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forum

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Energy trading in Europe is on the verge of a fundamental transformation. The implementation of a host of new regulations: the European Market Infrastructure Regulation (EMIR), the Markets in Financial Instruments Directive (MiFID), the Markets in Financial Instruments Regulation (MiFIR), the Market Abuse Regulation (MAR), the Capital Requirements Regulation (CRR), and the Capital Requirements Directive IV (CRD IV) will have profound implications for how international oil companies, trading houses, brokerage firms, investment banks, price-reporting agencies, and futures exchanges do business. While there is a consensus among the contributors to this *Forum* that the new regulations will change the landscape by increasing the complexity of the trading business and the cost of compliance, as well as increasing reporting and capital requirements, there remains much uncertainty as to whether these new regulations will achieve their intended objectives. Of particular concern are the unintended consequences of some of these regulations in terms of: reducing market liquidity, reducing the number of market players, the risks of regulatory arbitrage, and increasing the cost of hedging. Costs associated with these changes will ultimately be passed to end-users.

Liz Bossley sets the scene for the *Forum* by explaining the various regulations and directives affecting EU commodity markets and their intended objectives. She highlights the difference between a 'Directive' and a 'Regulation'. The former is a legislative act that sets a target that all EU countries must meet, but it is up to individual countries to decide how to translate this into national law. A Regulation, in contrast, is a binding legislative act and if it contradicts a country's national law that law needs to be changed. Bossley argues that the cost of compliance for banks and large multinational companies to the various directives and regulations being introduced is large and is already posing serious challenges to these institutions. For smaller companies, there is the risk that they would be driven out of the market, which could be 'regarded as collateral damage in the war against market abuse and systemic risk'. But to justify the costs of 'the heavier regulatory hand', these regulations must achieve their objectives, which remains to be seen.

Marco Kerste and *Bert Tieben* argue that the current regulations are based on the premise that the energy sector poses a risk of contagion to the real economy. However, the authors argue that this hypothesis has not been tested in the preparatory stages of introducing

CONTENTS

the new regulations. The authors' research shows that while adverse shocks to the energy sector can have repercussions on other firms within the energy sector itself, there is no evidence that the default of energy companies would pose an externality to the real economy. Their results also show that the contagion risks run from the banking sector to the energy sector, rather than the other way around. The authors conclude that the 'political haste in implementing strict regulation in the aftermath of the financial crisis is understandable, but continuing on this road without sound foundation is not'.

Peter Caddy argues that since the financial crisis, European energy trading regulation has moved from the traditional UK-style 'principles-based' approach, to a European 'rules-based' system. Caddy believes that European regulators are inherently suspicious of trading, and that the slew of regulations being proposed fails to distinguish sufficiently between the requirements of financial markets and those of physical commodities markets such as oil. This could damage market liquidity. With respect to the proposed EU benchmarking regulation, Caddy says that this can only benefit the US and Asian markets, where regulators are clearly working to produce a more appropriate regulatory regime than in Europe.

Orçun Kaya's article examines in details the recent reform of OTC derivatives, which consists of three main pillars: reporting all derivatives to trade repositories; clearing and trading all standardized OTC derivatives through organized exchanges; and increasing the margin requirements on non-cleared derivatives. Among these, the author argues that central clearing through a central counterpart (CCP) represents a fundamental transformation that would leave market participants no choice but to revise their risk management practices and business models. So far, however, central clearing of commodity derivatives has been limited. Kaya argues that while standardization is a prerequisite, it is not the only criterion and other factors such as eligibility, liquidity, and efficient pricing are also key for clearing. Also, the author argues that central clearing will increase the cost of derivatives trading, which will be eventually passed on to end-users. Kaya concludes that overall the new regulations will, without doubt, fundamentally transform the derivatives markets, but the impact these regulations will have on pricing, liquidity, and trading of commodity derivatives remains unclear.

*Ben Pot*t and *Graham Francis* focus on MiFID II, arguing that its implementation will have a profound impact on the intermediated commodity markets. This will pose many challenges for market participants, particularly for intermediaries, which will have to undergo a significant reorganization of their businesses. The requirements to trade on venues, and the organizational requirements on intermediaries to trade on venues, will transform the trading landscape. A key issue raised by the authors is the host of transparency requirements, both pre- and post-trade, which will depend on a number of factors such as the nature of the instrument and the size of the order – equivalent to the block-size thresholds currently in operation. The authors argue that getting these thresholds wrong would have significant impact on commodities markets as they could damage liquidity and may result in the trading of certain assets being driven outside the EU. The authors argue that venue trading will also be impacted by provisions on position reporting. Pott and Francis conclude that if 'full pre-trade disclosure were to be required, many markets may well be starved for liquidity, and trading would migrate to dark pools in related assets, or move into third-country markets with lesser transparency requirements'.

