Review of Directive 2003/6/EC - the Market Abuse Directive (MAD)

Argus Media response to the Call for Evidence from the European Commission

10 June 2009

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Introduction

Argus Media is an independent energy price reporting and market intelligence agency, established nearly 40 years ago. Argus provides a price discovery [see glossary] function for the energy sector, by investigating and reporting spot market [see glossary] trading across diverse international energy markets. Argus is one of a number of competing market reporting agencies that serve their subscribers and the broader energy market by bringing price transparency to these energy markets.

Argus' submission addresses the questions in the Call for Evidence relating specifically to physical commodities and commodity derivatives.

The Argus perspective on this Call for Evidence is guided by three key principles:

- Effective markets are served by competition and transparency.
- Regulation is necessary to prevent potential market abuse and to protect consumers, but regulation needs to be carefully considered to avoid unintended consequences that harm effective markets and competition.
- Fundamental rights under European law underpin the role of information gathering in markets by a free press, and the competitive provision of this information is crucial to the operation of energy markets in the interest of European consumers.

These three key principles apply to the energy markets as a whole and to the role of price reporting agencies:

- Reporting agencies operate in a competitive environment, and provide transparency in the physical and "over-the-counter" (OTC) energy derivatives markets. At the same time, the service provided by these agencies promotes effective competition between participants in the energy markets by providing a price discovery mechanism.
- By providing unbiased, arms-length assessments [see glossary] of market prices, together with information on market activity, Argus and other price reporting agencies [see glossary] are a crucial check on the markets and help ensure that consumers are not the victims of market abuse.
- The flow of market information to reporting agencies is essential to the functioning of energy markets. Without this free flow of information to pricing services, oil markets would become more opaque, less efficient and more susceptible to abuses. Participants would have no way to reliably identify prices for hundreds of grades of crude and products. Price reporting agencies' information gathering is carried out through journalistic enterprise, and the information gathered — including sources — is protected by intellectual property rights and journalistic privilege.

Argus Media — an energy price reporting agency

Argus Media is a leading independent provider of price information, market data and business intelligence for the global petroleum, natural gas, electricity, emissions and coal industries. Founded in 1970, Argus is a privately-held UK limited company, owned by its employees and by the family of its founder. There are no external shareholders. Argus has 250 employees worldwide, with offices in London, Singapore, Beijing, Tokyo, Dubai, Kiev, Moscow, Washington, Houston, New York and Astana. Argus produces over 70 publications on the energy markets.

Argus provides three major areas of service:

- Price discovery and price reporting on daily spot physical and energy derivatives markets;
- Informed news, analysis and comment, provided both online and in Business Intelligence Reports; and
- Databases and research services on the energy markets.

Almost everywhere that an active spot market exists in an energy commodity throughout the world, Argus produces price assessments.

Most energy markets are opaque to a greater or lesser extent, making price discovery a challenging task. Argus has almost 40 years experience of employing a variety of methodologies to determine a price that best reflects an industry consensus of market value.

Argus clients include every major oil company plus most smaller ones, and financial and governmental institutions.

Our market coverage is extensive. Argus has reported on the major physical oil markets since its foundation. Its coverage has broadened in recent years to include natural gas and power, coal, LPG, NGLs, biofuels and emissions.

Markets covered by Argus

	Americas	**Europe/ Africa**	**Former Soviet Union**	**Asia/ Middle East**
Crude oil	X	X	X	X
Oil products	X	X	X	X
Natural gas liquids	X	X	X	X
Asphalt	X	X	X	X
Petroleum coke	X	X	X	X
Natural gas	X	X	-	-
Coal	X	X	X	X
Electricity	-	X	-	-
Emissions	X	X	-	X
Freight	X	X	X	X

How price assessments are used by the energy industry and others

Major client usage of Argus includes:

