The Iran Oil Bourse – A New Direction?

By Chris Cook

The "Iran Oil Bourse" project, beloved of Internet conspiracy theorists, has taken on something of a mythical character, not unlike the Loch Ness monster, with persistent sightings but an absence of actual manifestation. Hopefully this article will both dispel the myths and set the scene for what is potentially an extremely important development, particularly for the Islamic world.

Origins

The origins of the project lay in a disciplinary case on the International Petroleum Exchange (IPE) in 2000 where a trader was disciplined in respect of market manipulation. I assisted him in defending the matter before a disciplinary tribunal.

It became apparent, too late to help the trader, that it was in fact the customers of the IPE who were manipulating the market, as the IPE knew perfectly well. In fact – as the Commissioner's report into my allegations documented – the IPE had actually reported this conduct to the regulatory authority, the UK Financial Services Authority, but did not see fit to inform the disciplinary tribunal of the fact.

When, because I could not believe the breathtaking cynicism and unfairness of the case, I "blew the whistle" on the systemic (unfortunately, I used the word "systematic" at the time) manipulation of IPE settlement prices by intermediary traders and investment banks, I ran up against the UK establishment, and the scandal was buried, and so was I, in terms of ever working in the City again.

An Iranian colleague of mine suggested that I inform the Iranian government of the situation through the then governor of the Central Bank, whom he knew, and in June 2001 a letter was written to the governor recommending that Iran should lead the formation of a Middle Eastern Energy Exchange (not an Iranian Exchange) with the express purpose of a creating a "Persian Gulf" benchmark price less prone to manipulation by intermediaries.

In May 2004 we were invited to lead a consortium in creating a new Petroleum Exchange in Iran, and in August 2004 we completed a major "Pre-Feasibility Study." Unfortunately the project was controlled by the Iranian Oil Ministry and it has gradually become ever clearer in the intervening two years that the Ministry has no interest whatsoever in bringing any greater degree of transparency to the market than already existed.

So while cosmetic steps were taken, such as setting up a legal entity, and buying a building on Kish Island which they were pleased to call an Exchange, nothing substantive was ever done, although announcements in the press gave a different impression. Worse than this, the Oil Ministry took the cynical view that the best way to prevent actual progress was simply to fail to pay those commissioned to carry it out for the work they had done – a distinctly un-Islamic approach to business conduct.

However, following our representations earlier this year to President Ahmadinejad, who has always favored the transparency the project will bring, control of the project was recently transferred to the Ministry for the Economy, and is now hopefully back on track.

In the intervening period we have been able to develop our thinking in relation to the architecture of the proposed Exchange, its integration with Iran's financial market infrastructure, and – most relevant to readers of **Islamic Finance** *news* – an entirely new contract design and market structure, or "enterprise model," consistent with Islamic values.

Market architecture

There are two functions which are generic to all markets and, in fact, may be said to define a market:

- the requirement for a legally binding contract – or "transaction registration;" and
- the requirement for "exchange of value" – or "settlement" – requiring transfers of "title," typically in commodities on the one hand and money on the other.

Our strategy in respect of the Oil Bourse is to commence by implementing a simple electronic transaction confirmation mechanism – "OilClear" – consisting of:

- an internet-based confirmation system;
- a "Transaction Registry" database of confirmed contracts; and
- a legal protocol to the effect that the parties agree that they will be legally bound by trades once registered.

At this point it will not be necessary to change any aspect of the existing practice either in relation to how transactions are arranged, how they are performed, or to transparency. However, in view of the sensitivities of the issues in respect of trading and transparency, we will be addressing first the neutral "post-trade" clearing and settlement process.

The outcome will not be an Exchange as we know it, but rather a "Market Network" built upon OilClear transaction registration where members of the market contract directly with each other bilaterally or "peer to peer."

The conventional approach to clearing and settlement is to use an intermediary clearing house (which constitutes a "single point of failure") – whose function is to act "back to back" as a buyer to every seller and a seller to every buyer, thereby guaranteeing their performance.

Our approach is to dispense with an intermediary central counterparty by creating a "Clearing Union," whereby market participants are subject to a mutual guarantee, backed by a "Default Fund" and managed and operated by a "Risk Manager" as a service provider.

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The key to the clearing union and to the contract design, which I will refer to below, is a new partnership-based "Enterprise Model," or legal and financial structure – the "Open Corporate."

Introducing the Open Corporate

A corporate entity is a fictitious legal person capable of owning assets and entering into contracts in the same way as an individual: in other words, it is a "legal wrapper" or vehicle.

In April 2001 the UK Government was coerced by the UK accountancy profession (which had previously "purchased" legislation in Jersey and threatened to go "offshore") into introducing the UK Limited Liability Partnership (LLP). Despite the misleading name, an LLP is not legally a partnership with joint and several liability, but is a corporate body with a continuing legal existence independent of its members. As with a Limited Liability Company, members cannot lose more than they invest in money or money's worth.

Unlike a company, where the legal agreements (Memorandum of Incorporation and Articles of Association) are prescribed by statute, an LLP agreement between members is open. It need not even be in writing, since there are partnership-based default provisions, and it is infinitely flexible, since it may be whatever the members consensually agree.

