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Paying for Someone Else's Pricing Mistakes

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March 25, 2015

***farmdoc daily* (5):55**

Recommended citation format: Peterson, P. "Paying for Someone Else's Pricing Mistakes." *farmdoc daily* (5):55, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, March 25, 2015.

Permalink URL http://farmdocdaily.illinois.edu/2015/03/paying-for-someone-elses-pricing-mistakes.html

Prices obtained, or "discovered," through active negotiations between buyers and sellers are considered to be the fairest for both parties, because they provide the highest selling price and the lowest buying price at any particular point in time. However, the negotiation process can require a substantial investment in time and effort. For this reason, many producers have abandoned negotiated prices and instead rely on other people's transactions to determine the price for a purchase or sale.

Two earlier *farmdoc daily* articles (June 25, 2014; October 22, 2014) discussed some of the pitfalls of this approach, with an emphasis on manipulation, or the intentional distortion of prices. The first article reviewed the decline of negotiated prices in many agricultural markets. It also examined the intentional distortion of various "benchmark" prices for interest rates and foreign currencies, and how this has resulted in billions of dollars of losses to customers. The second article examined some of the ways that prices can be distorted in non-competitive markets.

Accidental Pricing Errors

Prices also may become distorted due to technical problems or other accidental factors. This can happen in both competitive and non-competitive markets, and is more common than one might think. Readers may have noticed a price followed by an "x" on a ticker of real-time futures prices or on a quote screen; the "x" indicates an erroneous price. Likewise, most users of historical prices for charting purposes, and nearly all readers of the financial pages in newspapers, have encountered a price that is clearly out of line. The point of these examples is to show how these things can – and do – occur, without any malicious intent. In other words, stuff happens.

Sometimes this "stuff" happens at the highest levels of the federal government. Last Friday, USDA announced that the National Agricultural Statistics Service (NASS) discovered multiple data errors in the March 19, 2015 Livestock Slaughter report that were caused by a data processing issue. The report in question was removed from the NASS website, and a revised report will be re-released as soon as the problem is corrected.

This "stuff" also can happen at exchanges. On March 16 the Commodity Futures Trading Commission (CFTC) issued an order against ICE Futures US for reporting faulty data to the CFTC. Fortunately, these faulty data did not appear on the ICE website or other publicly-accessible venues, so no customers were harmed. The problems were limited to data that ICE provided to the CFTC. Nevertheless, it serves as a useful case study of how things can go wrong, and how difficult they can be to fix.

The cause of the problem was traced to "technology upgrades and data migration projects" and persisted for approximately 325 trading days between October 2012 and May 2014. It affected such things as high/low and open/close prices for futures on coffee, cocoa, sugar, orange juice and the dollar index; and strike prices and settlement prices for natural gas options. Some of the erroneous natural gas prices reported to the CFTC were 1,000 times the actual level.

Why Does This Matter?

Let's bring this issue a little closer to home. Suppose that you have a contract to buy or sell some type of commodity, and the price specified in the contract is tied to a particular price in a particular publication on a particular date. Now suppose on that date, the published price is wrong. Worse yet, it's wrong in the other party's favor. Now consider the following questions:

- Would you even realize the price is wrong? [Unless it's wrong by a large amount, probably not.]
- Even if you realize it is wrong, will the other party in the contract still hold you to the published price? [You can hope for the best, but you should expect the worst.]
- What are your chances of negotiating a "do-over" of the contract? [Somewhere between slim and none.]

After all, your agreement was pegged to an "official" or "published" price, and now you must live with it.

Shifting Benchmarks

Prices also can become distorted by changes in the composition of the benchmark used as the reference price. This often happens when the underlying commodity is no longer available and other, related commodities are used as substitutes. A timely example is the situation in the crude oil market, where Brent crude is the most widely-used benchmark price for oil in the world. But Brent comes from a specific oil field in the North Sea near Scotland, and production has dwindled to just 1,000 barrels – enough to fill about 1½ railroad tank cars – per day.

To obtain the necessary volume for a credible price, different grades of oil from other locations must be included in the calculation. Those different grades, which today make up 99.9% of the so-called "Brent" price, trade at different prices in the marketplace, so each of those prices must be adjusted and weighted as part of the calculation process. Whether or not the final result represents the price that Brent crude would actually trade at, if there were enough of it, is anyone's guess.

Final Impact

In the end, a loss caused by an incorrect price from a typo or a technology glitch, or by a benchmark that doesn't accurately reflect the commodity you are trading, is no different from a loss caused by a manipulated price.

Few people enjoy the back-and-forth of negotiations. But it is the only way that buyers and sellers can be assured of a price that is free from outside distortions, and a price that reflects exactly what is being bought and sold.

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