- Crude oil
  - North Sea crude: at least 25% of term contracts [see glossary] refer to Argus spot price assessments in their price formulas
  - The UK tax authorities use Argus in setting market price averages for taxation purposes for North Sea crude
  - Argus is the preferred provider of energy price benchmarks [see glossary] in the US domestic crude market
  - Argus crude assessments are used in calculating the Russian crude export duty formula

- Petroleum products
  - Argus European gasoline barge assessments are used as the price benchmark in the European gasoline swaps market [see glossary].
  - Argus is the preferred provider of price benchmarks for the European biodiesel market
  - Saudi Arabian and Indian product supply term contracts refer to Argus spot price assessments in their price formulas

- LPG — Argus provides the main international benchmark in Europe and Asia
- Coal — Argus is the main provider of price indexes [see glossary] for physical and derivatives markets in Europe, South Africa and Asia
- Natural gas — Argus provides the leading northwest Europe index in gas-to-gas pricing
- Electricity — Argus is the main provider of European mark-to-market values
- Emissions — Argus is a leading US provider of emissions indexation

How Argus assesses energy prices

Argus' primary role is to provide daily energy price information for spot physical markets. Some of these prices are then widely used as benchmarks in other spot physical trade, term contracts, and as indexes for OTC paper trades.

Argus journalists investigate the energy markets on a daily basis to assess spot trade transacted during that day and use this information for price discovery. They identify daily spot price benchmarks and differential prices [see glossary] for the markets they investigate. The methodologies used for these assessments vary according to market, reflecting the uniqueness of the different physical commodities, but are always defined in consultation with market participants. They are detailed and transparent. All methodologies are available publicly, and are published at www.argusmedia.com. Argus may choose to report either the bid and offer, or low and high, or mean value of market trades. This depends on industry practice and the route preferred for generating market transparency.

Argus gathers information from a wide range of sources representing all segments of the market. Argus receives its information from multiple sources, including transactional data supplied from the back offices [see glossary] of energy companies, as well as market surveys conducted over the telephone, instant message and email exchanges.

The market surveys seek to be balanced in their approach by obtaining information from buyers and sellers. They are conducted by well-trained specialists who are part of a dedicated team responsible for pricing. Many counterparties and brokers send Argus lists of transactions, complete with counterparty information, volume and timing.

Argus reduces the possibility of market abuse by applying intelligent interpretation to the information it receives. And Argus reserves the right to exclude information it cannot verify or that does not appear to be in accordance with trade in the rest of the market. Argus is well placed to do this because the significant volume of trading information that it gathers helps it identify and exclude errors or rogue data.

Without price reporting agencies such as Argus, companies would only be aware of the transactions in which they were involved. Argus adds transparency to markets by aggregating transactions and arriving at a single price for the day. In the interests of transparency, these transactions are published — with counterparty names removed — each day. This enables subscribers to raise any concerns they may have in a timely manner.

The information flow from companies to Argus is voluntary and robust. As discussed above, this information is gathered from multiple sources. The information is then checked, verified and analysed using long-standing expertise and according to a transparent methodology. The volume and spread of information received allows us to publish reliable and accurate price information that is available to market participants and allows the oil market to function effectively.

Argus works in a competitive market

Argus operates in a competitive market environment. Competitors to Argus include Platts, Icis-LOR, Icis-Heren, Reuters, Bloomberg, Dow Jones, Point Carbon, and other smaller providers of price transparency and indexation.

The business model of market reporting agencies is to achieve subscription revenue by providing fair, accurate and reliable price information, news and analysis for the markets that they cover. The competitive market between the different reporting agencies helps ensure that standards are maintained and prices are reasonable. The competition between market reporting agencies drives innovation in reporting, as they seek to establish themselves in newly opened markets, or seek to gain a share of established markets. There is no inherent conflict of interest in reporting markets and selling to clients, because subscribers are a wide range of buyers and sellers across markets.

