Motive, Means and Opportunity

By Liz Bossley

When the European Commission (EC) swooped, like the SAS, into the offices of Shell, BP, Statoil and the Price Reporting Agency, Platts, on May 14th this year looking for evidence of manipulation of Platts prices, it seemed like a major over-haul in the oil market, not just in oil price reporting , might be in the offing. This EC raid triggered a separate oil price investigation at the end of June by US Federal Trade Commission (FTC) and, perhaps scariest and least predictable of all, a class action suit 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.

Now, six months later, the market has got tired of waiting for the dénouement and it is business as usual in oil trading.

No News is No News!

But that does not mean to say that all is well in the world of oil pricing, even if the EC and FTC investigations eventually decide not to publish their conclusions. It may just mean that the data that is submitted to those regulatory authorities that police the market, or that they themselves have seized in the hope finding a smoking gun, is so complex that they are not yet ready to share their findings. Or it may be that those findings are showing "the wrong result".

The "Independent" newspaper reported on 15th May, the day after the EC raid, that *"Oil executives could face jail if they conspired to keep petrol prices high by rigging the market, David Cameron has warned".* This suggests that the public perception of the "crime" under investigation is one of artificially inflated prices and that the "victim" is the man in the street.

But if the EC investigation shows evidence that oil executives conspired to keep prices low does that mean they should get a pat on the back from the UK Prime Minister?

It worth reminding ourselves of who is motivated by high oil prices and who is motivated by low oil prices before throwing around accusations about which companies, if any, are up to no good in their reporting of price information to the oil Price Reporting Agencies (PRAs).

Motive

Upstream producing oil companies like high crude oil prices for obvious reasons, but they do not necessarily like to see those high oil prices recorded and publicised by the PRAs. The higher the crude price that gets reported, the higher the price used by state- owned National Oil Companies (NOCs) in Production Sharing Contracts (PSCs) to calculate the number of barrels that the contractors are allowed to take in order to recover their exploration and development costs and to earn a profit before the state qualifies to take a share. High crude oil prices are also used to calculate the size of the royalty and other production tax bills that the contractors must pay. In those regimes that use Service Contracts, rather than PSCs, the higher the reported crude price the more the oil industry must pay to buy barrels from NOCs.

This is not news: it was the tendency of the oil industry to under-state oil prices that prompted the formation of OPEC back in 1960.

The high upstream rate of tax – sometimes in excess of 80%- means that the integrated oil companies, i.e. those that own refineries and distribution outlets, would prefer to see their profits being earned in the downstream sector where the rates of taxation are much lower- sometimes lower than 30%. The dream ticket for the integrated oil company is low crude oil prices and high refined product prices.

But surely non-integrated exploration and production (E&P) companies can be relied on to push for higher oil prices? After all no-one wants to minimise their tax bill by earning less income, i.e. selling at low prices? Not necessarily. If E&P companies can disguise the high oil prices they receive and only let the regulatory and taxation authorities see lower prices, then they can enjoy tax free income. The easiest means of achieving this is using non-arm's length transactions.

Means

In the oil sector the term "arm's length" refers to trade between companies that are not affiliated in any way, carrying out deals that do not involve barter or swap arrangements. In an arm's length deal there is no "consideration", other than price. It is a routine feature of the industry that a large number of deals that get reported to NOCs and other authorities are non-arm's length. For example, oil producers regularly supply their own crude oil production to their affiliated refining system. When such deals are reported as non-arm's length the NOCs and tax authorities use the prices assessed by PRAs to calculate cost recovery, profit share, royalty and other taxes, rather than the price reported by the producing company.

It is possible, but unlikely, that oil companies would mis-report non-arm's length deals as arm's length deals to regulatory or tax authorities. That would probably constitute fraud. But PRAs are not regulatory or tax authorities. The suspicion that prompted the EC investigation is that the prices that get shown to the PRAs are not subject to the same degree of rigour as those reported to the statutory authorities.

