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***Argus Media Limited responds to the call for evidence on derivative markets (COM (2009) 332 and COM (2009) 563)***

**1. Background to the Argus submission**

- 1.1. Argus Media Limited (“Argus”) is the only independently owned global energy market price reporting and market intelligence service. Argus is a UK limited company owned entirely by its employees and the family of the founder. It has twice won the Queen’s Award for Enterprise, most recently in 2009.
- 1.2. Argus produces daily price benchmarks for the spot physical energy markets. On a daily basis Argus polls market participants in a wide range of physical energy markets, producing expert assessments of the prevailing spot market price based on the output of these surveys. These benchmarks are widely used within the industry where an independent spot market price assessment is required. For example, HM Revenue and Customs uses Argus North Sea crude oil benchmarks as a price reference for taxation. Argus price benchmarks are extensively used by the energy industry in their contracts for physical energy supplies. Argus price assessments are also widely used for the settlement of energy derivative contracts.
- 1.3. The generation of reliable energy price benchmarks is a full-time enterprise that is already provided by price reporting agencies (PRAs). Argus believes that the European Commission would be well served by satisfying itself that the PRAs such as Argus are well placed to provide this function. Argus would be willing to enter a deeper dialogue with the Commission to help explain our price assessment processes, including the rigorous safeguards in place to ensure the integrity of the assessments.
- 1.4. Argus supports the aims of the Commission in increasing the robustness of the derivatives market, but notes energy derivatives are inherently more robust than financial derivatives. Energy derivatives are used for vital commercial risk management functions by businesses with an energy price exposure. They are underpinned by the physical asset or commodity, and therefore do not represent anything like the same degree of systemic risk as purely financially based derivatives. In addition, energy derivatives markets are much smaller than the markets in financial derivatives, both in aggregate and as individual products.
- 1.5. As Argus is a service provider specifically for the energy markets, this response addresses only energy derivatives. It does not concern other financial derivatives

such as credit default swaps, foreign exchange or interest rate swaps. Argus is both an independent observer of energy markets as well as a service provider to them and our response reflects these two roles.

- 1.6. Strictly speaking, the term “derivatives” covers both regulated exchange-traded futures and options markets, as well as unregulated markets that are either traded bilaterally (“over the counter” or OTC) or cleared via a central counterparty (CCP). The European Commission proposals are purely concerned with the latter category, as is this response.

## **2. Derivatives**

### **What economic benefits do derivatives bring?**

- 2.1. OTC energy derivatives are important, because they can be tailored to specific requirements and so allow businesses to manage their exposure to energy prices much more effectively than by purely using regulated futures markets. OTC energy derivatives also facilitate increased liquidity in exchange-traded energy derivatives, which further improves the efficient transfer of risk.

### **What risks are associated with derivatives and derivatives markets?**

- 2.2. OTC derivative contracts exhibit two important risks that need to be mitigated. Firstly, there is the risk of counterparty default. This is managed by two means in derivative markets. Either the two counterparties in a transaction are mutually satisfied by their respective counterparty risk and enter a bilateral transaction (the bilateral agreement may impose counterparty risk reduction obligations on one party such as the requirement to post a bank letter of credit). Or if they are not satisfied, they may choose to use a clearing service provided by a clearing house or CCP. Secondly, there is the risk of a misleading or false underlying asset valuation, leading to mistrust in the financial instrument itself and potentially to a financial settlement that exceeds the boundaries initially set by the counterparties.

### **What role did derivatives play in the recent financial crisis?**

- 2.3. Argus is not a commentator on financial markets, and therefore does not have a view on how financial derivatives affected the recent financial crisis. However, Argus strongly believes that energy derivatives did not play a role in the systemic breakdown of financial markets. In fact throughout the financial crisis the energy markets continued to perform a highly effective role in providing a price balancing mechanism for global supply and demand.
- 2.4. It is argued by some that excessive speculation caused the price spike that occurred in the energy markets in mid-2008. Argus does not support this view. It ignores the facts that the world was then at the peak of a period of unprecedented economic

growth and that during this growth phase there was a fundamental shortage of high quality energy products to drive the economic growth. A number of authoritative studies of trade data from futures markets have shown that during this price spike, so-called speculators such as fund managers were reducing their net energy futures positions.<sup>1</sup>

### 3. Clearing Directive

#### **What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?**

3.1. Argus is one of a number of PRAs that compete in the provision of robust, reliable, independent price benchmarks of the physical energy markets that are used for settlement of various energy derivatives. It is important to ensure that the financial settlement of OTC derivatives is set on firm foundations. The Commission may wish to consider requiring CCPs to use only independent benchmarks, to minimise the risk of any misleading valuation of the underlying asset.

#### **Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?**

3.2. This question assumes that “standard derivatives” has a universally applicable meaning. It is not, and could vary by market or legal jurisdiction. This in turn carries a danger of regulatory arbitrage, through inconsistent definition and application of what is standard and what is not.

3.3. Any proposal to mandate clearing of OTC energy derivatives should recognise that clearing houses already innovate and compete to provide clearing services for a wide range of specialised energy derivatives. Argus is not aware of any instances of an OTC energy derivative market counterparty seeking to obtain a clearing service and being unable to do so. Mandated clearing carries with it the risks, firstly of higher cost in the provision of clearing services – costs that would ultimately be borne by the consumer, and secondly of the CCP taking on board types of clearing risk it would otherwise be unable to effectively manage. Argus therefore believes that it is preferable to facilitate the existing dynamics of market innovation that are providing the required risk mitigation services.

3.4. We make no comment directly on MiFID and in particular how this should be modified if the Commission concludes that central clearing should be mandated.

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<sup>1</sup> The most comprehensive of these studies is by the US Commodities and Futures Trading Commission, who regulate futures exchanges in the USA, published in December 2008: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/marketreportenergyfutures.pdf>. Also, HM Treasury: *Oil Prices: the True Role of Speculation*, Noel Amnec, Benoit Maffei and Hilary Till, EDHEC Risk and Asset Management Research Centre (November 2008). <http://www.edhec-risk.com/features/RISKArticle.2008-11-26.0035>.

#### 4. Trade Repository Directive

##### **What benefits do the use of trade repositories bring both in terms of transparency and improved risk management?**

- 4.1. Trade repositories would benefit the Commission by bringing increased transparency on counterparty risk and positions in OTC derivatives markets. However, the Commission should underestimate neither the extremely high degree of complexity in the derivative markets and therefore the complexity of the trade repository, nor the challenge of interpreting the raw trade data.
- 4.2. Should the Commission require PRAs such as Argus to provide its own price benchmark updates into the trade repository for the purposes of position valuation or mark-to-market, Argus would be willing to do so, on the assumption that the repository is intended purely for regulatory purposes and not for public consumption. Argus respectfully requests that such settlement information on market prices and trade only be made public on a time-lagged and aggregated basis, if at all. This is in order to protect the viability of the commercial service already provided by PRAs including Argus.

#### 5. Further issues

##### **Are current EU regulatory plans regarding derivative markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?**

- 5.1. The Commission should take care to recognise where there are exemptions to regulation in the US that may not exist in Europe. For example, in the US, a significant volume of energy market price risk management takes place on markets known as “physical forwards”. These are essentially OTC derivative markets that are settled by physical delivery of the underlying commodity, rather than by financial settlement. These physical forwards contracts are explicitly exempted from the draft US legislation on OTC derivatives. However, a similar market exemption does not exist in Europe. This means that EU regulation may be stricter than in the US, potentially causing either higher risk-management costs in Europe and/or a migration of business to the US markets.

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This evidence is submitted by Argus Media Limited on a corporate basis.