Spot market prices

If the flow of information is free and unfettered, markets will respond to price signals and move energy from regions of surplus to those of deficit, or — where appropriate — store energy resources in times of plenty in expectation of shortage ahead. These decisions will be taken because price provides the necessary economic indicator.

The efficient operation of free markets is the best way to protect the interests of European consumers. For example, when diesel prices are high in Europe, markets can find cheaper sources in regions such as the US and import it until such a time as prices start to ease. Equally, markets can allocate resources around Europe, so cold weather in Germany may draw heating oil away from the Rotterdam area.

The prices that provide those economic signals in spot markets are assembled by the price reporting agencies. That is why it is vital that the free flow of information to price reporting agencies is not jeopardised in any way.

The prices reported by Argus reflect values obtained from the spot, or "cash", market. The spot market is where excess physical supply and demand are balanced. Buyers that have excess supply sell on the open market to buyers that have a shortfall of physical energy. The prompt [see glossary] nature of delivery in spot market trading enables it to best reflect the near-term value of energy.

Most energy trade is transacted on a long-term contractual basis, with the prices in contracts set at agreed differentials to a price benchmark such as Argus that are based on the spot market. The spot market represents the "tip of the iceberg", perhaps just 5% of energy trade. Hence the spot market plays a critical role in setting prices for a larger volume of trade. This leverage acts as a strong encouragement for market participants to report to price reporting agencies.

In addition to these spot markets, there also exist derivatives markets that are used to hedge risk and facilitate physical trading. Derivative contracts frequently use spot market indexes to settle against or "cash out". This makes effective price discovery in the spot markets crucial for the effective functioning of the wider market. The spot market is considerably smaller than the derivatives markets, with less liquidity and less transparency.

The clearing price of the various crude and petroleum products, as identified by market reporting agencies from the various spot markets, is of vital importance. These published prices underpin:

- The pricing of term trade
- The ability of companies to analyse market movements
- Internal transfer pricing within companies
- Taxation reference points for governments
- Performance measures for internal and external use by companies
- Risk management tools for energy companies and financial institutions
- The capital investment decisions taken by the energy industries

Market context

Financial markets, especially OTC derivatives in credit default swaps and securitisation, have been subject to much scrutiny and criticism in recent months, because of their linkages to the failure of the worldwide banking system. Energy markets are not subject to the same systemic risk as these financial markets. Energy market participants — including the majors such as Shell or ExxonMobil, state-owned oil companies, and large independent trading companies — are generally highly solvent organisations, frequently with better credit ratings than banks.

Additionally, energy derivatives are ultimately backed by a link to the underlying physical asset or commodity. For example, a jet fuel swap contract will be most typically transacted between a buyer with exposure to the price of the product, such as an airline, and a seller with an exposure to the production or trade of the product, such as an oil refiner. Risk in energy derivatives is therefore not open ended and not subject to systemic failure.

This contrasts with financial derivatives before the credit crisis, where the underlying asset was highly opaque, frequently even to the participants in that market. The credit crisis followed rapid changes in the way debt was handled as new products were invented to trade loans — collateralised debt obligations on asset backed-securities (CDO on ABS), structured investment vehicles (SIVs), and credit default swaps (CDS). Some of these financial products were not even backed by underlying assets at all. Energy markets have made no leaps as large and risky as the move into an alphabet soup of CDOs, ABS, SIVs and CDS.

The size of energy market derivatives in the context of the global financial system is smaller than perceived. The recent International Organization of Securities Commissions (IOSCO) report on unregulated financial markets and products assessed the open interest at end June 2008 on OTC derivatives markets worldwide at a total of $684 trillion. Non-gold commodities amounted to $13 trillion, or slightly over 4%. Within that, oil and energy commodities are estimated at $7 trillion, or around 1% of total OTC derivative open interest.[1]

The trading value of any commodity derivative is ultimately bound by fair value of the underlying commodity, a value that is driven by supply and demand fundamentals. In energy markets, the link to the underlying physical commodity provides a fundamental protection against systemic risk.

