The Tail Wagging the Dog: Further Developments in the Brent Market

Tuesday, June 26, 2007

In March of this year OilVoice reported that the commencement of production from the Buzzard field through the Forties Pipeline System had led to a decline in the relative value of the Brent international oil marker price. (See The Law of Unintended Consequences: A Change in the Value of Brent Tuesday, March 27, 2007*)

The story took a bizarre new twist at the beginning of June when Platts, a major oil price reporting service used as a data source in calculating oil prices in international oil sales contracts, changed its reporting parameters such that some deals actually being transacted by oil companies in the market are excluded from the pool of data used by Platts to assess the key Dated Brent price marker. On June 18th Platts reported a Dated Brent price that was $0.75/bbl adrift from an actual Dated Brent market transaction. Oil traders are questioning exactly what the Platts Dated Brent price now represents.

Platts' Brent prices are used as the main variable for calculating the prices that apply for:
ÅInternational oil sales contracts from the North Sea, parts of the Middle East, Russia, the Caspian and Africa;
ÅCash settlement of futures contracts on the Brent futures market;
ÅTaxation, profit share and cost recovery in many production sharing contracts;
ÅStrategic oil price hedges; and,
ÅOil field development financing and loans based on Brent-based derivative hedges.

The Story So Far

Since 2002 Forties Blend and Oseberg Blend have been used as substitute grades in the assessment of the international benchmark Dated Brent price. The actual Dated Brent price reported has actually been based on the lowest of Brent, Forties or Oseberg deals done in the market each day. Brent, being of the lowest quality of the three grades, in most cases determined the Dated Brent price quotation unless, because of declining production, a shortage of Brent cargoes led to an artificially inflated Brent price. Since that time Forties and Oseberg have also been used as contractually substitutable grades deliverable into the Brent forward contract i.e. 21-Day Brent/Forties/Oseberg or ó21- Day BFOô.

On 19th April the Platts oil price reporting service announced that, from June 8th, 2007, it would add Ekofisk to the range of grades of crude oil it tracks in arriving at its Dated Brent price assessment. It further stated that it would only report those 21-Day deals done that included Ekofisk as a contractually substitutable grade in the forward contract.

Market players were by and large indifferent to the inclusion of Ekofisk in Dated Brent and , now, 21-Day Brent/Forties/Oseberg/Ekofisk or ó21-Day BFOEô, but were dismayed by the short notice period before the change was to take effect. Pre-existing deals did not provide for the delivery of Ekofisk into a 21-Day contract so traders found that they were not back-to-back and had a contractual mismatch between their purchase and sales contracts. By consensus and to prevent a disorderly market traders agreed to amend all outstanding contracts to a 21-Day BFOE basis: since Ekofisk usually traded at a premium to Brent the financial consequences of the change were limited.

The inclusion of Ekofisk did nothing to address the real issue preoccupying traders at that time: the declining quality of Forties.When the Buzzard field started producing into Forties Blend in January 2007 the quality of Forties Blend fell below that of Brent and Oseberg: Buzzard is of substantially different quality from the rest of the Forties Blend, particularly in its much higher sulphur content. This has meant that Forties now has the lowest price out of the three contractually substitutable grades and is now the grade most usually delivered into the 21-Day BFO contract. It has also become much more influential in setting, and by implication lowering, the value of the Dated Brent price assessment.

Both the forward production profile and the quality of Forties Blend are extremely sensitive to the amount of Buzzard in the blend, but the forward profile of Buzzard is itself uncertain. Tradersô worries about the quality of Forties and the value of their pre-existing Brent contracts focused on the summer maintenance period in the North Sea. With many of the more mature fields in the Forties Pipeline System (óFPSô) down for maintenance in July and August it was feared that Buzzard might prove to be an even higher proportion of Forties Blend and that the value of the Dated Brent international price marker might be depressed even further.

In response to calls from the trading community for further information FPS have started publishing a weekly update of the percentage of Buzzard in Forties both historically and forecast for the next 3-4 months. Based on expected maintenance schedules Buzzard could reach 32% of Forties Blend in August 2007. The sulphur content of Forties Blend cargoes at 0.55%S is already much higher than that of Brent and FPS estimate that, with 32% Buzzard, the sulphur content of Forties Blend could top 0.6%S. API gravity is not anticipated to present a problem.

