From Iran Oil Bourse Myth to Gulf Clearing Union Reality?

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In recent years he has been a strategic market consultant, entrepreneur and commentator. As the author of the "Iranian Oil Bourse" project he has been developing partnership-based enterprise models, in respect of financial infrastructure generally and Islamic sound structures in particular.

Genesis of the Bourse

The "Iran Oil Bourse" (IOB") has taken on an almost mythical status among Internet conspiracy theorists. In this article I propose to dispel the myth, and to illuminate the reality.

In June 2001 I wrote to the Iranian Central Bank Governor (sadly, now deceased) Dr. Nourbakhsh pointing out that the principal global benchmark crude oil – Brent Crude – was being routinely manipulated by trading intermediaries at the expense of "end user" producing nations, like Iran, and their counterparty consuming nations, such as Japan and China, but of course also of everyone who uses oil products.

I recommended that Iran should lead the formation of a Middle Eastern or Gulf Exchange – explicitly not a domestic Iranian Exchange - aimed at creating a new Gulf crude oil benchmark less subject to manipulation and speculation.

The requirement for such an initiative is even more imperative now, as the relationship between the dollar and crude oil goes into uncharted territory, and volatility reaches new highs.

This idea met with Iranian Presidential approval and my understanding is that Saudi Arabia's initial hostility to the concept was, after a year or two, modified to a position of neutrality. The Iranian Oil Ministry was thereupon ordered to commission the IOB project, and in May 2004, the "Wimpole" consortium of which I am a member, was awarded the contract in partnership with the Tehran Stock Exchange.

Bourse Off Course

Wimpole's initial "pre-feasibility" study incorporated a comprehensive critique of the global oil market, the disintermediation of markets in the age of the Internet and the effects upon oil market architecture.

The report also made clear that a conventional approach to contract design was neither consistent with Islamic values nor capable of overcoming existing barriers to entry from what is essentially a global duopoly cartel of intermediaries in the shape of ICEFutures (formerly the International Petroleum Exchange) and the New York Mercantile Exchange - NYMEX.

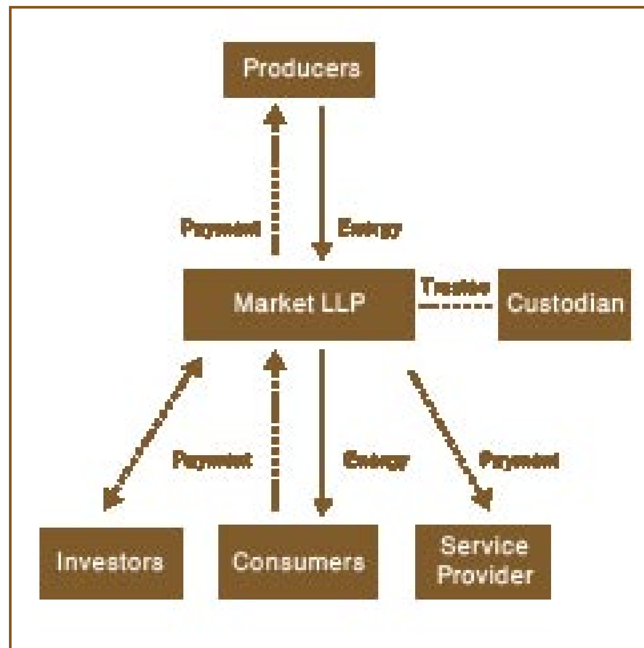
Wimpole nevertheless outlined an alternative strategy, which we have developed since, and which I will describe below.

The project thereupon ran into entrenched opposition from elements in the Iranian Oil Ministry who resist any increase in the transparency of Iranian crude oil sales. In diplomatic terms, not all oil sales in Iran would withstand close examination as "arm's length" transactions.

Progress was essentially halted through the simple expedient of a blank failure to pay in respect of the study which was carried out in good faith upon the personal written undertaking of the responsible Oil Ministry official.

This reality of a complete project standstill has never been apparent from the continuing stream of rhetoric and announcements of entirely non-existent "progress" which before long took on a life of their own and became associated with all manner of internet conspiracy theories. In particular, there is the pervasive IOB "dollar-killer" narrative, which is from the same stable as the theory that the cause of Saddam Hussein's downfall was the cessation by Iraq of oil sales in dollars and a move to Euro oil pricing instead.

It is certainly the case that the denomination of oil sales has been a recurring subject at OPEC meetings, and Iran has, of course, recently moved away from dollar pricing for pragmatic reasons. However, to my personal knowledge, the denomination of contract pricing has never been a consideration.



Not only did Wimpole never reach the contract design phase, but we were explicitly told by the Iranian OPEC representative personally, in London, that crude oil contracts could only be a medium or long term objective. The initial contracts will therefore be in unimportant "fringe" oil products such as bitumen or even petrochemicals. So much for what the IOB was not: perhaps more relevant is what it was, is and could yet be.

Proposed Bourse Architecture

A bank acts as a credit intermediary between borrower and depositor, backing an implicit guarantee with an amount of capital set by the Basel-based Bank of International Settlements.

