Part IV - Case Study

BP warns of regulatory hit to commodities prices

By Neil Hume (1 April 2014)

The head of the world's biggest energy trader has said some of the regulation being imposed on financial markets could have "very worrying" side effects on commodities prices.

Speaking at the Financial Times' Global Commodities Summit, Paul Reed, chief executive of BP's integrated supply and trading division identified a range of new threats from new regulations, including higher capital requirements and a push to using clearing houses to settle trades.

Through its IST arm BP is one of the world's largest energy traders, both in physical and derivatives markets. The unit, which in past years has made profits of billions of dollars, employs about 3,000 people in trading floors in Chicago, London and Singapore.

In 2013, the oil major registered as a derivatives dealer in the US, owing to its size and role in the market. The designation subjects BP to minimum capital and margin levels.

Regulations crafted in response to the financial crisis were meant to reduce systemic risk. But the new rules also affect commodity markets where derivatives are used widely by banks and energy companies.

"The threat to business can be quite significant if we get it wrong," he said. "A lot of the rules coming in could have the opposite effect to what they were intending to achieve."

Mr Reed said higher capital requirements could make it more expensive for traders and energy companies to hold stocks, which are a buffer against supply shortfalls. This would be a particular concern if interest rates went up

"We have vast sums of money tied up in working capital. If there are further burdens put on that what does that do to our attitude for holding stocks? And if you don't hold stocks what does that do to volatility?" warned Mr Reed.

Higher capital requirements have also led many several banks to retreat from commodities trading. Deutsche Bank, one of the five biggest players in commodities over the past decade, has almost completely abandoned the sector, as have UBS and Royal Bank of Scotland.

Mr Reed said the bank exodus had already affected prices of commodities for long term delivery. "Bid/offer spreads are rising and liquidity is less," he said.

Speaking on the same panel in Lausanne, Ian Taylor, the chief executive of Vitol, the world's biggest independent oil trader, said he had also experienced reduced liquidity some markets.

"I hate to say it, but I'm quite keen to see Goldman Sachs stays in the business," quipped Mr Taylor.

Mr Reed also said the push to move derivatives contracts, such as oil and gas swaps, into the safety of clearing houses was concentrating risk.

"If anyone is too big to fail, it's a clearing house," he said.

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Now that you have read the case study, test your understanding by answering the following questions. Once you have finished writing your answers, you can click through to reveal feedback for the questions.

Q1: Discuss the objectives of working capital management, and explain why BP is particularly concerned about the impact of regulation on commodity prices.

Q2: Discuss the main types of risk to be recognised and managed by a financial manager in the context of working capital and short-term finance management.

Q3: Explain the term ‘derivatives’ and why they can be important to the financial manager of a company.

Answers