Physical energy markets trade on a basis of trust between market participants. In some cases, trade takes place through brokers, and in many cases there is direct trade between counterparties. In either case, the nature of the trades and contracts is highly customised, and thereby regulated through the law courts. To the extent that contractual legal frameworks are standardised, this is generally driven through consensus across the industry on certain standardised terms and conditions that are again ultimately governed through the courts.

Information flows between market participants and price reporting agencies on a basis of trust. Not all market participants report their transactions, but as described earlier, reporting agencies can derive information from elsewhere — from counterparties, back offices and brokers. The free flow of voluntarily-provided information to price reporting agencies allows them to make markets transparent, thereby enabling their price discovery role without the need for mandatory disclosure.

There is a risk of unintended consequences from market regulation, especially where the nature of information exchange is as important as in the energy spot markets. The current Market Abuse Directive supports crucial energy market information flows. It sets a standard for market manipulation, and requires a free flow of market information while not creating a compulsory standard. This allows market participants to find the most effective mechanism to conduct trade. This is important in the physical energy and energy commodity derivatives markets because of the highly tailored nature of the contracts, and because it facilitates growth and innovation in these markets.

[1] Unregulated Financial Markets and Products (IOSCO, 5th May 2009)

The Call for Evidence — Areas of response from Argus

2.1. THE SCOPE OF THE MAD
2.1.1. Only regulated markets? 14 (Articles 1(3) and 9 of Directive 2003/6/EC)

Question: Do you consider that the scope of the MAD should go beyond regulated markets? In particular, should it be extended to cover MTFs?

The Commission should bear in mind that:

- **The extension beyond regulated markets carries with it the threat of reducing competition and innovation in the market price reporting sector, by potentially favouring one price reporting or electronic trading platform over another.**

- **Concern over systemic risk in non-regulated commodity derivatives markets can be over-estimated, as commodity derivatives are ultimately linked to the underlying commodity or asset.**

- **Any disclosure requirements set for non-regulated markets should not create a burden that either reduces the value of the markets to their smaller participants, or drives the trade on to a less transparent bilateral basis.**

Non-regulated markets in the energy sector can perform quite different functions from the regulated markets, and should therefore not be seen as an alternative route to the same goal. Specifically, they allow market participants to manage different types of basis risk that cannot be fully offset using the regulated markets. An example of this already partly outlined earlier is an airline managing its jet fuel procurement costs. By using forward markets, an airline can "lock in" a cost of fuel for future purposes. If the airline did this using the regulated futures markets [see glossary], it would be restricted to managing the risk using a related product such as heating oil or crude, as there is no futures market for jet fuel. The airline would therefore be exposed to the differences in price between the futures contract [see glossary] and the jet fuel price. By instead purchasing a jet fuel swap in the OTC market, the airline can access a risk management instrument directly related to the underlying commodity whose purchase it is hedging.

OTC contracts can be highly tailored to specific types of risk. They therefore attract a different range of market participants, widening competition in the energy markets, and greatly expand access to risk management possibilities for businesses. For example:

- Agri-businesses that wish to manage their revenue from biofuel production
- Smaller crude producers with unusual crude qualities that vary in value compared with regulated crude grades underlying futures contracts
- Shipping companies managing the cost of bunker fuel procurement using fuel oil swaps

These non-regulated markets are fundamentally linked to the underlying commodity or asset, which in itself creates a limit to the ultimate risk borne by using these instruments, as discussed earlier. Risk is further limited by offsetting OTC exposure in regulated markets. It is important to note that market makers in non-regulated markets invariably use the regulated markets to offset their own risk. For example, an oil company writing a jet fuel swap for an airline will manage the associated risk through offsetting it on a regulated futures exchange, as well as by its own production of jet fuel.

