Regulatory and accounting issues: a focus on energy commodity markets

Wendi Farrell, Executive Director, **Shane Henley**, Senior Manager, and **Rida Rahmani**, Manager, of FAAS Commodity Trading Risk Management, **Ernst & Young**, provide relevant and timely insights into the important regulatory and accounting changes facing commodity and energy markets

The two important changes facing commodity and energy markets are market regulation and accounting developments for Liquefied Natural Gas contracts.

A wave of regulation is on its way – will it create a sea change for traded commodity markets?

In response to the 2008 global financial crisis, both US and European regulators embarked on a significant shake-up of the way in which regulators would like to see traded markets regulated and supervised. These changes are likely to have a significant impact not only on financial markets, but also on traded commodity and energy markets.

With the Dodd-Frank legislation leading the way in the US, Europe duly proposed similar regulation in the form of MiFID2 (Markets in Financial Instruments Directive) and EMIR (European Market Infrastructure Regulation). The former builds on existing regulation and seeks to further tighten the rules regulating trading venues and participants in financial markets, while the latter introduces new requirements including the mandatory clearing of over-the-counter (OTC) derivative trades.

Liquified natural gas plant, Qatar

The lack of transparency of the OTC derivative market is considered to be a major contributor in enabling the financial crisis. Greater transparency over these derivatives at an aggregate level is viewed by many to be a key component in helping to avoid similar failures in future. Both regulations, MiFID2 and EMIR, currently progressing through the EU legislative process, may carry significant implications for European commodity and energy market participants which were largely exempt from existing regulation.

In parallel with the enhanced financial market regulation, pan-European regulation has been introduced that specifically aims to regulate traded wholesale electricity and gas markets. Regulation of Energy Market Integrity and Transparency (REMIT) shares a number of similar objectives of the financial market regulation. This includes ensuring market transparency and the prevention of market manipulation across an ever-increasingly integrated European energy market. Although introduced at the end of 2011, the impact of this regulation is likely to be felt over the next 12 months as the main operational and compliance requirements are implemented.

The collective impact of these regulations on commodity and energy markets is not yet fully understood by the participants. Market participants have expressed concern over the adverse or unintended consequences of the regulations. These include the potential for increasing capital requirements, reduced market liquidity and the heavy operational

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Liquified natural gas plant, Arizona

and technology investment required to report trading activity to the various regulatory bodies as proposed under the regulation. It is crucial, however, that over the next few months, market participants dedicate the necessary resources to identify what these changes might mean for their organisations and to put in motion an appropriate response. Our market intelligence indicates a surprisingly large number of organisations have yet to approach this in a concerted way.

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Accounting for LNG contracts: fair value or accrual account?

The Liquefied Natural Gas (LNG) market was previously characterised by LNG being contracted on fixed long-term agreements with pricing formulae indexed to other commodities. These contracts were primarily used as equity purchase agreements in the portfolio. Therefore, most of these contracts were scoped out of International Accounting Standard (IAS) 39 as they did not meet the criteria of derivatives for financial reporting purposes.

Over recent years, however, LNG trading has gained substantial momentum to become one of the more actively traded commodities. Due to the increased liquidity in the European, Asian and US markets, there has been a significant rise in spot contracts which are now becoming a core feature of a commodity trader's portfolio.

As the LNG market is transforming from a niche, high-cost activity focused on specific markets into a core feature of the global gas trading strategy, players are reassessing their accounting approach. With the increased liquidity in the market and traders capturing regional arbitrage opportunities and optimising their positions across the global LNG market, it may not be long before most LNG trading contracts fall comfortably within the scope of IAS 39. However, the valuation of these contracts might remain challenging, given the lack of available quoted prices. ■