in the

same way as financial markets were. Governments and regulators would control these markets more effectively through gaining an understanding of how the markets operate in practice and by working to achieve reforms if these were considered necessary. In this regard, it is notable that the International Organization of Securities Commissions (IOSCO) produced guidelines for the creation of financial benchmarks, and the energy markets have responded well to these guidelines, which are considered to have introduced sensible and realistic standards. Given the work of IOSCO, it seems unfortunate that the European Commission does not simply leave the markets to work with these guidelines.

Whether the European Commission's current proposals in relation to the Benchmark Regulation are brought into effect in due course or not, a significant

deterrent to market manipulation will have been introduced from July 2016 when the Market Abuse Regulation is implemented. Through this regulation, it will become a market abuse offence to manipulate benchmark rates (including in relation to commodities). The UK civil market abuse regime will also be extended to cover products traded on Multilateral Trading Facilities and Organized Trading Facilities. These reforms should, in turn, provide regulators with sufficient additional tools in order to tackle market abuse and market manipulation in the energy markets. The Market Abuse Regulation in itself may therefore provide a more effective tool for managing the risk of manipulation than the current proposals for a Benchmark Regulation, which could in fact result in the energy markets being damaged by creating distorted and unreliable prices.