Argus believes that a level playing field and competition already exists between regulated and non-regulated markets, as described in the examples above. Additionally, price reporting agencies compete to provide transparency in the non-regulated energy markets, both physical and paper. This competitive environment and the shared interest of market participants in reporting transactions to enable price discovery by market reporting agencies ensures that an appropriate level of transparency exists.

Argus is concerned that an increased burden of participation in terms of cost and mandatory disclosure would reduce the number of companies involved in energy markets, and thereby reduce competition in European energy markets. Smaller entities such as agri-businesses, small airlines and transport companies — which are attracted to the non-regulated markets — would no longer wish to participate if the burden becomes too costly.

Market participants may try to avoid regulatory oversight by switching from competitive markets to direct bilateral counterparty trade, making markets more opaque and potentially damaging the interests of consumers.

We have witnessed in the past a “chilling effect” on market information flows when increased regulation threatens to add to the financial burdens of trading in markets. This leads to less transparency in the market than existed before new regulatory proposals, showing how regulation can sometimes be counterproductive and have unintended consequences.

2.1.2. What kind of financial instruments should be covered by the MAD, especially in comparison with the MiFID? (Article 1(3) of Directive 2003/6/EC)

Questions: Do you agree with an alignment of the MAD definition of financial instrument to the definition for the same concept provided for in MiFID? Do you think it could be useful to explain in more detail in the MAD what is meant by a financial instrument "whose value depends on another financial instrument" or to list asset classes, such as CFDs and CDS, which belong to this category?

- **Argus believes that an alignment of the definitions of financial instrument between MAD and MiFID is appropriate, and is not a contentious issue from a commodity trade perspective**

In the area of commodities and commodity derivatives, there are no contentious areas in either the individual definitions or in their combination.

The commission should bear in mind that attempting to list all classes of derivative instrument can become limiting, by setting a boundary either to innovation in risk management instruments or to regulatory reach. Setting a broad definition in the style currently used in MiFID is likely to be more helpful to both market participant and regulator alike.

2.1.3. The specific case of commodity derivatives markets (Article 1(1) of Directive 2003/6/EC)

Question: Do you see a need for introduction of a market abuse framework for physical markets?

The Commission should bear in mind that:

- **Physical contracts are bilateral contracts that are typically heavily customised, and are regulated through the courts, whereas regulated markets have standardised contracts and terms and conditions, and are therefore easier to regulate.**

- **In the physical markets, there is a regular transfer of information between trading companies, and between traders and market reporting agencies.**

- **Regulation of the physical markets carries a danger of reducing this flow of information, as traders could fear the consequences of unwittingly being subject to an accusation of market abuse.**

- **This would lead to a reduction in information flow, and potentially a reduction in market liquidity, thereby endangering the strength of price benchmarks derived from market information, which are used for taxation, long-term contracts, risk management and capital project evaluation.**

2.2.2.2 Disclosure duty in commodity derivatives markets

In the context of the issuers' duty to disclose inside information, as set out in Article 6(1), questions have been raised whether this general requirement is suitable for commodity derivatives markets. In those markets, issuers of commodity derivatives are typically the operators of the markets (e.g. exchanges). Those 'technical' issuers in normal circumstances are not in possession of inside information that is sought to be disclosed. Due to their role in spot markets (or activity profile), certain stakeholders (or even market participants) could be better placed to disclose such inside information. Consideration should be given to reviewing the obligation to disseminate inside information for commodity derivatives issuers (e.g. electricity and gas derivatives).

Question: Do you agree with this approach? Can you identify cases where a modification or deletion of the obligation may be undesirable for market integrity?

