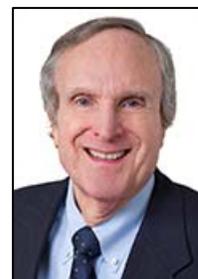


Brent Crude Oil Price-Fixing: Have We Seen This Before?

Law360, New York (August 01, 2013, 1:23 PM ET) -- The recently filed cases against BP PLC, Royal Dutch Shell PLC and Statoil ASA alleging manipulation of Brent crude oil prices,[1] and the resulting manipulative effect on the price of Brent crude oil futures traded on futures exchanges, may be a case of history repeating itself. The allegations in these new complaints are very similar to those made in the well-known 2004 commodities class action *In re Natural Gas Commodity Litigation*. The Natural Gas plaintiffs similarly alleged that manipulation of physical natural gas prices affected the prices of natural gas futures traded on futures exchanges.[2]



Bernard Persky

In this article, we review the striking similarities of these two commodity manipulation matters, ranging from the alleged misconduct and government investigations to the industries' structures and characteristics, including the incentives and alleged ability to manipulate prices in physical and futures markets that are common to both cases.

Regulatory Scrutiny and Investigation

Natural gas and Brent crude oil price manipulation have attracted considerable regulatory scrutiny. Prior to the Natural Gas private civil class actions, in 2002 the Federal Energy Regulatory Commission conducted an investigation into price manipulation in the natural gas industry followed by Commodity Futures Trading Commission enforcement investigations in 2003.

The government investigations focused on the ability of large energy companies to manipulate natural gas prices through misreporting to price reporting agencies ("PRAs") and trading publications in order to affect the published indices that serve as benchmarks for pricing in the physical and futures markets. These investigations resulted in many natural gas companies paying over \$200 million in penalties to the CFTC. The Natural Gas private civil class actions settled for almost \$101 million, which was then the second largest commodity manipulation class action settlement on record.

More recently, regulators and government authorities around the world have examined the potential for price manipulation in the Brent crude oil market. In 2011, the International Organization of Securities Commissions opened an investigation into the role of PRAs in the functioning of oil markets, with a focus on the susceptibility of PRAs to manipulation by market participants.

IOSCO's final report, published in October 2012, concluded that vulnerabilities in the price assessment processes conducted by PRAs created opportunities for energy market price manipulation. In May 2013, upon concerns that BP, Shell and Statoil may have misreported Brent crude oil transaction data to Platts — the preeminent oil PRA — the European Commission launched an investigation into Platts' Brent crude oil price assessment process, noting that manipulation of PRA benchmarks "may have a huge impact on the prices of crude oil, refined oil ... potentially harming final consumers." [3] In June of this year, the Federal Trade Commission began a similar investigation here in the U.S. and it has been reported that British regulatory authorities are also investigating this matter.

Alleged Misconduct

In both Natural Gas and the new Brent crude oil cases, plaintiffs accuse defendants of reporting false, inaccurate or misleading information about their physical trading activities (prices and volumes) to PRAs and trading publications that are widely relied on by market participants in the price discovery process relating to each of these commodities.

Transactions in the natural gas and Brent crude oil physical markets involve "over-the-counter" contracts that are privately negotiated. Because these transactions are private, the physical natural gas and Brent crude oil markets are not transparent. This is precisely the reason PRAs collect the private transaction data and disseminate it to the markets at large. That is, PRAs and trading publications attempt to bring to light transaction information in what would otherwise be murky markets in order to create and publish pricing benchmarks which are relied on by participants in the physical and futures markets for these commodities.

To obtain data on OTC contracts in the natural gas and Brent crude oil physical markets, PRAs and trading publications rely on self-reported transactions by market participants like the Natural Gas and Brent crude oil cases defendants. Although the PRAs ostensibly put in place procedures to guard and protect the integrity of the reported and collected data, the plaintiffs in the Natural Gas and Brent crude oil cases allege that the defendants were able to successfully game this data collection process to manipulate physical natural gas and Brent crude oil prices to the benefit of their derivative energy positions in related financial markets.