Crucially, the members have no responsibility for each other's actions individually (as in the "several" liability of a partnership), but rather have a "joint" or collective responsibility bound by the LLP agreement.

This entity has recently been introduced in the new financial centers of both Dubai and Qatar, and is under consideration by other jurisdictions. In tax terms it is tax transparent – that is to say, LLPs themselves pay no tax (unlike companies, which pay corporation tax), but their members do so in respect of income or gains made through the LLP.

An Open Corporate enables a unique synthesis of collective and individual rights and obligations and, in particular, the creation of:

- Clearing unions — linking together consortia of market users with consortia of service providers, and a default fund held by a custodian or trustee.
- Pools of commodities such as oil, oil products and LNG, in which proportional equity shares constitute an entirely new and tradable class of asset-based contracts.

Deficit-based contracts

Conventional futures contracts consist of an obligation entered into at an agreed price to make or take delivery of an agreed underlying or physical commodity or asset at a future point in time.

Because the seller need not be in possession of the underlying, he is therefore able to sell short (i.e. something he does not currently own) and profit from a fall in price by buying back the contract at a lower price. Such contracts are therefore inherently deficit-based.

A clearing house typically requires from both buyer and seller a deposit or margin payment in cash or collateral – increased and decreased relative to the market's volatility – which underpins its guarantee of contract performance.

The fact that a relatively small deposit controls a much larger contract value gives rise to the phenomenon of gearing, and leads to the possibility of rapid speculative profits and losses.

This gearing is exactly congruent to that possible from the use of deficit-based bank credit to acquire property or assets, and the process of margining, which backs a futures contract, is exactly parallel to the process of fractional reserve banking, where credit institutions create credit as a multiple of their capital base in accordance with capital requirements set out in the 1988 Basel Accord by the Bank of International Settlements.

Islamic scholars can be found who are prepared to assert that gearing arising from deficit-based financing and futures contracts is consistent with Islamic values.

Asset-based contracts – introducing the pool

Whereas deficit-based futures and debt contracts rely upon a commitment to exchange value at a future point in time, asset-based contracts are based upon actual ownership within a legal wrapper.

The asset classes with which investors may be familiar are:

- Shares in limited companies such as exchange-traded funds, which own the underlying commodity or enter into derivative contracts in respect of them.
- Units in trusts – a legal wrapper based upon the judge-made legal constructs of trust law.

The enterprise models for both are complex, suffer from taxation difficulties and from well-documented conflicts of interest – the principal/agent problem – with those responsible for marketing and operating them.

The Open Corporate permits what may well be an optimal enterprise model and results in an entirely new asset class – proportional equity shares in asset "pools."

Pool outline

A pool is an Open Corporate with the following members:

- Trustee or custodian – which owns the commodity and possibly also the delivery infrastructure such as storage and processing installations, pipelines and transport.
- Sellers – who produce the commodity and deliver it into the pool.
- Buyers – who take delivery from the pool.
- Investors – who do not make or take delivery of the commodity, but are interested in investing in the pool.
- Managers – who operate the necessary infrastructure.

These members will essentially buy and sell proportional equity shares in the pool.

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A periodic pricing mechanism, possibly utilizing a similar auction mechanism to the London Bullion Market "fix," will be arrived at between buyers and sellers, but without the participation of investors. The resulting "spot" (ie immediate delivery) pricing benchmark will then provide a basis for all other transactions to take place bilaterally on a market network.

The stakeholders' positions are as follows:

- Sellers – sell current and future production into the pool and not only lock in a price for production sold forward (i.e. hedge), but also receive what is essentially an interest-free loan.
- Buyers – may lock in a price to meet future consumption by buying "forward."
- Investors – receive no return on their capital, as they would not if they buy gold, for example, but will gain or lose in line with the movement in the market price.
- Managers – receive proportional shares in the relevant revenue flows, and have an interest in operating as efficiently and effectively as possible, as this will maximise their return.

Outcomes

First, this model creates a single homogeneous asset class of equity shares on commodities, without the fragmentation of liquidity inherent in a cycle of periodic (typically monthly) futures contracts where positions are "rolled over" from month to month at very considerable cost:

(a) between one market constituency and another (dependent on market conditions);
(b) in brokerage commissions and the bid/offer spreads from intermediaries.

Secondly, this model opens up an entire new mechanism for project finance, particularly relevant to the massive investment necessary for LNG infrastructure.

Thirdly, the absence of gearing in this asset-based model, coupled with a partnership-based enterprise model, combine to give an outcome which, it is submitted, few if any Islamic scholars who understood it would be prepared to criticize.

Conclusion

Iran is uniquely positioned to lead the development of new asset-based global market benchmarks in the Persian Gulf and elsewhere, but can only do so in partnership with other producers and consumers.

The proposed market architecture incorporates the logic of the internet, which is to link market participants "peer to peer" globally, and thereby requiring intermediaries to adapt to new roles as value-added service providers.

Most of all, it is intriguing to observe that what has the potential to be an optimal global legal and financial infrastructure – extending to an International Energy Clearing Union – is at its heart entirely in accordance with Islamic values.

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