August update

You have to hand it to the bankers. With memories of the 2008 financial crisis still fairly raw in people's minds, the last 12 months have seen a dazzling display of both ineptitude and dishonesty. In no particular order, we have seen the culmination of the PPI (Payment Protection Insurance) scandal the mis-selling of interest rate swaps to small businesses and further whopping losses incurred by trading "legends" working for UBS ($2bn) and JP Morgan ($5bn). Now to top it all, we have the Libor scandal, where emails actually exist saying things like "hi guys, we got a big position in 3m libor for the next 3 days. Can we pls keep the libor fixing at 5.39 for the next few days. It would really help". I daresay it would my friend, but not as much as a very good defence lawyer…

Financial scandals

So with no seeming end to these financial scandals, is it any surprise that the pricing mechanisms used in the oil industry are now coming under scrutiny? Probably not and the press, politicians, the trade and various trade associations have all lined up to claim that the oil price can be/is being rigged in the same way as Libor and that something should be done about it.

To compare the banking and oil industries, let's first go back to 2008 when the financial crisis hit and the oil price collapsed. From 2004 onwards, prices had risen to an unprecedented high of $150 per barrel and then in the space of four months (Jul 08 - Oct 08), the value of oil went down to $35, thus wiping out all of the rises that had been experienced over the previous four years. Virtually overnight, profits of the Oil Co's were quartered, billions and billions of $ were owed in derivative contracts and ruinously empty oil tankers were anchored off ports around the world for months on end, whilst the charter fees rocketed.

the oil kept flowing – against a backdrop of complete financial meltdown

Of course, the well-publicised Government bail-outs for the likes of Shell, Exxon, BP and Glencore have been explored before….erm, wait a minute, there were no bail-outs for the oil industry! In fact, the industry just went about its business as usual. There were no major bankruptcies, nor major payment defaults. Swap and derivative arrangements were all fulfilled and most fundamentally, the oil kept flowing – against a backdrop of complete financial meltdown. The oil majors and minors simply cut their cloth accordingly and in an astonishing move, actually cut the bonuses of their top brass to reflect the lower returns being generated.

Yes, Oil Co's are huge and profitable beasts, but they are not banks and do not behave like banks either. No they don't help themselves with their sometimes complex approach and jargon, but just because something is complex does not mean that it is flawed. And finally yes, banks do trade oil, but they do it from a screen whereas the industry does it from the well-head, the refinery gate, the product jetty and the petrol pump.

Setting Libor v reporting oil prices

And that is the difference between the setting of Libor and the reporting of fuel prices. Note the difference in wording there, because one rate is set, whilst the other is reported on. Libor to be clear, is the average interest rate as estimated by leading banks in London (that they would be charged if they borrowed from other banks on the following day). So Libor is not only an estimate for the future (thus making it completely subjective), but it is also set by a panel of London banks (the so-called "Contributor Banks"), normally not numbering more than 10. European petrol prices on the other hand are based on actual wholesale trades of petrol (whether to barge or ship) that have taken place in Antwerp, Rotterdam and Amsterdam (ARA). On any given day that the Libor Contributor Banks are "forecasting" their rates, between 15 and 20 actual sales in excess of 3m litres are taking place in ARA, with buyers and sellers often totaling more than 40 separate players. So when Platts and Argus (the two independent price reporters in Europe – another difference versus Libor), say that their prices are robust, this is because they are basing them on hundreds of actual sales, for every grade of fuel and in every corner of the world.

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Oil pricing actually demonstrates the purest rules of supply and demand to be seen in any economic sector. If high oil prices make few people happy, then blaming the oil industry seems to conveniently ignore the well documented demand increases that the world has experienced in the last 20 years (and which were explored in the last Portland FON Report). Conspiracy theorists will always believe the worst and let's face it, the world's bankers have given them material for the next 100 years, but oil prices are not set in darkened rooms by shady Russians, mysterious Saudi Sheiks and villainous traders. Instead, they are set by supply and demand. Supply is represented by the industry which brings the product to market, whilst demand is you and me, plus the other 7 billion fuel users in the world.

For more pricing information, see page 26

Portland Fuel Price Protection
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