# New EU Rules May Be a Fix for Something That Isn't Broken

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**The pricing of oil, gas, and other commodities has been under fierce regulatory scrutiny since 2008. Regulators – especially those in Europe – have focused on the role of Price Reporting Agencies (PRAs) and questioned the subjective nature of their price assessments. The regulatory mind likes tidy methodologies based on 'verifiable' data, and this bias could now be leading to the introduction of tightly prescriptive rules that would seriously distort physical commodity trading and make it less, rather than more, transparent.**

The draft European Commission directive on benchmark regulation comes in the wake of the global financial upheavals and is aimed at financial derivatives markets. It appears also to be part of the French-led agenda within the EU to limit the influence of what many European politicians regard as undue Anglo-American dominance of the global economy.

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## Commission Benchmark Proposals

The Commission's benchmark directive makes a number of unprecedented proposals that, if implemented, would have the unintended effect of reducing transparency in physical commodity markets. Inter alia, the draft suggests:

- That market sources voluntarily providing information to PRAs should be subject to direct regulation by an EU body.
- That no contributor of information should be party to more than 25 per cent of either the volume or the value of transactions used in the calculation of an index. (Such a restriction would make it impossible to provide benchmarks for North Sea crude oil, some refined products, and potentially some natural gas and electricity indices.)
- That the PRAs police their information sources and, where they suspect misconduct, report their sources to the authorities (the EU).
- That the EU would create a category of 'Authorized Contributors'. (These would apparently include physical/industry players and authorized investment firms. Such definitions are unworkable in the wider global arena in which oil, liquefied natural gas, and coal are traded, and in any case would disqualify genuine transactions or market information contributed to PRAs by non-qualifying entities.)
- Finally (and potentially most damagingly) the draft would impose unlimited financial liability on 'Authorized Contributors' in respect of any information they provide. (This is likely to severely discourage the flow of reliable information, on which the PRAs, and beyond them the operation of the free markets, depend.)

## IOSCO and PRA Principles

From the energy market's perspective, the Commission seems determined to ride roughshod over other and more coherent regulatory interventions. The most wide-ranging investigation of the role of PRAs was that undertaken in 2011/2012 by the International Organization of Securities Commissions (IOSCO), an international umbrella group primarily concerned with the integrity of securities markets.

IOSCO's probe into the PRAs' role in oil markets, mandated by the G20, was lengthy and exhaustive. It took evidence from about twenty interested parties.

A minority severely criticized the PRAs for being subjective, unprofessional, and open to manipulation.

However a majority of respondents (including, of course, the three principal PRAs) were broadly supportive of the reporting agencies, and warned against any attempt to regulate them.

BP, one of the world's largest and most active oil traders, responded thus:

'We understand the concerns … that the use of PRA benchmarks in the design and pricing of OTC and exchange-traded derivatives contracts may give rise to market integrity issues. However, we do not believe it is correct or appropriate to characterise the activities of price reporting agencies as posing systemic risks or moral hazard to the financial system. It is certainly the case that physical oil markets are important to the global economy; however, the mere fact that PRA benchmarks are reflected in the design or pricing of a commodity derivative instrument does not give rise to the same type of risks as credit maturity transformation activities performed by banks.'

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The three PRAs all offered lengthy defences of their methods and output. ICIS – the least influential in the oil market but the leader in gas pricing – made the point that:

'Transparency in physical oil markets is a function of multiple approaches to information: it is not simply the product of number-gathering. Price-reporting services have created transparency by researching, analysing, and publishing information on verified transactions, bid/offer levels, market sentiment, movements in and relationships to other related markets, freight and processing relationships, and derivatives markets.'

The point is that oil markets in particular are physical and non-standardized, even though they are capable of sustaining highly liquid futures and derivatives markets. In fact, the PRAs play a vital role in both creating and sustaining the conditions in which such energy-based securities markets can flourish. They do this by weighing carefully all the information available to them – transaction data (verified and unverified), bids and offers, statistical data (especially that relating to supply and demand), and opinion.

