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Energy market regulation intensifies

Participants in energy markets could be forgiven a siege mentality at present, especially in Europe. New regulations seem to be coming from all directions - on sanctions, registration and licensing, position limits, derivatives clearing and reporting, price reporting, market conduct...the list goes on. And many of the new requirements are being imposed globally - but with inconsistencies, even conflicts, between the rules in different parts of the world.

This article focuses on market conduct and price reporting, particularly the EU's proposed Market Abuse Regulation (MAR) and, briefly, the Principles for Oil Price Reporting Agencies recently published by the International Organisation of Securities Commissions (IOSCO).

Context of new EU market abuse legislation

MAR will update the 2003 Market Abuse Directive (MAD), and is part of a package (often referred to as MAD II) including a new directive imposing criminal sanctions for market abuse. MAR will greatly extend the scope of the EU market abuse regime to cover a wider range of commodity instruments and markets, broaden the definition of "inside information", especially in relation to commodities, and create several new offences.

MAD II should be seen in the context of the wave of post-financial crisis regulation that is nearing its peak. Two other EU measures in particular are likely to have a major impact on energy and other commodities markets:

- The European Market Infrastructure Regulation (EMIR), which imposes requirements to report derivatives, clear OTC derivatives and collateralise any uncleared OTC derivatives, and sets regulatory standards and processes for central counterparties and trade repositories.

- MiFID II, the package of a new directive and regulation to update the 2004 Markets in Financial Instruments Directive (MiFID),

which will require more energy firms to be licensed, many derivatives to be traded on organised venues and introduce new transparency and position requirements for commodities.

Whereas EMIR was formally adopted last July and is already well into the implementation process (it is likely to be implemented in phases from January 2013), the MAD II and MiFID II packages are at advanced stages of the legislative process in the European Council and Parliament. Implementation is expected from 2014.

Other energy and emissions measures

For energy markets, however, MAD II must be seen also in the context of the EU's energy market liberalisation measures and the European Commission's policy to seek stronger supervision and to increase transparency and integrity in commodity markets and related derivatives markets. In gas and power, the October 2011 Regulation on wholesale market and integrity (REMIT) is already in force, and mechanisms are being developed for registration, reporting, monitoring and enforcement. REMIT penalises manipulative practices and abuse of inside information in the markets in physical power and gas (and in related transportation and derivative products, though the offences generally do not apply to financial instruments covered by MAD nor to the emissions market), and imposes transaction reporting obligations.

In the emissions market, abuse is being addressed in several ways, including regulation of auctions of allowances under the EU Emissions Trading Scheme (ETS) and extensions to the scope of MiFID and MAD. In November 2010, the Commission adopted a directly effective Auction Regulation, establishing a framework for auctions of emission allowances for the third trading period under the Emissions Trading Scheme Directive. This Auction Regulation in effect extends the application of certain MiFID, MAD and Anti-Money Laundering Directive requirements to emissions allowances that are not financial instruments under MiFID – spot contracts, for example. MiFID II will classify ETS allowances as financial instruments so that financial regulators will be responsible for supervising secondary spot trading alongside their oversight of derivatives and their new responsibility in respect of auctions. MAD II takes this into account by making specific provision for emission allowances.

How MAD II will extend the EU market abuse regime

MAD II will replace the original MAD with a regulation (MAR) and a directive requiring mandatory criminal sanctions for market abuse (CSMAD). As a regulation, MAR will be directly applicable, so most of the provisions do not require implementing legislation in member states (though some may amend their laws to ensure consistency or to take MAR into account). For this reason, and because it is more detailed and prescriptive, MAR will eliminate some of the variations seen in the national laws which implemented MAD.

An important aim of MAD II is to increase the effectiveness of enforcement, enhancing regulators' information gathering and investigation powers, harmonising sanctions and administrative measures, and facilitating cooperation among regulators across the EU, including expressly the Agency for the Cooperation of Energy Regulators (ACER) which has specific authority in relation to REMIT. While MAR lists the types of supervision, investigation and administrative sanctioning powers that regulators must be given, CSMAD provides a set of minimum criminal penalties and imposes a degree of vicarious liability for offences committed by "leading" individuals. Market abuse may therefore be prosecuted as both a criminal and regulatory offence - concerns about double jeopardy are currently the subject of heated debate.

