

to act as a price discovery mechanism for materials that are the building blocks of economic activity, unlike many other traded markets whose primary purpose is to raise or increase capital.

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‘THE FACT THAT SOME INSTITUTIONS WHICH ARE ACTIVE IN THE CAPITAL MARKETS ARE ALSO ACTIVE IN COMMODITY MARKETS, DOES NOT MAKE THE MARKETS ALIKE.’

The capital markets are also fundamental to economic activity but they are different; they serve a different purpose, function in a different way, and pose different risks. The fact that some institutions which are active in the capital markets are also active in commodity markets, does not make the markets alike. Hence the need for policy makers and regulators to ensure that their proposed regulations do not have unintended consequences, particularly for the end consumer.

The focus of both policy makers and regulators on improving markets is understandable in the wake of the financial crisis, the call on taxpayer funds, and subsequent investigations into market manipulation. The concern is that by treating commodity markets from an investment market perspective, with respect to regulation, the risk exists that their efficacy is eroded, to the cost of both the real economy and the end consumer.

This will result in two unfortunate outcomes. The first is that the market will become less efficient and more volatile, with the consequence that costs to end consumers will rise. The second is that activity, and in some cases entire markets, will migrate to other jurisdictions, most notably the fast growing markets in Asia.

Europe’s place at the heart of world oil markets is largely accidental. North

Sea Oil, market openness, the rise of the price-reporting agencies, and the establishment of the International Petroleum Exchange (today’s Intercontinental Exchange or ICE) in the 1980s, all contributed to European benchmarks and pricing being those used in contracts globally today.

But there has been a significant shift, both in terms of production and, more importantly, consumption. At its peak, the North Sea accounted for just under 9 per cent of production globally, today it is 3 per cent and, in the current price environment, this is likely to fall further. Similarly, in 1980 Europe accounted for 24 per cent of global consumption, compared with 15 per cent today (the USA has always been the largest consumer with 28 per cent in the 1980s and 20 per cent today). In contrast, as you would expect, Asia’s increase in both absolute terms and share of global consumption is marked: from 10.5 million barrels a day to 30.4 million barrels a day (17 per cent to 33 per cent) over the same period. Today, China’s consumption alone is equivalent to the whole of Asia’s consumption in 1980. If India’s and China’s consumption patterns evolve to emulate Europe’s relatively low levels of consumption, they will account for 18 per cent by 2020.

In this context, it is unsurprising that challengers to Europe’s energy derivative markets and pricing mechanisms are already arising. Policies and regulations which diminish the competitiveness of Europe’s markets will only strengthen the position of competitors and drive pricing activity to other regions. The losers will not only be Europe’s consumers and industries, who are likely to experience relatively higher prices, but the markets themselves. All participants have benefited from markets which function efficiently within a stable, respected, and appropriate regulatory framework, as has generally

been the case to date. That is, one which takes account of the unique characteristics of the energy markets.

To consider our concerns more specifically, at present two areas come to mind; the implementation of Markets in Financial Instruments Directive (MiFID II) and the issue of ‘systemic risk’.