A Cure Worse than the Disease

On June 7th Platts announced that ówith immediate effectô it will only include Forties transactions in its dated Brent assessment and will only report 21-Day BFOE deals if the seller commits that if it delivers Forties, the cargo will have an API gravity greater than 37 o API and a Sulphur content of 0.6% or less. Platts said that it would ómonitor quality of [Forties] loadings to ensure adherence to these editorial guidelinesô.

On 11th June oil trading consultantôs, CEAG, in cooperation with the law firm LeBoeuf, Lamb, Green and MacCrae held an oil industry briefing at the Guildhall in London to consider these recent market developments and to discuss the implications of the Plattsô announcement. This was attended by major Brent market players, Forties producers, the Oil Taxation Office and the Financial Services Authority. This concluded that, as a purely operationally practical matter, the industry could not give the Forties quality guarantee sought by Platts and therefore the Dated Brent price reported by Platts could no longer be considered representative of actual market transactions if it excludes deals with no quality guarantee. The market might wish to consider a change to the way it traded ï for example, by excluding Forties from the 21-Day BFOE contract- but until it did so, Platts would be at odds with the market reality.

Forties Blend is a commingled stream containing the blended production of almost 60 separate fields and satellites, the output from each of which fluctuates on a daily basis. Production and quality forecasts from each field are provided to the FPS operator, BP, by individual field operators on an annual cycle with regular updates in real time as actual production varies from forecast. With the best will in the world the FPS can only provide indicative forecasts of Forties Blend quality going forward. It would be a brave trader or equity producer who would guarantee the quality of a commingled cargo even in normal circumstances, let alone the circumstances that surround annual maintenance cycles.

To comply with Platts reporting requirements a seller of 21-Day BFOE would, by definition, be required to guarantee 21 days in advance of loading that any cargo of Forties it will deliver will be of a quality that meets with Platts specifications. Sellers of physical Forties cargoes, mainly oil producers, would have to give this guarantee potentially further in advance than 21 days before loading, which is when the majority of physical dated cargoes tend to trade.

If a Forties producer or seller gave this quality guarantee, but the actual cargo presented for loading onto the buyerĝs ship turned out to have a sulphur content of 0.601%, the seller would be in breach of contract. The buyer would be entitled to seek damages or, worse still, could refuse to load the cargo. In the latter circumstances the Forties producer could potentially be forced into a óFailure to Liftô situation under its Joint Operating Agreement with its field partners or its Forties Pipeline Transportation Agreement with BP, with all the consequential losses that that entails.

Unsurprisingly therefore the deals done by Forties sellers or sellers of 21-Day BFOE do not give the quality guarantee required by Platts and are therefore excluded from the Platts assessment process. Consequently, it is difficult to understand the basis on which Platts is currently providing its dated Brent market assessment and its reports of the 21-Day forward market. As stated above, these price reports feed into a range of international contracts, including PSCs, hedges and forward oil field financing transactions.

On June 18th Platts hosted a meeting of industry players, including the OTO and the FSA, to explain its new reporting guidelines and heard strongly expressed criticism of the approach it has taken. At the end of the meeting Platts invited comments from the industry to be submitted by 29th June on how the situation should be resolved.

BP has proposed a solution, which is thought to have the qualified support of two other majors, Stasco and TOTSA. This is that industry players amend contracts such that the price of Forties de-escalates by $0.30/bbl for every 0.1% over 0.6% is the actual sulphur content of any Forties cargo delivered into the physical or 21-Day BFOE contracts. This solution would require the agreement of all the industry players, any relevant taxation/PSC authorities and Platts to be workable. The majors who buy Forties Blend direct from Forties producers on long term contracts are unlikely to be able to impose this amendment on sellers for the key months of July and August when Forties quality is most immediately at risk from maintenance shut downs.

Some small producers with contracts based on the now deflated dated Brent reference price could decide to switch their contractual price source away from Platts to either Argus or LOR to gain more certainty on the meaning of their contractual price. It would be more difficult for major oil companies and traders to resolve the problem in this way because many long term contracts and hedge instruments are locked in to the Platts reference price. To substitute an alternative data source would be to introduce hedge basis risk i.e. hedging the price of apples with a hedge instrument based on the price of oranges.

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http://www.oilvoice.com/The_Law_of_Unintended_Consequences_A_Change_in_the_Value_of_/9190.htm