Joint IEA-IEF-OPEC Report

on the 4th Workshop

"Interactions between Physical and Financial Energy Markets"

31 March 2014

Vienna, Austria

Executive Summary

The Fourth IEA-IEF-OPEC Workshop on the Interactions between Physical and Financial Energy Markets was held in Vienna, Austria, on 31 March 2014. The Workshop is one of three joint high-level expert meetings that the IEA, IEF and OPEC hold under the consumer-producer dialogue mandate to enhance the understanding of important energy market developments and evolving market dynamics.

In keeping with the format of the previous three Workshops, the event once again brought together speakers and participants from a wide variety of backgrounds to take part in roundtable discussions, including experts from industry, governments, and the financial and regulatory sectors of the developed and emerging economies.

The event, held under the Chatham House Rule, highlighted a range of views and issues, including the following:

- Participants noted that oil prices have been characterized by lower volatility in recent years and that this has impacted both market developments and participation.
- Commodity trading houses were seen to be facing a more challenging environment due to reduced volatility, increased regulation, and loss of competitive advantage in market intelligence. However, they were likely to see continued opportunities from shifting demand patterns toward Asia, the exit of banks from the commodity space, and the potential to benefit from expanding activities along the supply chain.
- Market players involved in commodity trading generally need liquid futures and swaps markets to manage risk. It was noted that these financial tools had taken time to develop, none was considered to be perfect, and they were likely to continue to evolve to meet the diverse needs of market participants.
- As crude oil flows evolve, crude oil markers likewise evolve. Going forward, a number of potential developments were seen as possible with regard to the evolution of benchmarks, highlighting the need to keep an open mind as this process unfolds.

- The role of policy in shaping market developments was also highlighted. US resource policy has allowed tight oil to develop, representing a new feature of the market. However, the longstanding US ban on crude oil exports, combined with infrastructure constraints, has affected price relationships and shifted some financial trade from WTI to Brent. At the same time, it has also been a driver behind the sharp rise in US product exports, as US refiners benefit from the increasing availability of competitively-priced domestic crude supplies.
- With reference to the ongoing regulatory effort, it was recognized that financial energy markets benefit from deep liquidity, with a good range of participants and a well-regulated structure around them. At the same time, it was further noted that regulation had been written in a time of increasing participation and liquidity in the financial oil market, but was being implemented at a time of reduced liquidity. This highlighted the need for a continued, measured approach in moving forward, along with adequate market consultation, particularly given the importance and complexity of the financial and physical energy markets.
- The on-going exit of financial firms, particularly banks, from the commodity space was also addressed. Drivers behind this trend include regulatory changes and reduced commercial opportunity linked to lower volatility and increased competition. While some participants expressed concern that new regulations might reduce liquidity, particularly farther out along the forward curve, there was also the view that other players, including trading houses, are filling the space previously occupied by financial firms.
- The Workshop reviewed the G-20 initiative on Oil Price Reporting Agencies (PRAs) carried out by the International Organization of Securities Commissions (IOSCO) in collaboration with the IEA, IEF and OPEC, and the resulting IOSCO PRA Principles published in October 2012. The Principles were seen to be proportionate and workable, and should help increase confidence in the underlying crude oil benchmarks used in commodity derivative contracts.

Participants noted that the joint Workshop has emerged as an important industry event, bringing together a diverse range of market participants to

discuss issues that are not addressed in other high-level fora. The organizers thanked the speakers, moderators, and participants for the active exchange of views and looked forward to hosting the next Workshop.

I. **Background**

The joint IEA-IEF-OPEC Workshops on the "Interactions between Physical and Financial Energy Markets" were first established at the 12th IEF Meeting in 2010 as a product of the Cancun Ministerial Declaration[1]. Their purpose is to bring together a diverse range of market experts and participants to facilitate an exchange of views on the interactions between physical and financial energy markets.