The effectiveness of the regime is intended to be bolstered by various measures in MiFID II, such as an extended transaction reporting regime, new exchange requirements on position reporting, and a new position management and intervention regime including, most controversially, position limits.

Perhaps of greatest interest to energy market participants is the way in which the scope of MAD is being extended in the new legislation:

- The Commission proposed aligning the definition of inside information for commodity derivatives with the current general definition, which applies a price effect criterion instead of the criterion (used for commodity derivatives) of whether market users would expect to receive the information in accordance with officially-accepted market practices. The special definition for commodity derivatives was

achieved after a long and fierce battle by market participants: the impact of the change will be felt most by those who are involved substantially in underlying physical markets, especially in the way they handle information concerning their physical assets.

  - In the current Council draft of MAR, non-public information can constitute inside information if *either* it would be likely to have a significant price effect if made public, or if that information is required or reasonably expected to be disclosed. In applying this provision, account will be taken of the extent to which a "reasonable investor" would be likely to use the information.

  - The information can relate directly or indirectly to the commodity derivatives or, in another extension of the regime, directly to the related spot contract or market.

- MAR will also broaden the range of trading venues which trigger application of the market abuse regime. The regime will therefore capture financial instruments (a term that includes commodity, transportation, weather and other derivatives regulated under MiFID) that are traded on multilateral trading facilities (MTFs) or on "organised trading facilities" (OTFs) - the new category of venue being recognised under MiFID II that will include derivatives trading systems and broker crossing systems.

- In addition, the regime will apply to a broader range of OTC instruments because the insider dealing and market manipulation prohibitions cover financial instruments not admitted to trading on any formal venue category but whose price or value depends on or affects a financial instrument which does trade on such venues. The market manipulation offences apply also to spot commodity contracts and (a recent addition to the text) benchmarks.

- The range of offences has also been widened. Key additions are to penalise (i) attempts to manipulate a market, even if the attempt was ineffective (attempts at insider dealing are already prohibited under MAD), and (ii), in light of the LIBOR scandal in the summer, providing false or misleading information or any action which manipulates the calculation of a benchmark. CSMAD requires member states to criminalise inciting, aiding and abetting, and attempting insider dealing and market manipulation. These are not offences under the original MAD but are covered to various degrees by existing laws in the UK and elsewhere.

Regulating benchmarks

The Commission reacted swiftly to the LIBOR scandal by proposing amendments to both MAR and CSMAD in July. Its consultation on regulating index production and use, published in September, parallels similar consultations in the UK and IOSCO. All resulting proposals seem likely to cover commodity as well as financial benchmarks. The UK review (by Martin Wheatley who is a managing director of the FSA and chief executive officer designate of one of its successor bodies, the Financial Conduct Authority) published its final report in September and on 17 October the British Government announced its acceptance of the recommendations and that it would accordingly amend the Financial Services Bill which is currently before Parliament.

The IOSCO Board Level Task Force on Financial Benchmarks is unlikely to complete its work until the first quarter of 2013. Meanwhile, however, on 5 October IOSCO published Principles for Oil Price Reporting Agencies (PRAs) – a work product of its Task Force on Commodity Futures Markets collaborating with the International Energy Forum (IEF), the International Energy Agency (IEA) and the Organisation of Petroleum Exporting Countries (OPEC). This work is a response to a G20 request that IOSCO review the functioning & oversight of PRAs. The review revealed vulnerabilities that, if not addressed by controls and policies, could result in assessed price being an unreliable indicator of market value, such as selective reporting and opacity and variations in methodologies.

The approach of the Principles is to incentivise the development and application by PRAs of processes that enhance reliability. Although the Principles are voluntary, IOSCO recommends regulators to ban trading in derivatives that reference PRA-assessed prices unless the Principles are followed. The Principles address a range of issues including:

- Transparency of methodology, change process and external audit.

- Priority for concluded transactions.
- Robust policies for such matters as quality control (including the integrity of submissions), conflicts of interest, and document retention.
- Formal complaints process.
- Cooperation with regulators.

Although both the oil industry and PRAs themselves will have ongoing concerns, the Principles involve less intrusion than had been feared. However, market participants can expect increasing financial regulatory interest in data submitted to PRAs.