The Natural Gas plaintiffs alleged that defendants misreported transaction data to Natural Gas Intelligence, Gas Daily and Inside FERC,[4] all publications relied upon by traders and industry participants when making their buying and selling decisions for both physical natural gas and natural gas futures.[5] In the Brent crude oil cases, plaintiffs allege that the defendants misreported transaction data to Platts. Platts' Brent crude oil benchmark prices are considered the preeminent gauge of the physical Brent crude oil market, which, as discussed below, is an integral component for price formation and risk assessment in the Brent crude oil futures markets.

Industry Organization and Information Asymmetry

The defendants in both Natural Gas and the Brent Crude Oil Cases are important players in their respective physical markets as buyers, sellers or both. The chief condition to participate in the physical markets is the ability to handle the commodity. In the case of natural gas, this could mean being the owner or operator of wells, pipelines, storage tanks, etc., or the owner or operator of power plants that purchase and consume natural gas to produce electric power.

Alternatively, it could mean being a pure commodity trader who, while having no direct interest in either the upstream or downstream markets, has the ability to fulfill a role in the vertical chain of, for example, transportation or storage of natural gas. These physical traders also would have the needed infrastructure to handle the commodity. Indeed the defendants in Natural Gas were many of the largest natural gas companies in the U.S.[6]

Similarly, the defendants in the Brent crude oil cases are all fully entrenched in the Brent crude oil physical market by way of their ownership of crucial infrastructure.[7] BP, Shell and Statoil each own significant interests in Brent crude oil fields and also have interests in, or operate, the pipelines that transport Brent crude oil from the oil fields to the terminals. Additionally, BP, Shell and Statoil all have equity positions in, or operate, loading terminals, known as “delivery points” from which Brent crude oil is put into vessels (“carriers”) and transported to refineries around the world. The defendants also own and operate refineries that can process Brent crude oil, and thus, they are also important buyers in the market.

Therefore, in both the Natural Gas and Brent crude oil cases defendants enjoy a privileged position along the supply chain which gives them access to critical and valuable nonpublic information. They are better informed about current and future supply and demand balances and flows that are not available to the markets at large. More importantly, they can exploit this asymmetry of information to their advantage and to the detriment of other market participants, such as traders in futures contracts. To fully understand the defendants’ motivation to do this, we must understand the relationship between physical and futures markets.

The Relationship Between Futures and Physical Markets and Incentives to Manipulate

Physical purchases and sales of natural gas or Brent crude oil for immediate or near immediate delivery are conducted in what the oil-and-gas industry calls the “spot” market.[8] Broadly speaking, spot and futures prices are inextricably linked by the prevailing cost of funding (i.e., interest rates), cost of storage and market expectations regarding future availability of the commodity in question. The interrelationship between spot and futures prices can also be understood in terms of arbitrage opportunities for profit between spot and futures prices. For example, if futures prices vastly exceed current spot prices (i.e., above and beyond funding and storage costs) one can simultaneously sell a futures contract (i.e., the obligation to deliver the commodity at a later date) and purchase and store the commodity while making a profit in the process.

The economic forces that link spot and futures prices were recognized by the CFTC during its natural gas enforcement investigation when it stated “natural gas futures traders refer to the prices published by the reporting firms for price discovery and for assessing price risks. ... [F]utures traders take account of both price movements and changes in the supply/demand balance when conducting their futures trading.”[9]

Meanwhile, IntercontinentalExchange Inc., a major platform for trading Brent crude oil futures, explicitly incorporates Platts’ price assessments in the calculation of the settlement price of its Brent crude oil futures contract. This price settlement mechanism not only highlights the link between the physical spot and futures markets but, in fact, strengthens it.

As noted, the Natural Gas and Brent crude oil cases defendants are all major participants in their respective physical markets, and thus, they experience firsthand fluctuations in the price of natural gas or Brent crude oil. It is common practice for participants in physical markets to hedge their exposure to the price risk inherent in such fluctuations by conducting transactions in the futures market. In some instances, participants in physical markets also have proprietary trading operations taking positions in futures markets not for hedging purposes, but for pure speculation. Thus, whether hedging or speculating, physical traders often accumulate significant positions in futures markets and, in fact, this is what Natural Gas defendants did.[10] The defendants in the Brent crude oil cases are also likely to be active participants in the Brent crude oil futures markets.