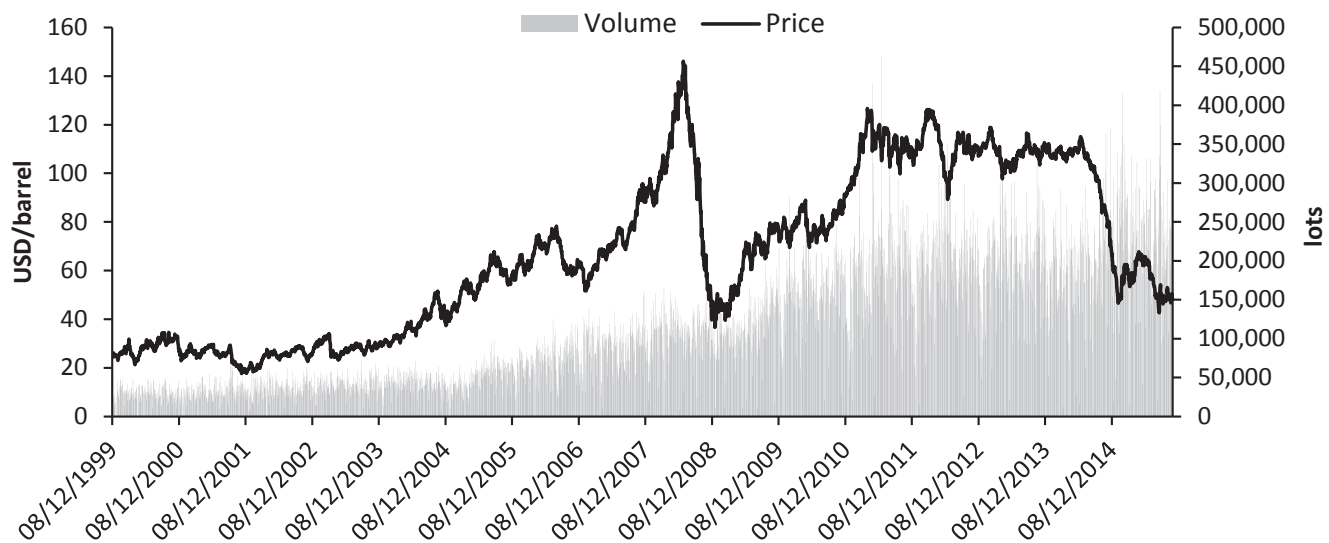
Concerns relating to implementation of MiFID II

With regard to MiFID II – which we should not forget is legislation originally conceived for the protection of investors, not to facilitate an orderly market in commodities – ESMA (the European Securities Market Authority) has recently published its proposed Regulatory Technical Standards (RTS). Whilst we appreciate that ESMA has sought an open and active dialogue with market participants throughout the process, areas of concern remain.

ESMA has recognized that companies which are not investment businesses are nonetheless at risk of being captured by the regulation – which could result in say, a utility company being regulated as if it were an investment firm. To try and address this, current proposals seek to match hedging activity through financial instruments with physical activity. Unfortunately this is a poor proxy and, as industry bodies have already proposed, it would be both simpler and more effective to look at the allocation of accounting capital to determine the company’s core business.

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‘INVESTMENT FIRMS INVEST TO GENERATE A RETURN, COMMODITY TRADERS MOVE PHYSICAL COMMODITIES ...’

Having spent my entire career in the physical markets, the differences between our business and that of an



Oil price and the volume of contracts traded

investment firm seem clear. Investment firms invest to generate a return, commodity traders move physical commodities – hence our obsession with logistical details and real consumer demand, country by country and fuel by fuel. Some of the tools we use may be the same, but that does not make the businesses the same; if hydrocarbons became obsolete overnight, most energy trading operations would no longer exist, whereas investment firms would simply find another asset class to invest in.

Similarly, position limit rules must be set in such a way as to reflect the practicalities of each market – practicalities which will differ from market to market, depending as much on the constraints of the underlying physical market as the financial markets. Here also there is a real risk that rules intended to promote market integrity result instead in a distorted, illiquid market, which is of limited use to end-users.

The recent collapse in the price of oil has demonstrated how effectively commodity markets have responded to the underlying realities of demand and supply, as well as how capably they can handle significant price volatility,

with no impact on liquidity, as the chart ‘Oil price and volumes of contracts traded’ shows. It has also served to demonstrate how conservatively commodity trade operations manage their risk exposure – without careful hedging, many market participants would have suffered significant losses.

Commodity traders don’t pose a ‘systemic risk’

In this context, the resurgence of questions from some quarters regarding the issue of whether physical trading operations should be regarded as a ‘systemic risk’ (akin to that created by the banking sector) is clearly misguided.

The rationale as to why commodity traders do not pose a systemic risk has been comprehensively articulated by Professor Pirrong of Houston University on a number of occasions. The funding model of commodity trading businesses – with long-term funding and short-term, readily marketable liabilities – is the reverse of that of the banks and some other financial institutions. The position has been further strengthened since the introduction of mandatory clearing

after 2008, meaning that short-term uncollateralized exposure is very limited and the likelihood of large, unfunded exposures forcing a sudden collapse and systemic failure is highly unlikely. This is not to say that trading houses will not fail. They will, and the consequences for employees and equity holders could be tragic, but their unfunded exposures to other market participants will not be sufficient to engender a domino effect.