The need for such a broad-based conversation became apparent in light of the increasingly dual role that crude oil had assumed as both a physical commodity and a financial asset. The tumultuous events in 2008, in both the oil market and the financial market, provided further evidence of the need for a better understanding of the impact of these interactions. Moreover, the tremendous push being undertaken in the financial markets to update regulation, improve transparency, and enhance oversight, including in the paper oil market, also highlighted the need to hear directly from policymakers and national regulators about these efforts.

It was with these aims that IEA, the IEF and OPEC convened the first joint workshop in London in 2010[2]. Noting the increasing participation of the financial sector in energy markets, participants at the workshop recommended the continuation of efforts to better understand the functioning of the financial and energy markets, as well as their interactions.

The Second Joint Workshop was convened in Vienna in November 2011[3]. Discussions considered the extent of the impact of speculative activity in the oil market, with a range of views expressed regarding the factors driving oil price movements, including fundamentals and the financialization of commodities. Participants noted the ongoing effort on regulatory reform in the financial and derivatives markets and

[1] http://www.ief.org/_resources/files/events/12th-ief-ministerial-cancun-mexico/ministerial-declaration.pdf
[2] http://www.ief.org/_resources/files/events/iea-ief-opec-workshop/press-release.pdf
[3] http://www.ief.org/_resources/files/events/2nd-iea-ief-opec-workshop-on-physical-and-financial-markets/joint-iea-ief-opec-report.pdf

stressed again that international coordination of regulation was essential to avoid loopholes and unintended consequences.

The Third Joint Workshop[4] was held in in Vienna in March 2013. Discussions therein noted the role that both derivatives and physical transactions play a role in oil price discovery, and addressed the considerable changes that had taken place in commodity investment strategies in the last 10 years--as markets have become accessible, barriers to entry have dropped, and price information has become more widely available. While liquidity in futures markets was seen to be concentrated in the front months, the type of liquidity needed by industry participants spanned the five-year horizon. Efforts by policy makers to bring regulations in line with developments in market structures and technology and to ensure that markets remained fair, competitive and efficient were discussed, with the recognition that the risk of unintended consequences continued to be a concern.

II. **The 4th Workshop on "Interactions between Physical and Financial Energy Markets"**

The Fourth IEA-IEF-OPEC Workshop on the Interactions between Physical and Financial Energy Markets was held in Vienna on 31 March 2014. In keeping with the format established in the previous three Workshops, the event brought together a diverse range of market experts and participants to facilitate an exchange of views on the interactions between physical and financial energy markets. Once again, the Workshop also provided the opportunity to hear directly from policymakers and regulators about the tremendous push being undertaken in the financial markets to update regulation, improve transparency, and enhance oversight, including the paper oil market.

Discussions, which were held under the Chatham House Rule, considered the following issues: the recent developments in crude oil price formation; the shifting role of various market players such as financial firms and commodity trading houses; and an update on key regulatory reform efforts

[4] http://www.ief.org/_resources/files/events/third-iea-ief-opec-workshop-on-physical-and-financial-markets/report_third-joint-iea-ief-opec-workshop_final-clean.pdf

with a focus on the G-20 initiative on Oil Price Reporting Agencies (PRAs), as well as recent developments in EU regulation.

III. **Summary of discussions**

Participants noted that oil prices have been characterized by lower volatility in recent years and this has impacted both market developments and participation, as some financial players have exited the paper oil market.

In a session covering commodity trading houses, discussions highlighted the more challenging environment facing these market players due to reduced volatility, increased regulation, and loss of competitive advantage in market intelligence. However, shifting demand patterns toward Asia, the exit of financial firms from the commodity space, and the potential to benefit from expanding along the supply chain were seen providing continued opportunities.

Market players involved in commodity trading need liquid futures markets and swaps markets to manage risk. These risk management tools have taken time to develop, none of them are perfect, and they are likely to continue to evolve to meet the diverse needs of market participants.

