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Oil markets should heed Libor lessons

By Gillian Tett

Five years ago, the word “libor” sparked a yawn from investors and journalists. For back then, the process for setting these benchmark interest rates looked arcane, if not dull. And while it was clear that the Libor methodology was potentially open to abuse (since it sets rates based on prices that players report, not actual deals), the system was so well entrenched that it was rarely questioned.

No longer. Since 2007, those Libor rates have sparked controversy, as it has become obvious that “reported” prices can sometimes be distorted, particularly during a crisis. More recently, global regulators have started investigating allegations that traders have sometimes deliberately manipulated Libor too. So now, after years of denial, the British Bankers Association, the body that runs Libor, has finally started a full-scale overhaul. What was taken for granted, is – belatedly – in play.

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Could something similar be about to occur in oil markets too? It is a fascinating question. Six weeks ago, the International Organisation of Securities Commissions published a dry-sounding report called Functioning and Oversight of Oil Price Reporting Agencies, and duly asked for reactions. Unsurprisingly this sparked little wider public debate. But inside the murky oil sphere, there is a lively fight underway, which echoes the Libor debates, for reasons good and bad.

The issue revolves around the role played by price reporting agencies – PRAs – such as Platts, Argus Media and ICIS. These wield extraordinary power in the energy sector, since, as Liz Bossley, head of the Consilience Energy Advisory Group says in her submission to Iosco: "The vast majority of physical oil production moves under contracts that use PRA benchmarks as a reference point", and "perhaps 60 to 70 per cent of OTC swaps and options are priced or cash-settled by reference to PRA quotes".

But the PRAs do not create these indices just based on prices established by actual trades; instead, they also rely (sometimes heavily) on reported quotes from a pool of selected financial players, with sometimes as few as five participants taking part, as the Iosco report notes. And there is limited external scrutiny, let alone regulatory oversight of the prices, because reporting activities have been defined as "journalistic" activity and are shielded by free speech rules.

Now, the PRAs argue that this is the only feasible way to get benchmark prices because liquidity is often too low to create accurate "traded" prices. The PRAs also insist that they make the reported prices credible and consistent, and point out that if market players dislike (or disbelieve) the numbers, they can simply stop using them; there are, after all, several of these PRAs. Or as Platts says: "The use of Platts' prices for physical transactions is at the sole discretion of the buyer and seller."

Most of the time the prices do seem credible. Philip Verleger, another prominent consultant, has told Iosco that reform is unnecessary. But others disagree. One problem, as Iosco notes, is that "there is a risk that a PRA's benchmark price can be manipulated by the submission of false prices . . . or selective report[ing]." This worries the Commodity Futures Trading Commission, which has fined companies such as Marathon Oil over alleged attempted manipulation. Or as CFTC commissioner Scott O'Malia has warned: "Contract settlement and pricing details in a futures market contract, which references a physical or OTC benchmark, must not be susceptible to manipulation or gaming."

And even if deliberate manipulation is rare, there is concern about opaque differences in methodology between PRAs – and the amount of power that groups such as Platts wield over the derivatives and physical markets, because it can exclude players from its price-reporting groups. Some observers also argue that the fact Platts hosts an e-trading window, linked to the InterContinental Exchange, creates additional conflicts (something Platts denies.)

Now, the good news, if you like, is that the regulators do appear to have learnt some lessons from Libor; by acting now, with the current report, Iosco seems to hope that it can stave off any truly big scandal. And some potentially sensible ideas have been mooted, most notably to raise the external oversight of PRAs. But the bad news is that the PRAs seem vehemently opposed to radical change. “We see no connection whatsoever between Platts’ price assessments and recent issues concerning Libor,” Platts says. “We are not aware of any evidence that the current system is broken or that “reforming” the system would outweigh the costs and potential risks.”

At best, this suggests a fight looms; at worst, it looks dangerously myopic. Especially at a time when political anger about the oil price is already rising across the western world. The PRAs would do well to look at the recent history of the BBA or credit rating agencies – and learn some lessons, fast.

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