If a company wanted to use the non-arm's length technique to depress reported prices this would involve the company in selling one cargo of crude oil to a third party and buying back a different cargo from the same third party, with both the purchase and the sales prices being below the true market level. That way neither company loses out. If only one of the two deals is shown to the PRA this would mislead the PRA into believe that prices are lower than they are in reality. The reported prices of refined products could also be artificially inflated using the same technique.

This places a heavy burden of responsibility on PRAs to spot when they are being misled, without having the authority to audit or sanction those companies that they suspect may be misinforming them. In what was probably an attempt to protect itself from manipulation the PRA on which most EC and FTC attention is being focussed, Platts, introduced its "window" system. In doing so it may have inadvertently opened up a window of opportunity to any oil company wishing to push reported prices down or up and may have actually facilitated what it wanted to avoid.

Opportunity

The Platts' window provides a snapshot of a wide range of benchmark prices at certain key points during the day in a variety of regional markets such as 4.30 pm in London and in Singapore and 3.15

Eastern Standard Time. To ensure that it is shown consistent and comparable data Platts publishes guidelines and methodologies explaining what form companies' contracts must take in order to be included in its price database. Furthermore Platts will not accept data from just anyone. If in its sole opinion a company does not deal on equal terms with other players in the market it can and does exclude deals done by that company from its database.

For example, during the banking crisis Platts excluded data for a period of time provided by American banks like Morgan Stanley and Goldman Sachs. Similarly if a company indicates in the Platts window that it will deal at a particular price level, but does not honour that commitment if a third party tries to accept its price indication and execute a deal with it, than Platts will "box" the defaulting company for a period of time, which may be days or weeks. In other words Platts sanctions companies by locking them out of the window process.

The actual window price discovery process is straightforward. Companies that want to ensure that their voice is heard in the determination of the price that is eventually published, and who are acceptable to Platts, need only phone, fax, email or otherwise e-messenger Platts with bids and offers during the half hour window. Alternatively companies can engage with other players in the window directly online using the Platts software that is hosted by the Intercontinental Exchange (ICE). The half hour progresses with bids and offers changing within limits, or increments, dictated by Platts.

For the key benchmark grades of oil and refined products the only deals *or price indications* that matter are those transacted in the last few minutes of the half hour window. It is often the case that no deals are transacted and that the price assessment that is published is based on the best bids and offers at the Market on Close (MOC). The market does not actually close- MOC is the term used by Platts to refer to the end of its half hour window. Trades in non-benchmark grades throughout the day are considered assessing the price differentials that are applied to the snapshot of MOC benchmarks.

In the days before the Platts window existed, i.e. pre-2002, any company that might have wanted to influence the oil price that is reported had to remain vigilant around the clock, stepping in to back a play to push the price one way or another a significant volume of trade. After the introduction of the Platts window any company with a similar motivation only has to engage with the process during a half hour period and can have an impact on the price that is published often without actually transacting any volume.

Platts is at considerable pains to ensure that it is not being misled and that any company that indicates its willingness to deal at a particular level must stand by that indication if a third party steps in to hit any bid that is too low or lift any offer that is too high compared with market levels. But nothing can protect Platts from any non-arm's length transaction done at "off-market" prices, which are shown to Platts as if it were arm's length. Platts has no power to force any company to reveal all the deals it does. So companies can cherry pick which deals to show in the Platts window and which to exclude. There is no sanction against showing only one half of a non-arm's length transaction.

This is what the EC and the FTC must be looking for as they plough through the data they have seized on their raids on the oil companies. Only time will tell if the regulatory investigations will uncover any evidence of the misrepresentation of prices to Platts.

So, with apologies to Cluedo, are we going to see a case of the oil companies in the Platts' window with the non-arm's length transaction? The EC and the FTC are going to have to exercise the little grey cells to solve that complex puzzle.

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