Pay attention – the oil market is changing

Recent changes in the oil trading market and unregulated changes to benchmark contracts, including the debacle on the inclusion of quality escalators and de-escalators in the 25-day BFOE contract, are the tip of a rather large iceberg, writes Liz Bossley*, *CEO of Consilience Energy Advisory Group (research by* James Walmsley*).*

It is an oft quoted, but difficult to verify, statistic that the international Brent benchmark price sets the value of about two thirds of global oil production – between 55mn and 60mn b/d. However, the time to replace Brent as the definitive reference price marker has come and gone. Brent has been a broken benchmark arguably since the mid-1980s, but certainly since the early 2000s. Despite this, we still turn to Brent not only to establish the price of physical oil, but to manage price risk of hundreds of millions of barrels each day using the forward, futures and over-the-counter (OTC) derivative markets. That's because, for all its problems, Brent is still less bad than any alternative benchmark the market has thrown up.

What is Brent?

The Brent market is actually a complex suite of inter-related contracts.

Physical cargoes – This is what is called Dated Brent. As Brent production has declined from a peak of 800,000 b/d in the early 1980s to about 120,000 b/d today, trades in alternative North Sea grades such as Forties, Oseberg and Ekofisk have been included since 2002 in the database used to assess the Brent price each day. However, the inexorable decline in the production of all four crudes continues – the production of all four together has dropped to below 1mn b/d, putting the market on a treadmill of further and still further changes over time.

Forward market – What used to be called 15-Day Brent has evolved over time into what is today a market in 25-Day BFOE (Brent, Forties, Oseberg or Ekofisk). This is a fixed price contract that can be traded months in advance of delivery. The seller only tells the buyer 25 days before a cargo loads whether it will be delivering BFOE and the precise loading date range of the cargo. This was one of the first price risk management tools that emerged in 1981 as the volume of trade in the spot market began to grow, bringing with it the need to manage oil price volatility. The price of 25-Day BFOE is inextricably linked to the price of Dated Brent. Recently, there has been an unseemly squabble amongst some of the major oil companies and one of the main oil price reporting agencies about how this contract will trade from May 2013 (see later in article).

Futures market – This is the one the regulators like because a large volume of trade takes place on regulated electronic platforms that can be measured and monitored. The price and the cash settlement mechanism are tied directly to the 25-Day BFOE price.

Over-the-counter (OTC) derivatives market – The regulators don't like this one because even larger volumes of diverse swaps and options contracts trade in the twilight zone that the regulators don't see and can't measure. These are the contracts that the US Dodd Frank and the European EMIR legislation are trying to shoe-horn onto regulated exchanges. The prices and the cash settlement mechanisms in this market use either Dated Brent, 25-Day BFOE or Brent futures contracts.

The missing link – There is a further OTC contract called the 'dated-to-paper' swaps market, otherwise dubbed the contract-for-difference (CFD) market that trades in the price differential between Dated Brent and 25-Day BFOE. This is an essential tool for the 'trading techies' and, although it is a crucial component of the daily price-establishment and risk management process, it is invisible to the casual oil price observer. This contract had to be created because as the volume of Dated Brent declined there were several attempts to squeeze the forward contract and the price rela-

tionship between the physical commodity and the forward contract used to hedge it broke down. The CFD market allows traders to cope with substantial basis risk between the physical market and the financial risk management market.

The pervasiveness of this evolved web of correlated contracts is what makes it so difficult to abandon the Brent benchmark, even as its feet of clay become all too apparent. However, if you were to set out to design the ideal market today, it is unlikely that Brent would be your starting point.

The ideal benchmark

One of the key prerequisites of a successful benchmark grade of oil is the existence of a market in that grade expressed in $/b, not by reference to a formula. Hence, the most active crude oil benchmarks are those where there is active trading in a 'flat-priced', ie $/b, forward or futures contract. Other key characteristics of the ideal benchmark grade might be:

- A large volume of production, such that it is difficult for any party to 'corner the market'.
- A large number of producers to prevent one company, whether a national oil company (NOC), an oil major or a large independent, controlling supply.
- Stable quality that does not have any particularly difficult physical attributes, so that the grade can be bought by a large number of refiners.
- Good loading terminal logistics with enough storage to accommodate a number of days of production, with sufficient flexibility to handle operational changes and shipping delays.
- Sufficient jetties with capacity to load a range of tankers to optimise freight and promote inter-regional arbitrage.
- A transparent schedule of cargoes so that all buyers and sellers can assess the changing availability of oil on an equal footing.
- Standardised, transparent general terms and conditions of trade (GTCs), so that companies can buy and sell repeatedly on back-to-back terms.
- A benign host government that does not intervene in either price or supply and that permits the free export of oil.

