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**The hunt for WMDs in the oil price process**

*Monday, July 8,* 2013 *By Liz Bossley CEAG*

The EC raid on the offices of BP, Shell and Statoil on May 14th seeking evidence of oil price manipulation has created a level of consternation not seen since the hunt for weapons of mass destruction (WMDs) in Iraq. If the WMDs had been there they would probably have been found. The difference with the search for evidence of oil price fixing is that, if it is there, it will be very difficult to recognise. If the evidence does not actually exist, it would be easy to mistake the actions of traders going about their lawful, if complex, business for market abuse.  
  
**Looking Through the Window**  
  
The spotlight is currently on the Platts' window. Platts is a price reporting agency (PRA). The prices it publishes are used throughout the industry -from the physical market to the regulated futures markets to the opaque over-the-counter (OTC) derivatives market - to solve the price formulae included in a huge number of contracts. Most physical oil contracts do not stipulate a fixed and flat price such as $X/bbl. Instead the contract price clause refers to the average of the price published on a specified number of days by a named PRA.  
  
The Platts half-hour window is a price discovery process, not a market. The actual market trades round the clock in different geographical regions. The Platts' window exists to provide a snapshot of a wide range of benchmark prices at certain key points during the day in a variety of locations. To inform that process with consistent and comparable data Platts determines who can input data to its price discovery process and what form its contracts must take in order to be included in the Platts database.  
  
The confusing aspect of the window process is that deals can actually be executed on the Platts electronic platform- the so-called e-window- to aid the price discovery process. Oil companies wanting to ensure that Platts has sufficient data to go on, because the numbers that gets published have a significant impact on a large number of their deals, need only trade in small quantities during a very short time period each day to have their say in the benchmark number that is published by Platts. Trades in non-benchmark grades throughout the day are considered in the assessment of the price differentials to the snapshot of benchmarks that get published.  
  
A buyer or seller wanting to offer a transaction to the widest possible pool of counterparties will typically place its bid or offer in the highly liquid futures market or through a broker to the OTC market at any time during the trading day and in any form the two parties to the deal want the contract to take. But dealing in the Platts window is more restricted. Deals that qualify for inclusion in the Platts' database can only be done in the Platts way, at the Platts time and with counterparties permitted by Platts.  
  
It will be very difficult for the EC's 'weapons inspectors' to distinguish between deals done to populate the Platts price database with reliable numbers and deals done to skew the Platts price that is reported in one direction or another.  
  
Even though there is a smaller pool of players in the Platts' window than there is in the wider market the quantity of data the inspectors will have to plough through will be vast.  
  
If there is evidence of manipulation to be found, and I am not pre-judging the outcome of the EC search, that evidence will not necessarily lie in the trades reported to Platts in its window or traded on its e-window platform. It is most likely to be found in offsetting private and confidential deals done elsewhere that do not get reported*1*. That is why the inspectors' job will be so difficult.  
  
**Cui bono?**  
  
Much of the press reporting of the search for evidence of oil price manipulation appears to assume that if oil prices are being manipulated then they must be artificially inflated to the detriment of the consumer. That may make a good story, but it is not necessarily so.  
  
In the case of crude oil, companies are taxed at a much higher rate upstream at the wellhead than they are downstream in the market for refined oil products, such as for gasoline or for diesel. So, arguably, integrated oil companies, that both produce crude oil and sell refined products, would benefit from low crude prices and high product prices.  
  
Offsetting, or supplementing, the actions of oil companies, there are the commodity trading houses that actively buy and sell both crude oil and refined products on any given day in the wholesale cargo market. On some days their trading books will benefit from higher prices and on others they will benefit from lower prices, depending on whether they are 'long or short'*2* at any point in time. Many of these companies also input their trading data to the Platts price discovery process and also to that of the other PRAs. Private trading houses are no slouches when it comes to defending their own positions against any attempt to load the dice against them.  
  
So the assumption, that if prices are being manipulated then they must be manipulated up, is highly questionable.  
  
**Beware of What You Wish For...**  
  
The US Federal Trade Commission (FTC), at the behest of the Department of Justice, upped the stakes on the EC investigation by launching its own oil price probe at the end of June.  
  
A class action suit, reported on 28th May in Courthouse News Service, was brought by a Chicago trader in the District Court of the Southern District of New York against a range of oil companies and un-named co-conspirators for reporting inaccurate information to Platts.  
  
It was in the District Court of the Southern District of New York that the late Judge William C. Conner ruled in 1990 that 15-Day Brent contracts, the ancestor of today's 25-Day BFOE oil market, were illegal off-exchange futures contracts. This was swiftly followed by 'The Brent Interpretation', which clarified that '15-day Brent system  
crude oil contracts were forward contracts that were excluded from the CEA [Commodity Exchange Act] definition of 'future delivery,'' and thus were not futures contracts.*3*' This put them within the scope of the forward contract exclusion from regulation by the Commodity Futures Trading Commission (CFTC).  
  
The majority of the benchmark contracts reported by Platts and the other PRAs are either unregulated physical contracts, or they fall within regulatory exclusion zones, or they are subject to light-touch codes of conduct.  
  
**Appropriate Regulation**  
  
Irrespective of the outcome of the various investigations mentioned above, some sensible regulation of the oil market is over-due.  
  
As we pointed out in our book, published in May 2013, 'Trading Crude Oil: the Consilience Guide' [http://tradingcrudeoil.co.uk/](http://tradingcrudeoil.co.uk/" \t "_blank) , there is no forum where oil market actors can sit down together to agree simple housekeeping issues, such as the form and content of benchmark contracts, without fear of accusations of collusion. Love it or hate it, the Platts window process evolved in this regulatory vacuum to fill a perceived industry need. In my opinion this regulatory vacuum needs to be filled.  
  
As we suggested in the book referred to above 'an expert panel, subject to regulatory oversight, might be convened to deal with contractual trading housekeeping issues …. The terms of reference of such a panel might be to host regular industry meetings at which issues of relevance to oil trading contracts might be discussed. These issues might include declining volumes of key benchmarks, quality issues, logistical problems etc. that might require a concerted contractual amendment by stakeholders or a change in reporting methodologies of the PRAs.'  
  
If, however, the EC and/or FTC investigations do find evidence of criminal collusion to distort prices then all bets are off and the culprits can take what is coming to them. But, we would suggest, what has to be avoided is the smashing of a vibrant and necessary market with sledgehammer to crack the walnut of what may turn out to be a random minority of manipulative wrong-doers. But first we have to wait and see what evidence is uncovered, if any.  
  
*1. For example Exchange for Physicals (EFP) transactions on regulated exchanges. The volume of EFP transactions is reported, but the price is not. This is because the deal is agreed 'off-exchange' by two willing counterparties and is then transferred onto the exchange for clearing and settlement. The deal has not been shown to the futures market participants and the price is therefore irrelevant to that market.  
2. A company that is long has oil for which it has no use and which it needs to sell. A company that is short has a commitment to supply oil that it does not possess and which it must buy before the delivery date.  
3. http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-18003*

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