The IOSCO report made many recommendations, and led to a set of principles for Price Reporting Agencies which largely embodied, but also reinforced, the already strict internal governance rules that each PRA had developed over many years. But essentially it gave the PRAs a clean bill of health:

'IOSCO acknowledges that PRAs meet a legitimate physical oil market need, have increased transparency in the markets for physical oil where there are no requirements for transaction reporting to PRAs, have facilitated hedging activities by creating benchmark prices and have, to varying degrees, instituted policies that reflect a concern for quality and integrity in their work-product. … IOSCO also appreciates that PRA price assessment processes involve analyses of complex and varied oil markets and products and produce market views that promote price discovery in the physical oil markets.'

However, one of the areas of concern shared by IOSCO and the Commission is the verifiability of data and, in particular, the transaction data used in assessing prices.

Any competent price reporter knows (a) that it is vital to obtain as much transaction data as possible, and (b) that this is rarely the whole story. That is why, even in highly liquid and transparent markets such as the UK's NBP gas market, PRAs publish both transaction-based indices and bid–offer assessments.

The IOSCO report made its preferences clear, but did not demand full transaction-based price reporting:

'PRAs [should] give priority to concluded transactions in making assessments and implement measures intended to ensure that the transaction data submitted and considered in an assessment are *bona fide*, including measures to minimize selective reporting. These measures are intended to promote the quality and integrity of data and in turn the reliability of assessments.'

## Assessment or Transaction-based Reporting?

I can here provide only anecdotal evidence, of the kind deprecated by regulators, but in my personal experience over four decades of energy market reporting it tends to be senior company executives and regulators who prefer transaction-based indices, while traders and others closer to the action see the value of assessments.

Transaction-based indices give a sort of spurious sheen of accuracy, backed up, in the case of those indices generated on electronic trading platforms, with a verifiable audit trail. Understandably, they seem to remove doubt, and above all subjectivity, from the benchmarking process.

Yet even in highly liquid and transparent markets such as NBP or TTF gas, there are usually other considerations which may lead a professional price reporter to assess a closing price, or more importantly, a closing bid–offer spread slightly – usually very slightly – differently from the transaction-generated index.

The proof of the pudding is in the eating. Oil and other energy markets have consistently opted to benchmark to price assessments published by PRAs. Of course, in the real world – and they operate in the real world – they have little choice. Only PRAs can accurately reflect and benchmark the opaque physical markets that underlie the huge OTC derivatives and futures markets that grab the attention of regulators and politicians.

Possible exceptions to this rule are the closed system markets such as gas and electricity, especially the latter. Here the PRAs, face two different challenges, both of which commend themselves to tidy minds.

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Power markets have to balance in real time, and thus tend to produce prompt indices of undoubted accuracy. However, PRAs provide most of the transparency along the electricity forward curve, and thus their skills and published assessments are vital to this sector.

In European gas, the challenge comes from brokers who have overcome their innate mutual suspicion to pool transaction data in the so-called Tankard Index (named, it is said, from the silver tankards of champagne being quaffed in a London gentlemen's club by some leading brokers). Tankard produces prices very similar to the PRAs' assessments, but it has not been adopted and seems unlikely to be. The reason is simple: it is owned by brokers and brokers are part of the market, always acting as agents to market principals. That is why broker indices – which have a long history in the oil as well as the gas market – are bound to fail. Ultimately they lack the commitment to impartiality which is the PRAs' stock in trade.

One of the Tankard participants was recently fined $87 million for its part in manipulating LIBOR. There are two lessons to be drawn from this. First, that brokers in any market are bound to be tempted to help their clients manipulate prices from time to time. Second, that a benchmark like LIBOR – or indeed any financial benchmark – cannot be produced reliably by the industry's trade association, no matter what safeguards. Third-party assessment by an agency whose very existence depends on getting it right is absolutely essential.

The energy PRAs have been severely tested in recent years, and they have been subjected to severe regulatory scrutiny from which they have emerged with stronger and more transparent governance. The European Commission's benchmarking directive ignores that history and, by trying to regulate and potentially criminalize information flows, runs the risk of making global energy markets more opaque and more liable to manipulation.