With regards to crude oil benchmarks, it was noted that as crude oil flows evolve, crude oil markets are likewise evolving. A number of potential developments were seen as possible going forward, highlighting the need to continue to keep an open mind regarding the direction that benchmark developments might take. It was noted that crude oil benchmarks have a complex set of differentials that exist around them, which can be brought in when the need exists and there is sufficient convergence of market activity.

The divergent challenges facing the US and Brent crude oil benchmarks was also discussed. With growing production, the US does not have a volume problem and pipeline structure allows traded contracts that facilitate relatively high volumes of transactions, providing the conditions for more transaction-based indices. However, despite greater liquidity and structural advantages, existing export policy prevents the US from providing a global crude benchmark. At the same time, there appears to be

a desire by market participants to see North Sea Brent continue to be a widely-used price reference, despite reduced output. As Brent is a free floating grade, the potential to bring in competing West African and Russian crudes was also noted.

The role of policy in shaping market developments was also highlighted. US resources policy has allowed tight oil to develop, representing in a new feature of the market. However, US policy prohibiting crude exports, combined with infrastructure constraints, has changed price relationships and shifted financial trade from WTI to Brent. At the same time, it has also been a driver behind the sharp rise in US product exports, as US refiners benefit from the increasing availability of competitively-priced domestic crude supplies.

With reference to the ongoing regulatory efforts, there was a shared view that financial energy markets benefit from deep liquidity, with a good range of participants and a well-regulated structure around them. At the same time, it was further noted that regulation had been written in a time of increasing participation and liquidity in the financial oil market, but was being implemented at a time of reduced liquidity, thus calling for a continued measured approach and market consultation in moving forward, particularly given the importance and complexity of the financial energy markets.

A key challenge for regulators was seen as finding the appropriate place to draw the line between financial and physical commodity markets, in terms which firms need to be registered as investment firms and which activities should be considered financial activities. While regulatory arbitrage was considered a concern, the G-20 commitments on commodity derivatives should help to ensure that regulation is broadly consistent across the various jurisdictions.

The exit of financial firms, particularly banks, from the commodity space was also addressed. Not just regulation but also reduced commercial opportunity, due to lower volatility and increased competition, were seen to be behind this trend. While some participants expressed concern that this might reduce liquidity farther out, others expressed the view that other

players are filling the space previously occupied by financial firms, including pension funds, hedge funds, and exchange traded funds (ETFs).

The Workshop reviewed the G-20 initiative on Oil Price Reporting Agencies (PRAs), carried out by IOSCO in collaboration with the IEA, IEF and OPEC, and the resulting IOSCO PRA Principles published in October 2012. It was noted that the initiative was in response to a G-20 Leaders' request, with the aim of enhancing the reliability of oil price assessments referenced in derivative contracts, and had served as the basis for subsequent work on Principles for Financial Benchmarks. An update on the efforts of the PRAs to implement the Principles was also provided.

Participants noted that the process of preparing the Principles was positively enhanced through the participation of both financial market regulators and international organizations familiar with physical markets. The Principles were seen to be proportionate and workable, and should help to increase confidence in the underlying benchmarks used in commodity derivatives.

IV. **Conclusion**

At the conclusion of the Fourth joint Workshop, it was noted that the event had covered considerable ground and provided a thoughtful mix of information, debate, and academic discussion on a large and complex set of issues regarding the interactions between physical and financial energy markets.

In reviewing the progress that had been made since the Workshops were first initiated, it was noted that understanding of the interlinkages between physical and financial markets had become more nuanced and that there had been a richer discussion about cause and effect relationships.

Participants noted that the Workshop has emerged as an important industry event, bringing together a diverse range of market participants to discuss issues that are not addressed in other high-level fora. A follow-up survey after the event confirmed that participants found the Workshop to be well-organized and insightful, and saw continued benefit from it.

At the conclusion of the Workshop, the organizers thanked the speakers, moderators, and participants for the active exchange of views, and looked forward to hosting the 5th Joint Workshop.