Conclusion

For energy market participants, regulation and supervision is getting hotter. They are subject to attention not just of sector and competition regulators, but increasingly financial regulators, too. Many of the reforms flow from agreements by G20 leaders; in principle, they are global even if, in practice, the detailed manifestation varies significantly from one state to another. While market abuse regulation has tended to be more national, although subject to harmonisation across the EU, G20-led reforms in derivatives trading, reporting and clearing and other IOSCO-led reforms will impact the structure and operation of energy and other commodity markets.

With greater visibility into the physical oil, gas and power markets, and greater powers to regulate and enforce market conduct standards in the physical and financial markets in energy, financial regulators are changing the landscape for energy traders.

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Sanctions: If in doubt? Don't do it

Unlimited fines, lengthy prison sentences, exclusion from the US banking system, loss of customer and supplier confidence, enormous reputational damage. This sounds like a nightmare scenario, but these are amongst the consequences which can be faced by companies or individuals which fall foul of US or EU sanctions against Iran.

Restrictions imposed progressively over the past 18 to 24 months by the EU and the US have resulted in a web of overlapping restrictions on trade with Iran, sometimes complementary, sometimes contradictory, and many companies have decided that it is simply easier to cut all ties to Iran. Shipping firms Teekay, Frontline and OSG have all announced in recent months that they will no longer send vessels to ports in Iran.

However, the present restrictions fall short of a total embargo, and there will, of course, be companies, predominantly based outside the EU and US, which still want to trade with Iran or deal with Iranian crude oil, petroleum products or petrochemical products, or which have counterparties who want to do so.

It is worth stressing that there is clear political pressure being applied in both the US and the EU to dissuade companies from trading with Iran, and to persuade countries to reduce the quantities of Iranian crude oil, petroleum products or petrochemical products which they buy. It is likely that the restrictions on trade with Iran will only get more onerous, unless there is a significant political change. Companies should tread cautiously and obtain specialist legal advice before proceeding.

In the regulators' spotlight

Because the current sanctions may result in companies facing heavy penalties for the activities of others, such as their counterparties, on-sellers, and so on, any company with ongoing business in the Middle East needs to keep fully abreast of the latest developments to ensure they don't find themselves under the spotlight of the regulators in the EU and US.

As recently as a couple of years ago, international trade sanctions were used only sparingly, and were restricted to intransigent regimes such as those in Zimbabwe and Myanmar (Burma). But the past two years have seen a real sea-change with sanctions now flavour of the month, credited with achieving major diplomatic successes in Ivory Coast and Libya.

One of the principal attractions of sanctions to politicians is that they put the burden on international commerce. Businesses operating in difficult markets and jurisdictions must interpret a number of sometimes uncertain, often overlapping restrictions, while taking responsibility not only for their own actions but also for those of their counterparties.

The political temperature has changed markedly over the past few months,

with new measures from the EU anticipated very shortly, new draft bills in the US, and some recent, highly publicised, enforcement activity by US regulators.

Three companies - Fal Oil Company of the United Arab Emirates, Zuo Oil of Singapore and Zhuhai Zhenrong of China - were all sanctioned by the US State Department in January this year in connection with separate sales of gasoline and refined petroleum to Iran in 2010 and 2011. The companies were not added to the list of designated persons, but they were barred from receiving US export licences, as well as being barred from obtaining US Export-Import Bank financing and loans of more than $10 million from US financial institutions.

It should be noted that, rather than a consistent multilateral approach to Iran, there is, in fact, a patchwork of restrictions, with different measures imposed by the EU, US and other countries, such as Australia and Singapore. In this instance, we will only look at EU and US measures (domestic and extra-territorial) to give a flavour of the key restrictions.

The EU makes it complicated

US companies and individuals are effectively prohibited from trading with Iran, and that is likely to be the end of the matter for those companies and individuals. The position is rather more complex for EU companies.

At the heart of the EU sanctions are financial restrictions, primarily an asset freeze. The effect of this is that the funds and economic resources of prohibited persons are frozen and it is also forbidden to make funds or economic resources - in essence any valuable asset - available directly or indirectly to or for the benefit of those prohibited persons. As of 13 March 2012, there were 116 individuals and 442 entities which were subject to the asset freeze. The list includes Iranian government ministers, members of the Iranian Revolutionary Guard Corps and scientists, as well as Iranian businesses which are said to be involved in, or supporting, Iran's nuclear and/or ballistic missile programmes.

