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 cross-fire 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 crudes – 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 inter-twined 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 international sea-going trade. Additionally, Brent provides a price touchstone for international 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 declining 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 contract. ...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-1 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.