This begs the question of whether commodity markets can experience ‘systemic failure’ in the same way that credit markets seized up in 2008. There are multiple participants in energy markets – most of which are not significantly interlinked and all of which respond to the underlying economic drivers of physical demand and supply. So long as there is confidence in the demand for the underlying commodity, and the funds to facilitate trade, the market will continue to trade; the process of transferring ownership of a commodity is well established and relatively simple, certainly much simpler than with financial instruments. Hence the demise of any participant will simply be seen by its competitors as a commercial opportunity.

Importance of maintaining robust commodity markets

The world's major commodity markets are well established and robust. They have continued to function effectively even in the face of swings in price and huge shifts in demand from the OECD to the developing world, most notably Asia. Bubbles and temporarily inflated

prices are as much a part of commodity markets as 'irrational exuberance' is a human weakness, but eventually, as recent months have shown, the fundamentals of supply and demand take over. As I began by saying, commodity markets exist to continuously facilitate the movement of goods around the world. This is their primary and essential purpose and it is imperative that rules and

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'IT IS IMPERATIVE THAT RULES AND REGULATIONS ARE DESIGNED TO PROTECT THE INTERESTS OF THE REAL ECONOMY AND CONSUMERS.'

regulations are designed to protect the interests of the real economy and consumers by enhancing this function, above all others. Otherwise Europe will be the poorer.



Are regulators right to worry about the oil benchmarks?

Peter Stewart

The three most widely used crude oil benchmarks are North Sea Brent, West Texas Intermediate (WTI) from the USA, and Oman crude from the Middle East. As is well known, the bulk of the 92 million barrels of crude oil sold each day is priced based on published assessments or daily averages of deals done in these three grades of oil, known as benchmarks. The assessed value of physical or 'dated' Brent published by Platts, a leading price-reporting agency (PRA), is the most widely used benchmark. Billions of dollars worth of oil and significant volumes of gas and LNG change hands each day based on Platts' dated Brent assessment. Other benchmarks published by companies such as Petroleum Argus and ICIS are also used by the industry.

The Brent market has evolved over the years and it is now one of the most complex of commodity markets. From experience, it takes one full day on a training course to explain comprehensively from scratch how Platts makes its daily assessment of dated Brent. It is usually the most difficult day of such a course. People from outside the oil industry generally expect that oil is sold at a fixed price in dollars per barrel, which is how they

hear the price of oil on the television. They are baffled and often astonished when they find out the reality.

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'ASSESSING THE VALUE OF BRENT CRUDE OIL IS ANYTHING BUT SIMPLE.'

The scientist Isaac Newton said: 'Truth is ever to be found in simplicity, and not in the multiplicity and confusion of things.' Assessing the value of Brent crude oil is anything but simple. Brent crude oil is currently most frequently sold based on a value that Platts will in the future publish for the lowest in price of four not very similar grades of crude oils (Brent, Forties, Oseberg, and Ekofisk, also referred to as BFOE) on the days around or shortly after the cargo is loaded. That is usually 2-4 weeks after the deal between a seller and a buyer is concluded. The value that Platts publishes on the bill of lading date is itself not based on a transaction that is concluded at a fixed price. The calculation that Platts makes each day of the fixed price value for each of the four grades is usually derived from at least two, and arguably three, separate financial instruments: the Brent forward price and the Contract for Difference between the physical cargo and forward Brent. (The

forward Brent price is itself derived from the Brent futures price and the Exchange for Physical differential). Moreover the values are not the result of a survey or an average of deals; buyers and sellers meet and transact their deals on the Platts screens – in what has become known as the Platts 'window' – bids and offers are posted and may or may not result in actual transactions, and only the market price at a particular moment in time (4:30 London time) is reflected in the daily assessment. These assessments and the real-time flow of bids and offers can be seen by anyone who wants to pay a hefty subscription fee. Although Brent is generally regarded as the market with the most complex structure, similar mechanisms of varying degrees of complexity are used in assessing the value of other benchmarks.

Platts' methodology and those of its competitors – Petroleum Argus, ICIS, and others – have evolved over time, and the assessment systems have been adapted as the market itself has changed. So the fact that the assessment methodologies used are sometimes convoluted cannot be laid solely at the doors of the PRAs (Platts took a more active role in defining the