Oil Price Benchmarks in International Trade
LIZ BOSSLEY argues it is time for another oil change

The Brent market is reputed to determine the price for about two-thirds of the world’s oil trade. Yet Brent is probably the least appropriately regulated commodity market in the world.

The two-thirds estimate is difficult to verify because so much of what is traded takes place in the opaque over-the-counter (‘OTC’) market. Nevertheless the proportion of international oil pricing that relies on a Brent index is undeniably large and is still growing.

While Brent looks set to be caught in the crossfire of the Dodd Frank Wall Street Reform and Consumer Protection Act, particularly the Volcker Rule, the fundamental characteristics of the Brent oil market were changed in January 2012 without so much as the raising of a regulatory eyebrow.

Oil Trading

A quick refresher on how oil trading and the Brent market work:

• When cargoes of physical oil are traded the buyer and seller do not usually agree a price for the oil, for example $110/b. Instead they agree a price formula. There are various ways the formula might be expressed,
but probably the most common is
something along the lines of the
average of the prices of Dated Brent
as quoted by a publication, such as
Argus or Platts, on five days related
to the loading date of the cargo, +/-
a differential to reflect the difference
in the value of the oil being traded
compared with the value of Brent.

- Once sale of the physical cargo
is agreed, the buyer and the seller of
the cargo independently of each other
can unbundle the price formula into
its various components and manage
separately the risk associated with
each component. This allows buyers
and sellers to separate the decision
to acquire or dispose of a physical cargo
of oil from the decision to manage
the net hedged price applicable to the
deal.

On 1 January 2012 some key changes
were made to the five distinct contracts
that make up the ‘Brent’ market in which
elements of a crude oil price formula
can be managed. Prior to that date
the contracts’ characteristics were as follows:
1. Dated Brent is a market in identifiable
cargoes of a basket of crude – Brent,
Forties, Oseberg and Ekofisk, or
‘BFOE’ – with a confirmed three-day
loading date range for delivery in the
next 21 days;
2. Forward Brent known as 21-day BFOE.
This is a contract for cargoes of either
Brent, Forties, Oseberg or Ekofisk with
a three-day loading date range from at
least 21 days in the future up to about
6–9 months in the future. The actual
three-day loading date range and the
grade of the cargo are not known at the
time of the transaction and are
only confirmed by the seller 21 days in
advance of loading;
3. Brent Futures traded in lots of 1000
barrels on regulated futures exchanges
– CME NYMEX, DME and most
actively on ICE. The contract refers
to Brent oil for delivery at a future time
period and is cash settled by reference
to the 21-day BFOE market;
4. Brent swaps and options, otherwise
referred to as OTC Brent derivatives,
that are priced by reference to Dated
Brent, 21-day BFOE or Brent futures;
and
5. The contract-for-difference (‘CFD’),
dated-to-paper swaps market. This is a
market in the price differential between
Dated Brent and the first 21-day BFOE
forward contract. A variation on this
contract is the dated-to frontline (‘DFL’)
market. This is a market in the price
differential between Dated Brent and
the first quoted Brent regulated futures
contract.

These contracts are inextricably
interwoven and provide benchmarks for
the pricing of crude oil as geographically
scattered as North West Europe, Africa,
the Mediterranean, some Middle East
sales with western destinations, some
South American sales and trades in parts
of the Asia-Pacific region, including New
Zealand. Increasingly Brent is providing
the benchmark for US Gulf Coast
imports following the disconnection of the
US domestic market from the interna-
tional sea-going trade. Additionally, Brent
provides a price touchstone for interna-
tional oil tax reference prices and the price
that is used to calculate cost recovery and
profit oil in Production Sharing Contracts
around the world.

The Brent suite of contracts has evolved
over time. From 2002, in response to de-
clining physical Brent production, trades
in cargoes of two additional North Sea
grades of crude oil, Forties and Oseberg,
were considered along with Brent when
assessing the price of Dated Brent. At the
same time Forties and Oseberg were added
to make a basket of grades that could be
delivered into the then Brent forward
15-day market and the notice period was
changed from 15 days to 21 days. This
was done to prevent traders cornering
the market in physical Brent cargoes and
squeezing the forward contract. In 2007,
Ekofisk was added to the Brent basket
and a price de-escalator was introduced to
reflect a quantum change in the quality
of Forties when the lower quality Buzzard
field was added to Forties Blend.

The New Brent Landscape
In summer 2011 the price reporting
agency most commonly used as a Brent
price reference source, Platts, decided that
it would like to consider more cargoes of
Brent, Forties, Oseberg and Ekofisk in
assessing the price of the prominent Dated
Brent marker and would look at cargoes
of the four grades loading up to 25 days
forward, rather than just 21 days forward.
At the same time it announced that it
would like to change the notice period in
the 21-day BFOE contract to 25 days. To
accommodate this change the ICE Brent
futures contract would have to expire
earlier.