The alleged ability of the Natural Gas and Brent crude oil cases defendants to manipulate prices in the opaque OTC physical market by misreporting transaction data to PRAs also gives them the alleged ability to manipulate prices in the futures markets because of the strong link between the spot and futures markets. In effect, these defendants have both the incentives and ability to exploit their asymmetric advantage in physical markets to benefit their positions in the futures markets.

Conclusion

The allegations of price manipulation in Natural Gas and the Brent crude oil cases are strikingly similar. In both energy commodities markets transactions in the physical markets are opaque, and PRAs attempt to bring transparency to the markets by collecting and disseminating transaction data via published benchmarks.

However, the PRAs rely on self-reporting by self-interested market participants, leaving the data gathering process vulnerable to manipulation. Thus, when the EC opened its investigation into Brent crude oil pricing, we immediately knew what this case was about; we have seen this before.

--By Bernard Persky and Fabricio X. Nunez, Robins Kaplan Miller & Ciresi LLP

Bernard Persky is of counsel in Robins Kaplan's New York office. Fabricio Nunez, Ph.D., is a financial and economic consultant in the firm's Minneapolis office.

Persky serves as counsel for plaintiff Benvenuto in one of the pending Brent crude oil class actions discussed herein. While at his prior firm, he served as co-lead counsel in In re Natural Gas Commodity Litigation. Nunez was previously a senior energy economist with the energy division of a large privately owned company that trades Brent crude oil futures.

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[1] To date, seven class action complaints, containing similar allegations and claims, have been filed in the Southern District of New York: Benvenuto v. BP p.l.c., et al., Case No. 13-cv-04142; Prime International Trading, Ltd. v. BP plc, et al., Case No. 13-cv-03473; Smith v. BP plc, et al., Case No. 13-cv-03944; Sevy v. BP plc, et al., Case No. 13-cv-03587; Port 22, LLC, et al., v. BP p.l.c., et al., Case No. 13-cv-04938; White Oak Fund LP v. BP plc, et al., Case No. 13-cv-04553; and Karkut v. Royal Dutch Shell plc, et al., Case No. 13-cv-04872.

[2] See In re Natural Gas Commodity Litig., 337 F. Supp. 2d 498, 503-04 (S.D.N.Y. 2004).

[3] Press Release, European Commission Antitrust: Commission confirms unannounced inspections in oil and biofuels sectors (May 14, 2013).

[4] Notably, Platts is the publisher of Gas Daily and Inside FERC.

[5] See *In re Natural Gas Commodity Litig.*, 235 F.R.D. 199, 201-03 (S.D.N.Y. 2004).

[6] For example Natural Gas defendant Coral Energy Resources, L.P. is Shell's U.S. gas and power trading arm.

[7] The Brent crude oil physical market is known to industry participants as the "BFOE" market. BFOE stands for Brent, Forties, Oseberg, and Ekofisk. These are the four blends of North Sea crude oil that comprise what is commonly referred to in the industry as "Brent crude oil."

[8] For other commodities, such as in agriculture, the spot market is usually referred to as the "cash market."

[9] Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions at 3, *In re CMS Marketing Services And Trading Company and CMS Field Services, Inc.*, CFTC Docket No. 04-05 (C.F.T.C. Nov. 2003); see also *In re Natural Gas Commodity Litig.*, 337 F. Supp. 2d at 509 (on motion to dismiss, upholding allegations that defendants falsely reported trade data in the physical natural gas market to manipulate prices in the natural gas futures market).

[10] See, e.g., Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act Making Findings and Imposing Remedial Sanctions at 3, 3 n.2, *In re El Paso Merchant Energy LP*, CFTC Docket No. 03-09 (C.F.T.C. Mar. 2003) (stating Natural Gas defendant El Paso Merchant Energy L.P., a business unit of El Paso Corporation – one of the largest North American providers of natural gas services at the time – was "a large trader in NYMEX natural gas futures and options contracts on NYMEX.")