Role of Energy Charter in mitigating Counterparty risks
World is facing ...

How the unwinding of Quantitative Easing can be expected to affect Oil Demand?

Experts should now very much concentrate on what is likely to happen in near future.

More bad loans may kill their banking industry and lead to deflation with collapse of consumption.

The US is trying to inflate out of Debt Mountain by printing money and debauching dollar.

The second round is now being played in Europe where bank debts are transformed into sovereign debt.

Harsh cuts in welfare and other benefits/ subsidies and hike in tax are causing social unrest.

China is the elephant in the room; no one knows how to control it.

India is unrest in moving Oligarchic Capitalism with a concern of recent INFLATION & Current Account Deficit.

How are these going to end?
Historically, exposure against large, coveted counterparties were considered to be safer, ‘Too big to fail’ as the sayings went.

The conviction was deep rooted that the failure of Bear Stearns in March 2008 which had provided an early and sufficient indication of looming crisis.... was dismissed more as an aberration. This set the stage for a larger crisis....from which the World is not out yet.

Interestingly though, there are no fundamentals to support such a long and low-market sentiments.

Looking back, it is clear that perceived risk of Counterparty default was the catalyst which triggered-off unprecedented crisis in 2008, the impact of which has done damage of unimaginable magnitude on the confidence of investors.
Investment risk & rating

Rating agencies are no substitute for supervision.

Rating agencies have a large responsibility. Their statements have a big influence on the market. They give ratings to companies and sovereigns. Because of the impact, they should disclose their methods. Recently the EU & US decided that there should be an action against the rating agencies. It would have been better if the rating agencies would have been forced to make the methods public.

All rating agencies failed when they gave a AAA to junk. And this practice triggered extra risk taking since one could get rid of the bad things by securitization. The supervisors also failed but maybe they had an excuse because they were asked to believe the market values.
What are risks faced by enterprises?

There are four risks faced by an enterprise:

- Hazard Risk (extreme events, beyond control e.g. natural disasters etc.)
- Operational Risk
- Liquidity Risk
- Counterparty Risk

These topics need special treatment if we plan to mitigate the same.
Counterparty risk

Counterparty risk is the possibility of the other party (parties) to a transaction failing to fulfill its contractual commitment. It may be failure to make the full payment in a timely manner or accept the delivery or do its part of the obligation.

Materialization of Counterparty risk has been the starting of the economic recession in the last three decades (e.g. Bear Stearns).
Counterparty influences
Economy & regions ...

Commonotonicity
What to treat first – the symptoms or the malaise?

- This is a perpetual dilemma. New regulations have been directed towards treating symptoms.
- They carry the central theme of mitigating counterparty risks through measures like CVA, Mark-to-Market, Mandatory Clearing and limit of derivative positions. However, the malaise goes deeper, beyond enterprises to sovereign levels, as we know.
- Energy Charter, an often undermined piece of document...shows us the way.

In few minutes we will briefly review some of the features of Energy Charter which could have possibly minimized the impact of crisis if adopted more widely for bringing cross border harmony in financial services sector across sovereign nations.
Investment protection treaties mitigate political risks?

- This is based on Potential Future Exposure.

- When organization gets bigger, the initial Investment constitute a relative smaller part of the total exposure it carries on and off the balance sheet.
- Protection Investment is a good starting point and politically sounds attractive, however the real counterparty risk lurks under each large transaction.
- The risk could have a the devastating effect on the economy of a country or bloc of countries if Systemic Institutions are party to the transaction with limited ability to withstand the impact.

Political risk is the highest risk factor among the many as the financial markets move forward. These risks would extend to the whole range from sovereign expropriation of property to executive kidnapping, and on to the ravages of war and the redefinition of political boundaries and the imposition of new governments, including the autocratic and dictatorial kind.
Responsible governance as a precursor to confidence in counterparty

- Energy Charter aims to focus the malaise and not the consequential symptoms.
- Energy Charter offers unique model to safeguard the interest of counterparties through Protection of Investment, Compensation for Losses through the mechanism of Most Favored Treatment, Restitution or Compensation.
- Though these measures are directed towards sovereign nations, a private sector entity could structure its involvement in a country appropriately jointly with host country government so that it could stand to gain the protection offered under Energy Charter.

The protection could bring in significant certainty in Investment and the post-Investment phase. These principles are covered within the Articles 10, 12, 13 and 14 of the Energy Charter and provide an interesting range of options. Together these options bind the sovereign in a particular way which would insulate an energy company from the sudden weakness in the position of any counter party in the same geography or location.
Black swan affects price

Oil price ($/Barrel)

Loss for a consumer or trader having a short oil position.

Loss for a producer or trader having a long oil position.

Black Swan Risk

Downside risks to the growth outlook
Bilateral investment treaties mitigate bilateral (political) risks, multilateral investment protection treaties mitigate counterparty risks?

- Energy Charter protects capital investment. Its purview does not extend to energy transactions. So failure of counterparty is not protected under Energy Charter.
- However, the Charter provides measures for legal recourse.

The important challenge is that legal recourse are post acts of recovering monetary loss but can not avert bankruptcy or failure of operating model resulting from counterparty failure.
To mitigate the risk of counterparty failure, Energy Charter should work on creating a large central clearing house to be funded by the member countries. It will be optional to get any transaction greater than €5mn to have it entered through the Central Counterparty.