Shell International Trading and
Shipping Company Limited (‘Stasco’)
responded in a carefully worded open
letter in its capacity as custodian of
the SUKO90 contract that governs
BFOE trades, i.e. the general terms
and conditions of trade for the 21-day BFOE
contract. This letter pointed out that ‘to
successfully implement these changes,
the four BFOE loading programs will have
to be issued earlier (approximately five
days)’ which requires the consent of
all partners in the offshore joint venture
operating agreements in all four crude
blends. Dozens of agreements involving
an estimated 75-100 companies would
have to be changed formally.

Furthermore, Stasco pointed out, ‘an
extension of the BFOE contract to 25
days calls for a change in the monthly
expiry date of Brent Futures. If the expiry
date remains as it currently is (middle
of month M for the M+1 contract), but
the contract governing BFOE trades is
changed to reflect the 25 day nomination
period, this will result in a lower number
of available BFOE cargoes forming the
basis for the expiring futures contracts.

– This choice will artificially change
the value of the instrument.’

To allow time for all the contracts to be
changed and to ensure that the change in
the futures contract expiry would impact
on the minimum of futures contract open
interest at the time of the change, Stasco
proposed that the changes be deferred
until the first quarter of 2013.

Despite this plea Platts announced
it would introduce its changes from the
beginning of 2012.

Who is the Oil Market Regulator?

ICE scrambled to introduce a new
contract on 5 December 2011 called
‘Brent NX’, to run in parallel with the
existing Brent contract, for deliveries
from December 2012 to December 2019.
The expiry date of these contracts will
be around 8th to 10th M for contract
month M. The expiry dates for contracts
for delivery in March 2015 and beyond
will be the last working day of month
M-2. It is anticipated that the two separate
Brent contracts will eventually become one, based on the revised expiry dates. One might reasonably ask what role the regulator took in approving Platts’ actions. The answer appears to be none. Platts is unregulated. The Financial Services Authority must have been consulted and must have approved the change to the Brent futures contract because that is regulated. However, the value of OTC derivative swaps and options contracts stretching more than five years forward has been changed without a peep out of any regulator. The oil industry does not have a regulator with clear responsibility for oversight of the Dated Brent and 25-day BFOE markets off of which physical and derivative contracts are priced, nor is there a regulator with responsibility for oversight of the ancillary CFD and DFL contracts.

Perversely this lack of regulatory oversight ties the hands of the oil industry in challenging any changes imposed on these price management tools by external parties: there is no regulated forum in which such matters can be discussed and agreed amongst participants and stakeholders without fear of accusations of collusion.

Some of the biggest stakeholders in the Brent market are banks, particularly US banks, who have large-scale, long-term derivative contracts on their books. Yet their voices have been noticeably absent in the debate. This may be because they are preoccupied with fighting a rear-guard action against the US Dodd-Frank Act and the Volcker Rule in particular. Dodd Frank is not directly aimed at commodity markets such as oil, but the oil market is being swept up in its provisions.

**Dodd Frank and Volcker**

Dodd Frank is US legislation that was signed on 21 July 2010, but which has not yet been implemented. It was prompted by the financial crisis that began to unfold in 2008 with the collapse of Lehman Bros. It introduces a much harsher regulatory framework for financial institutions to eliminate systemic risk and to ensure that any adverse consequences arising from trading in toxic instruments fall on the bank doing the trades and on its shareholders and not on the US taxpayer.

Two of its provisions of direct relevance to the oil market in general and the Brent market in particular are: the objective of having OTC swaps and options cleared by regulated exchanges or clearing houses where the risks can be measured and monitored more closely by a regulator; and, the Volcker Rule’s prohibition on banks having a proprietary trading book while offering market-making services simultaneously.

The capture of the oil commodity in the Dodd Frank net is dangerous for the Brent market on several counts:

- it forces highly structured derivative products into the straitjacket of plain vanilla regulated instruments that are inappropriate for the needs of hedgers and project developers;
- it concentrates risk into a limited number of clearing houses just at the time that the market is reeling from the entry into administration of MF Global, allegedly taking supposed segregated client funds with it;
- it makes some of the biggest liquidity providers to the Brent market, the US banks, choose between trading on their own account and offering less lucrative market-making services to risk managers, leaving little doubt as to which way that decision will go; and,
- it misses the fact that one of the biggest commodity markets in the world, oil, is teetering on a crumbling base of North Sea oil production with no effective regulatory oversight of the process by which the base is to be re-enforced.

The simple passage of time will dictate that further fundamental changes will be needed to the Brent suite of contracts as production of the basket grades – Brent, Forties, Oseberg and Ekofisk – declines further.

What is needed is first to take oil out of the scope of Dodd Frank where it does not belong. Secondly, we need an international regulator with an understanding of the underlying business to supervise while the oil industry works out its own solutions to what are purely mechanical and logistical issues, safe in the knowledge that they will not be accused of collusion or market manipulation.