Because of the wide scope of the asset freeze, it is important that detailed checks are carried out on all counterparties, to ensure that a company is not indirectly making funds or economic resources available to a prohibited person, through a seemingly innocuous front company.

Even if your counterparty is not a prohibited person, you need to ensure that any payment to or from an Iranian person, entity or body (which includes any person in Iran) is notified or authorised in advance, as required by the EU regulation.

As well as these counterparty-related sanctions, there are also cargo-related sanctions. These also target Iran's oil and gas sector. There is a long-standing prohibition on the supply to Iran of key equipment for the Iranian oil and gas industry. This has recently been supplemented by much more wide-ranging prohibitions.

In particular, the import, purchase or transport of Iranian crude oil, petroleum products or petrochemical products is prohibited (subject to a short winding-down period). This new regulation will have a direct effect on EU-based shippers and traders, but also an indirect effect on shippers and traders based elsewhere. This is because the regulation prohibits EU-based insurers and reinsurers from providing insurance which relates to the import, purchase or transport of Iranian crude oil, petroleum products or petrochemical products. Traders and shippers who are based outside the EU often rely upon EU-based insurers and reinsurers not only for their own insurance, but also to pay compensation to third-parties in the event of a spill, so this restriction on EU-based insurers and reinsurers will be very significant.

There are also financial restrictions which essentially prohibit investing in Iran's oil and gas industry and entering into joint ventures with Iranian companies in that industry.

The restrictions in the US Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA) are even more difficult to manage. The prohibition on the supply of refined petroleum products is straightforward enough, but CISADA also contains restrictions which require companies to look not only at the nature of their goods, but also at how they will be used. For example, it is prohibited to supply to Iran goods, services, and so on, which may assist Iran's domestic production of refined petroleum products or enhance Iran's ability to develop petroleum resources.

Don't bank on it

And what about your bank and insurers? Even if you are not a company based in the US or the EU, it is likely that your bank and/or insurer will be. If they are a US bank, they may not process payments involving Iran. That will prevent the participation of even "third-party"

US banks which are involved only for the purpose of clearing US dollar payments on transactions which have no other connection with the US. UK banks may not engage in any transactions or business relationships with Iranian banks. Draft legislation which has been proposed in the US would prohibit SWIFT from doing any business with Iranian banks.

The issues affecting EU insurers and reinsurers have already been identified above in the context of the EU ban on Iranian crude oil, petroleum products or petrochemical products. But even where other cargoes are carried, EU-based insurers will still be reluctant to provide cover for Iranian business, and will not be able to pay claims by Iranian companies or provide security to them.

So what should you do, if you are certain that you want to continue to trade with Iran? You need to carry out comprehensive due diligence. On everyone. This goes beyond your customer. This means knowing who owns or controls them, who benefits from the goods you supply or payments you make. You need to check that the specific cargo is not prohibited. You need to talk to your counterparty so you can be sure they are carrying out all of the same checks down the line, and managing their counterparty. And you need to work closely with your insurer and your bank.

In short, take care!

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This article was first published in Petroleum Economist, May 2012 and is reproduced with their kind permission. A further article, updating the position in light of recent US and EU sanctions which impose significant additional restrictions on the oil and gas sector, is due to be published shortly.

Conferences & Events

Investing in Asian Mining Conference Indaba
Marina Bay Sands, Singapore
(29-31 October 2012)
James Donoghue, Brian Gordon, Nick Hutton, James Lewis, Chris Swart, Brendan Fyfe and Mark Tan

C5's OTC Derivatives Conference
Rembrandt Hotel, London
(6-7 November 2012)
Robert Finney and Costas Frangeskides

HFW Conference on Current Trends and Issues in Global Commodities
Mandarin Oriental, Singapore
(19-20 November 2012)

Argus European LPG Markets 2012 Conference
London
(20-21 November 2012)
Robert Finney

HFW Seminar: Trade Finance and Basel II/III
Geneva
(29 November 2012)
Matthew Parish, Janet Butterworth, Jeremy Davies, Paul Wordley, Robert Finney, Géraldine Piechaud, Ian Chung and Vitaliy Kozachenko

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