Jonathan Hill argues that the energy sector is grappling with an unprecedented wave of regulatory initiatives. Post financial crisis reforms extend financial regulation to the physical commodity markets with relatively little tailoring to take account of their underlying nature, posing significant implementation challenges for the oil and gas production industry. The resulting financial and structural impacts are becoming clearer, yet the impact on markets very much remains to be seen. Policymakers must now allow the impact of recent reforms on the oil and gas production industry and its crucial markets to be assessed before proposing any further changes. In particular, there is a need to better understand unintended consequences, cost, complexity, end-user choice, and liquidity.

Jonathan Farrimond and *Paul Wightman* argue that the implementation of MiFID II and MiFIR will introduce fundamental changes to the structure of financial commodity markets. The most notable change will be in relation to position limits. While position limits have been applied in the USA for many years, it is a new concept for European commodity markets. The authors argue that the 'move from a regulatory framework which has largely excluded the use of position limits to a place where position limits apply to the vast majority of commodity derivatives is a bold move'. Regulators also face the challenge of setting appropriate limits for potentially thousands of contracts simultaneously. Given the size of the shift, the implementation risk is high and it is therefore important for regulators to 'remain open to amending these initial limits in light of practical experience as the case may require'.

Ian Taylor believes that the scope and depth of energy market regulation which has recently been, or is in the process of being, implemented across both the USA and the EU is unprecedented and that the industry is entering 'uncharted territory'. The Vitol CEO says that commodity markets have a proven record of enabling the flow of raw materials, and as a price-discovery mechanism for materials that are the building blocks of economic activity. Taylor identifies MiFID II and the issue of 'systemic risk' as areas requiring particular attention. He argues that policy makers and regulators must ensure that the regulations they promulgate do not have unintended consequences, and in particular he highlights the need for regulators to distinguish between commodity and financial markets. Failing to do so could impair the efficiency of energy markets, potentially resulting in additional costs to the end consumer.

Peter Stewart seeks to understand regulators' suspicions of the oil market by examining the evolution of the North Sea Brent benchmark, the most widely used price assessment. He argues that regulators, traders, and price reporters each have different agendas, and use terms such as 'transparency' to mean different things. Stewart notes that the Dated Brent market has evolved since the 1980s from a relatively simple market structure in which cargoes were traded at a fixed price to one in which the fixed price value of the commodity is effectively discovered through the value of three separate derivatives instruments. While this structure suits the needs of traders, and the assessment process is regarded as fully transparent by the main price-reporting agency involved, it does not inspire the confidence of regulators. Simplifying the pricing structures could be one way of renewing confidence in the market and of reinforcing the price assessments published by reporting agencies.

Neil Fleming distinguishes between *market* manipulation and attempts by market participants to manipulate the price *benchmarks* published by energy price publications. Noting that allegations do not constitute proof, or even evidence, of manipulation, Fleming challenges the 'default assumption' that market manipulation is a systemic problem in commodities markets, or that price reporting agencies are vulnerable to market manipulation or conflicts of interest. He argues that contrary to the assumptions made by many regulators about the inherent superiority of automated price discovery and averaging systems, the price assessments produced by PRAs are in reality protected and enhanced by the expert judgement of pricing specialists. Fleming analyses the anomalies and pitfalls that can result from automated systems, and argues that true market transparency is the product of non-static systems guided by human intelligence, that have the capacity to evolve as markets develop and to react to anomalous events as they occur.

Andreas Walstad says that, while the regulatory debate around MiFID II has focused on the impact on large companies with substantial physical and derivatives market exposures, industrial players for whom energy trading is a sideshow will also be affected. He cites an open letter published in October and signed by energy trade groups across Europe and a number of energy-intensive industries, which points to the disproportionate capital, prudential, and liquidity requirements that could be imposed. Energy and energy-intensive companies were largely exempted from the obligations under MiFID I, but the revised directive casts the net wider and could seriously affect both the market and the industrial groups concerned. Walstad says the industry's calls for more flexibility should be taken seriously. A longer phase-in period of MiFID II for non-financial firms would be one way to give industrial players breathing space to adapt to the new requirements.

Andrew Tuson tracks the regulatory changes that governments and regulators have sought to introduce to prevent the manipulation of financial markets and to protect consumers since the financial crisis. He argues that 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. Tuson says that the proposed European benchmark regulation does not sufficiently address the difference between rate markets and physical markets, and could result in the energy markets being damaged by creating distorted and unreliable prices. He argues that the Market Abuse Regulation due to be implemented in 2016 may provide a more effective tool for managing the risk of manipulation.