In exactly the same way, a "Clearing House" acts as a "Central Counterparty" which comes between the seller and a buyer of a contract for future delivery of (say) a commodity, and guarantees the performance of both. The Clearing House collects a "margin" deposit from counter-parties which is set at levels based upon market volatility and this, plus the Clearing House's capital, and possibly reinsurance, provides the necessary security for the guarantee.

My approach to market architecture is to dispense with the intermediary, and instead all contracts taking place within a market network will be subject to the mutual guarantee of all market participants – a "Guarantee Society" not unlike a mutual "P& I Club" in the insurance world, and not dissimilar to the Islamic concept of "Takaful."

This guarantee would be backed, in the normal way, with margin deposits/provisions paid into a Default Fund or Pool, and possibly subject to reinsurance arrangements.

Key to this architecture was the enactment in the UK in 2001 of a new "open" corporate form – a simple, but radical, combination of Company and Partnership which has subsequently been introduced in Japan, in the financial centers of both Dubai and Qatar, and will shortly be introduced in India.

Using this "Open" Corporate form – so-called because the LLP agreement is not prescribed by statute and may take any form the members may consensually agree – it is possible for a "Clearing Union" architecture to be achieved. In this model, a consortium of service users – the market participants – become LLP members alongside a consortium of market service providers (see figure).

The Market LLP framework (see figure) aligns the interests of all the stakeholders in an entirely new way through the use of a partnership between stakeholder consortia.

Proposed Bourse Contract Design

Both debt and futures contracts require future performance of an obligation at a fixed price. Both result in a multiplication of risk known as "gearing" and require risk

management through the use of risk capital by a credit intermediary (bank) or risk intermediary (Clearing House) as the case may be.

Such contracts, which rely upon the issue of a claim over value (IOU) by a Bank, or a "short sale" by a seller may be characterized as "deficit-based" finance. Where a bank loan, or margin, is secured by collateral it may be said to be "deficit-based" but "asset-backed."

Having spent much time in the study of Islamic finance in recent years, I have yet to learn how "gearing" of any sort may be consistent with Islamic values.

"Asset-based" finance, on the other hand, is based upon investment through ownership of a productive asset and/or its production or revenues in a legal vehicle.

Conventional "equity" finance is based upon ownership using the legal vehicle known as the "joint stock limited liability company" or "corporation": however, the emerging use of unconventional legal vehicles is becoming a global phenomenon.

In Canada, for instance, virtually the entire capital market now consists of two tiers, the first being shares in conventional listed corporations, and the second being units in income trusts, whereby part of a company's gross revenues are committed into trusts and units sold to investors.

The phenomenal growth of income trusts has been due to the appetite of pension funds for gross revenues before company managements are able to access them: ie pre-distributed corporate revenues.

A similar outcome, but without the tax and management issues and complexities which make trusts so popular with lawyers, is also now possible using LLPs (or in the US, LLCs) to create "capital partnerships" whereby proportional units or "equity shares" in revenues or production are shared as between providers and users of capital. The outcome will be immediately recognisable to students of Islamic Finance as "Musharakah."

The contracts I propose essentially consist of units in a "Pool" of commodity production constituted as a fund within a corporate "wrapper."

Sellers will sell production into a Pool, and buyers will buy production from the Pool, and the market price will be based upon an auction process established by reference to actual deliveries – the "spot" price.

Investors may buy and sell units in the Pool at any time but do not – by definition – participate in the auction.

The result is a new asset class not dissimilar to "exchange-traded commodity" funds. Producers may both "hedge" sales by selling production forward and receive what is in effect an interest-free loan: likewise consumers may hedge purchases by paying now for future consumption. For investors the result is a simple new – un-geared, and hence suitable for "retail" investors – mechanism for investing in commodities.

The outcome is also of a continuous asset class of commodity "units," as opposed to a fragmented and continually "rolling" series of contracts typically with monthly expiry dates. This will lead to dramatic savings in the transaction costs of holding an investment in commodities over time. If gearing is required, units may be bought with borrowed money, or option contracts may be used.

Bourse Alternatives

There has, for many years, been considerable competition in the Middle East for the prize of a benchmark Middle East quality crude oil, the protagonists being the duopoly of ICEFutures and NYMEX with competing contracts. There is also the Qatari International Mercantile Exchange ("IMEX") initiative.

IPE, before its acquisition by ICE, made two attempts, in which I was personally involved, to launch a Dubai quality contract. The first was launched two weeks before Saddam Hussein invaded Kuwait, while the second struggled for years in a joint venture with Singapore's SIMEX before being put out of its misery.

In order to achieve a successful derivatives market it is first necessary for there to be "spot" physical transactions, which in turn requires that underlying physical contracts do not preclude re-sale. Neither Saudi nor Iranian crude oil is sold on such terms, and it has only been the Dubai quality of crude oil which has been freely available in this way.

The Dubai Mercantile Exchange contract is conceptually based upon its partner NYMEX's West Texas Intermediate ("WTI") contract which is deliverable by pipeline. Deliveries into vessel always raise practical issues in contracts where the trading unit is relatively small – 1,000 barrels – and the physical cargo size large, e.g. Brent crude oil's 500,000 barrels physical cargo size.

