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LATEST UPDATE: JUNE 2004

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Platts introduced its new BFO assessment methodology for establishing Brent values on July 10, 2002 after a series of squeezes on the Brent market in the first half of the year undermined confidence in the benchmark. Brent crude oil has since the late 1980s become the key global benchmark price, and crude oils from across the world - Russia, Africa, the North Sea and the Middle East - are tied to Brent assessments published by Platts.

The new methodology was introduced by Platts because over the years Brent production was declining, leaving the benchmark vulnerable to manipulation. In the new system, Platts stated that it would set its dated Brent assessment to reflect the most competitive spot value of Brent, Forties and Oseberg. By setting the assessment at the lowest spot price of the three crudes, the potential for upward squeezes could virtually be eliminated. The new assessment basis would take 600,000 bbl cargoes into account, and changed the time frame reflected in the assessment from 7-15 days to 10-21 days forward. The forward move on the delivery window to 10-21 days forward was put in place to prevent downward manipulation of the price, in case a company tried to dump prompt oil at a low price. Platts was equally concerned about the possibility of upward or downward manipulation. Platts also announced a set of editorial guidelines governing the assessments for a new forward instrument, 21-day Brent.

Platts has in the past made similar changes in other markets where declining liquidity threatened to lead to distorted benchmarks. In the case of Dubai, for instance, where volumes had gone down to 11 cargoes per month and were expected to go down to 6-8 cargoes, Platts in November 2001 made Oman deliverable into the Dubai contract for assessment purposes.

Reasons

The changes were required primarily because Brent production has been steadily declining, leaving the market vulnerable to squeezes. In 2002, the Brent price structure was supported at times by less than 20 cargoes per month. Production had declined from more than 550,000 b/d in mid 1999 to around 360,000 b/d by mid 2002, according to data released by operator Shell. Because there were a small number of Brent cargoes, it was relatively easy to physically buy most of the cargoes and gain control of the Brent programme. When physical control over a benchmark is achieved, prices can be squeezed. This created a paradox: less production resulted in more demand. After one such squeeze in autumn 2000, US refiner Tosco issued a lawsuit against trading firm Arcadia for alleged manipulation of the Brent market. Such squeezes were repeated several times in the first few months of 2002. The price structure of the market was supported by what appeared to be an increasingly creaky foundation.

What were the symptoms of this? The dated Brent, 15-day Brent, IPE Brent and other Brent derivatives became disconnected from the value of similar commodities. IPE Brent and NYMEX WTI

narrowed excessively, for example. The Dated Brent price appeared distorted vis-à-vis other similar physical commodities. In spring 2002, for instance, Brent prices rose because of the squeezes while Statfjord, which is a look alike crude in quality terms, traded at \$1.50/bbl under dated Brent. In short, Brent had ceased to reflect market conditions in the North Sea.

The new methodology dramatically increased the pool of physical supply which could be traded to establish the Brent assessments. In December 2002, for instance, a total of around 79 cargoes of Brent, Forties and Oseberg (BFO) were scheduled to be loaded, according to Platts data. This comprised 20 full cargoes of Brent, 39 cargoes of Forties and 19 cargoes of Oseberg. These were all 600,000 bbl parcels, moreover, whereas previously Brent was loaded in 500,000 bbl parcels. In volume terms, BFO output in December was scheduled at nearly 50-mil bbl in total, a volume which many agree is large enough to make manipulation a logistical nightmare.

Selection of alternative delivery crudes

Platts looked at a number of separate grades in the North Sea which it felt might be appropriate for alternative delivery. These included Forties, Oseberg, Ekofisk and Statfjord. Platts identified a number of criteria that would be required for inclusion in the alternative delivery mechanism: volume; physical proximity; logistical similarities; physical similarities; and price similarities. The overall goal in selecting alternative grades was to avoid distortions in the underlying market.

Using the above criteria, Platts established that Forties and Oseberg appeared to be the most appropriate for inclusion.

In terms of equity ownership, Platts felt that if the re-set benchmark included crude oil that resulted in an over-concentration of power in the hands of any one company, then the benchmark would be handicapped from start. Shell and BP as operators and schedulers of the Brent complex appeared to have a dominant position in the Brent system, but there was a wide range of other equity holders represented in the equity shareholding. Indeed, it has been argued convincingly that the diverse equity structure was one of the early reasons that Brent assumed its dominant position as a benchmark. Platts originally looked at simply making Forties deliverable into Brent positions, but BP's dominant position in this crude (40% of equity) was felt by many in the industry as likely to leave any such Brent Forties contract vulnerable.

Platts then looked at the physical characteristics of the crudes under consideration, and their longer-term price history. Platts found significantly more correlation between Brent and the price of Forties, Oseberg and Statfjord than it did between Brent and the price of Ekofisk. Forties and Oseberg were, moreover, typically at a consistent premium to Brent in normal market conditions while the price of Ekofisk in particular appeared to be more seasonally determined, and was often at a discount.

Because the aim was to stop squeezes by effectively introducing a floating price cap mechanism, therefore, Platts considered Oseberg and Statfjord as well as Forties as it moved forward.

Platts then also reviewed the logistical similarities between the crudes. Because Statfjord is offshore crude delivered CIF in dedicated tankers, the freight rate for which is not separated in the spot price for the oil, this was not a grade which could be easily used to establish price comparability with the FOB grades. Both Oseberg and Forties, therefore appeared to have much closer logistical similarities with Brent.

Platts identified three key problems with Brent late last year, and started actively discussing and proposing solutions to these problems early in 2002. The three main problems were: distortions caused by the issue of operational tolerance; low volumes underpinning the benchmark; and the prompt delivery window. Platts presented its proposals to recalibrate dated Brent at a forum in London on May 9. The proposals were made on the basis of 1) minimizing operational tolerance, 2) setting the assessment in line with the most competitive spot value from Brent, Forties and Oseberg and 3) extending the delivery window. It implemented these proposals with few changes in July, after extensive discussion with the industry.

Ahead of and after the implementation, BP and Shell announced variants on the Platts proposal for the benchmark. While BP sought to trade BFO (Brent, Forties, Oseberg) as a co-mingled over-the-counter forward contract with 20 days notice, Shell insisted that a specific grade needs to be declared at the time of transaction with 22 days notice. