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The Law of Unintended Consequences: A Change in the Value of Brent

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When the partners in the Buzzard field chose the Forties pipeline over the Flotta pipeline to bring their oil to market, little did they know as they compared the transportation tariffs on offer that their decision would have consequences for the price of two thirds of the world's oil. Now Buzzard is onstream and the uncertainty surrounding its future production profile has prompted the oil trading community at a meeting in London on 27th March to question Forties' role as a deliverable grade in the influential Brent contract. What they decide has far-reaching consequences throughout the industry.

In 2002 Forties Blend and Oseberg Blend were included as substitute grades in the assessment of the value of the benchmark dated Brent price and as deliverable grades in the Brent forward contract. So what had been 15-Day Brent became 21-Day Brent/Forties/Oseberg or '21- Day BFO'. All three of these grades were very similar in quality and were logical contractual substitutes at that time.

Forties Blend production was boosted in January 2007 by the start-up of the Buzzard field. Buzzard is of substantially different quality from the rest of the Forties Blend. Furthermore, the identification of hydrogen sulphide ('H2S') in some of the future Buzzard producing wells, which will have to be removed offshore before the oil from those wells enters the Forties pipeline, means that the market is uncertain about the forward production profile of Forties Blend and of its quality: Forties blend quality is so sensitive to the amount of Buzzard in the blend that Forties is now jokingly referred to as 'Fuzzard'.

Understandably, the Buzzard partners cannot or will not provide a field production forecast while they consider their options for removing the H2S. Consequently prudent traders assume the worst, namely that if they buy 21-Day BFO the lowest priced grade, Forties, will be delivered and that Forties will get heavier and more sour over time as Buzzard becomes an increasing proportion of the blend. So Brent and Oseberg producers selling into the 21-Day BFO contract can only achieve a lower Forties price for their oil. This is advantageous for refinery buyers.

The price of Brent is used as a reference point in approximately two thirds of international physical oil trades. It is also used as a cash settlement price in the Brent futures contract and in the oil derivatives market, the latter of which is the basis of long term strategic hedges and field financing transactions. The change in the quality of Forties and uncertainty over its future quality has led to a drop in the price of Forties Blend relative to Brent and Oseberg, caused adjustment problems for refiners and re-valued both international physical oil that is priced by reference to Brent and also long term forward oil positions in the derivatives market.

About 50 traders met in London on 27th March primarily to discuss the non-contentious possibility of including a fourth grade, Ekofisk Blend, in the assessment of the value of dated Brent. But at the meeting the idea of replacing Forties Blend with Ekofisk Blend in the 21-Day contract was mooted to restore the value of dated Brent and of the 21-Day contract. A new study by the Consilience Energy Advisory Group Ltd called ‘Brent: A User’s Guide to the Future of the World Price Marker’ (www.ceag.org/whatsnew.html) was cited in evidence that a 21-Day Brent/Oseberg/Ekofisk contract without Forties was feasible.

The study looks at the forward profile of each of the relevant blends and the market shares of all the producing companies in each contractual combination of Brent, Forties, Oseberg and Ekofisk. It concluded that no company would dominate the market if Ekofisk was either added to the contract or used to replace Forties. It also highlights the further risk to Forties quality when the Buzzard share increases as other fields in the blend decline and during periods when other fields in the Forties system are shut down for maintenance.

But the news for Forties producers facing the threat of losing the valuable option to sell their oil into the forward market was not all bad. As Forties becomes more heavy and sour, the quality of Flotta, the North Sea medium sour marker, will become more light and sweet with the start-up of the new Tweedsmuir field, raising the possibility of a 21-Day Forties/Flotta contract. According to CEAG, such a contract could be re-enforced by accepting Russian medium sour Urals Blend as a deliverable grade.

For reasons on anti-trust no single company or group of companies has the power to dictate a change in the way the market trades. When 15-Day Brent became 21-Day BFO, this was achieved by Shell and BP independently announcing that from August 2002 they would only trade the new contract, but that it was up to others to decide if they would participate. The market followed suit. Changing 21-Day BFO to 21-Day BOE and introducing 21-Day FFU would require the same process.

A large number of companies around the world have an exposure to the Brent price: it is used as a tax reference and cost recovery price in many production sharing contracts; producers as far apart as Russia and West Africa buy and sell production by reference to Brent; banks have secured oil field development loans based on Brent-based derivative hedges. All of these stakeholders have an interest in the now reduced forward value of Brent reflecting the lower quality of one of its constituent parts- Forties.

Whether or not the price of Brent will continue to be influenced by the new look Forties Blend, with uncertain quantities of Buzzard included, is now in the hands of about 50 traders.

Source: Liz Bossley (CEO), CEAG