Brent is failing against these criteria on at least two counts. First, production is declining and unless additional grades are added to the contract, the potential for illegal squeezes again rears its ugly head. However, unintentional squeezes also become more likely. We have seen large tranches of oil that would otherwise qualify for delivery into the 25-Day BFOE contract going to South Korea in response to government tax breaks. We have also seen certain refineries suck up increasing quantities of physical cargoes, simply because they like the quality of the oil. That can leave the 25-Day BFOE market bereft of sufficient physical cargoes to function without sudden price spikes.

Secondly, refiners know that when they buy a 25-Day BFOE cargo, the seller will always deliver the least valuable cargo on the day. That didn't matter when each of Brent, Forties, Oseberg and Ekofisk were broadly similar in quality. But when low quality, high sulphur Buzzard entered Forties Blend in 2007, the quality of Forties Blend fell below that of the other qualifying grades and became the default choice for delivery into the 25-day BFOE contract.

The first 'band-aid' that was applied to this variable quality problem was a sulphur price de-escalator – if you receive a cargo of Forties Blend in satisfaction of a 25-day BFOE, you receive a price break to compensate for the high sulphur.

May 2013 changes

On 8 February 2013 Shell announced that it would introduce 'Quality Premia' (QPs) into its SUKO 90 terms, which are the generally accepted terms and conditions of trade within this market. These changes took effect from cargoes delivered in May 2013. The QPs proposed by Shell were designed to incentivise the delivery of something other than the shrinking supply of Forties into the 25-Day BFOE contract. BP quickly expressed its support for this change.

The buyer of a 25-Day BFOE cargo pays the seller a premium if it receives a higher quality grade than trading economics would dictate, ie Forties. These premia therefore incentivise the seller to supply Brent, Oseberg or Ekofisk, not just Forties.

A main price reporting agency for the industry, Platts, disagreed with the level of the QPs suggested by Shell and that they should apply to each of Brent, Oseberg and Ekofisk. Platts preferred to apply QPs only to Oseberg and Ekofisk.

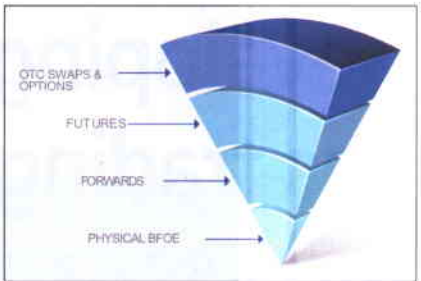

Figure 1: The tip of the pyramid on which the suite of Brent contracts is balanced is a physical market *Source: Consilience*

Platts does not report or assess deals that are not transacted in accordance with its own trading methodology. The industry agreed to adopt the Platts' flavour of QPs from May 2013.

Who is in charge?

The Shell QP idea will not be the end of the story. As production continues to decline additional crudes will have to be added to the BFOE basket, and those grades are likely to be of increasingly disparate quality and to come from further afield. This introduces the prospect of more complex QPs and probably freight escalators and de-escalators in due course.

We are likely to want to hang on to the brand name of Brent as the suite of contracts continues to evolve, but the actual commodity will probably become less and less like Brent over time.

So, who will be in charge of steering the world's biggest oil benchmark through these rocky waters and ensuring that the price that gets picked up by so many contracts worldwide is fair and truly representative of the real market price? The answer is no one. The tip of the pyramid on which this whole suite of contracts is balanced (see **Figure 1**) is a physical market – and no one regulates the physical market. Until we find something better, Brent is too important and too unstable to be tinkered without informed over-sight. Like LIBOR, perhaps Brent should be a candidate for inclusion in the Financial Conduct Authority's new regulation and supervision of financial benchmarks? ●

Liz Bossley is also the author of Trading crude oil: The Consilience guide, *published May 2013.*