The Commission should bear in mind that:

- **Types of information flow appropriate for disclosure vary by commodity market, and inappropriate disclosure obligations therefore may be undesirable for market integrity.**

- **Individual market regulators are best placed to determine the specific disclosure requirements for their markets, as these cannot be met by a broad-brush approach.**

- **Any newly required information should be disclosed on an even and transparent basis to all market participants.**

The duty to disclose information in order to protect market integrity varies by market. The example of sharing manufacturing plant outage information illustrates the dilemma. In the power generation business, prompt and timely disclosure of scheduled or unscheduled plant outage is vital for the efficient functioning of the markets, as power cannot be stored, and withholding such information could easily constitute market abuse. By contrast, the oil refining business has an inherent flexibility as oil can be stored and released from storage in times of a sudden change of supply. A refinery shutdown may therefore have no impact on a company's ability to supply customers. It is therefore likely that a burdensome disclosure obligation on refinery shutdowns (for maintenance turnarounds or emergency repairs) could increase market volatility by sending inappropriate signals to the market suggesting a supply shortfall where none in reality exists.

Argus therefore believes that any changes to the disclosure requirements, and therefore to accepted market practices, are best steered by the individual market regulators. In any case, Argus believes that the critical disclosure requirement exists on the pre-trade side, where hiding fundamental supply-demand information can create a distortion similar to non-disclosure of market-moving information in securities markets.

Glossary

Assessment • The value or price of a commodity in the *spot market*, such as Argus provides for various types of crude, refined product, LPGs, power, gas, coal and emissions traded in major market centres. Such assessments typically serve as an *index* that contracts may refer to for pricing purposes.

Back office • The portion of a company that handles verification of trades and accounting functions related to trades.

Benchmark • A highly liquid and commoditised product that serves as the starting point for discussions of spot values for related products. A *differential price* is added to the benchmark to account for factors such as differing qualities or locations.

Differential price • The value of crude or product, expressed as a premium or a discount to the price of the *benchmark*. The differential is meant to take account of quality, timing or location factors that are different when compared to the benchmark. Assessing the value of these differentials each day is one of the most important ways that *Argus* contributes to overall market transparency, allowing for price signals that encourage the flow of oil between regions of surplus to regions of deficit.

Futures contract • A financial instrument that allows for the trade of a commodity now, but for a time of delivery months or years forward.

Futures market • An exchange on which *futures contracts* are traded.

Index • In a contract, the price that two parties agree to use as the basis for valuing the product being traded.

Price discovery • Independently ascertaining the price of a commodity through obtaining a wide spread of information from as many participants as possible in a market that is otherwise opaque, and then publishing this price so that it may be used by the whole of the market.

Price reporting agency • A company that specialises in independent valuation of a commodity, as priced in the over-the-counter spot market where visibility and transparency are often more problematic. Some of the major price reporting agencies are *Argus*, *Platts, Icis-LOR* and *Icis-Heren.*

Prompt • In physical petroleum markets, this is the timeframe that refers to loading or delivery during a few days within the near-term future. In futures markets and swaps, *prompt* refers to the first-month contract being traded.

Spot market • The market where companies sell excess supply, or buy to cover a shortfall of product. This market allows industry to quickly reallocate volumes that are not committed to *term contracts* or to internal use further *downstream*. The spot market also allows quick and efficient reallocation of product in the midst of unforeseen circumstances with an immediate impact on company operations. In economic terms, the spot market allows for trade of the marginal unit of *prompt* product, which in turn sets pricing across the wider sphere.

Swaps market • A bilateral market in which companies exchange a fixed price for a floating price in order to transfer risk. The transaction is usually in the form of a comparison between a fixed price and an index average price, such as a monthly average. Seller and buyer agree the fixed price and the index average price for an agreed volume. The seller and buyer then exchange monies depending on the final calculated difference between the two prices.

Term contract • A long-running arrangement for the sale or purchase of crude oil or products. Such arrangements typically run from a few months to several years. Usually sold by the supply and trading department and representing a large, set volume of oil per day or per month. Most of these contracts are linked to independent spot market assessments such as those provided by *Argus*. Also known as a term deal or evergreen contract.