In the case of the IPE Brent crude oil contract this meant that in the late 1980s the first two iterations of the contract failed and the successful IPE contract is settled in cash upon expiry at a price based upon an Index calculated against independently observed and reported Brent forward "15 Day" contracts. The ICEFutures contract is "cash settled" against Dubai crude oil prices as reported by Platts – the independent market price observer – on the last day of trading. Unfortunately the Platts Dubai benchmark has declined in credibility along with Dubai production in the years since the failed IPE/SIMEX contract.

It is difficult to see how either the DME contract or the ICE-Futures contract can ever succeed without a huge infusion of liquidity into the underlying "physical" market.

The Qatari IMEX initiative faces the same problem in launching a crude oil contract and realistically could only hope to succeed with LNG – of which it is a dominant producer – if it can establish a liquid physical market.

Since the financing of LNG infrastructure using bank credit typically requires long-term supply contracts priced by reference to crude oil, the number of LNG cargoes reaching the open market will always be limited, and since the market is in a nascent stage the number of buyers is also limited.

Conventional "deficit-based" LNG contracts are therefore, at best, a long-term project.

A Gulf Clearing Union?

The Iranian OPEC representative informed us that he had advocated for some 20 years the institution of an "OPEC Bank" and related financial institutions.

In recent years we have seen proposals for a Gulf "single currency" among GCC states but this appears increasingly remote, particularly now that Kuwait has led the way in leaving the "dollar peg," and the dollar appears to be in secular decline in the absence of remedies the US is politically unable to apply.

While some commentators suggest that the Euro may come to replace the dollar as a global reserve currency, the truth of the matter is that no deficit-based currency is sustainable in the long term in a world of finite resources.

What then is an Alternative?

Using the market and contract architecture outlined above it is possible to imagine how Gulf States, extending to Iran and Iraq, could commit a proportion of production of both crude oil and LNG to "Pools" the units of which could form a "Carbon dollar." In fact, I believe that

it is only through the use of an "LNG Pool" in this way that a viable global market in LNG can ever be attained.
This is due to the incompatibility between

- the need for spot cargo trading upon which to base a futures market; and
- the necessity to tie up production in long-term contracts in order to obtain deficit-based infrastructure finance.

The "Carbon dollar" would initially be launched – in the same way that the Euro price was "frozen" in relation to all the national currencies of its participant member states – by calculating the amount of carbon in each form of crude oil, LNG etc. a dollar would buy on the launch date, or upon the accession of a new energy source to the Pool. "Carbon dollars" would thereafter diverge from "Fed" dollars and would thereafter be a new "asset-based" globally "fungible" unit of exchange.

Transactions would be made within a global market network, which, with the addition of a mutual guarantee would constitute the International Clearing Union which J M Keynes proposed at Bretton Woods in 1944 based upon an abstract "Value Unit" he called a "Bancor."

Why would banks possibly agree to such a radical structure?
Or, in other words, why would they wish to risk their capital by creating credit based upon it when in fact they may instead act as pure service providers:

(a) managing the bilateral creation of credit among trading counterparties – a classic "Trust Banking" approach;
(b) appraising investments, bringing investors together with investments and providing liquidity – a classic "Investment Banking" service.

So, in this model, banks would have a future as a service provider rather than as an intermediary, and their interests are entirely aligned with those of other stakeholders as opposed to being in conflict with them.

Carbon Dollars and Kyoto

The problem with the proposed global markets in "Carbon" e.g. "emissions trading" and carbon offsets is that they are based upon markets in carbon emissions of CO2, as opposed to the carbon content of fuel.

The "deficit basis" of these carbon markets is best understood by an analogy overheard at a gathering of traders – always noted for the dispassionate and objective nature of their judgments: "If you want to keep a donkey healthy, you don't regulate what comes out of it, but what goes in".

The inconvenient truth of these markets in carbon is that they were invented by trading intermediaries largely for trading intermediaries.

The use of Carbon dollars based upon the carbon in fuel as opposed to that in emissions essentially monetises carbon, and means that to reduce carbon use will – literally – be to save money.

Summary

There is a window of opportunity for Gulf States to lead the creation not only of a simple oil market architecture, which is not dominated by manipulation and speculation by intermediaries, but also a new "asset-based" financial system based upon a "Carbon dollar" value unit.

The use of this architecture in respect of LNG would combine both a new financing mechanism for the massive necessary investment in (and indeed refinancing of) global LNG infrastructure and a resulting new market in homogeneous undated and un-geared LNG "units" with vast potential.

Since LNG is a new market, without the sensitivities of the existing fragmented and opaque markets in crude oil so evident in the Iran Oil Bourse project, there is scope for development using the new "asset-based" architecture I describe above.

The concepts outlined in this article require an immense amount of research and development, in addition to diplomacy and statesmanship of a high order.

An International Carbon Clearing Union similar to the concept outlined by Keynes at Bretton Woods is both achievable and urgently necessary since no deficit-based financial system is in the long term sustainable in a world of finite resources. ❑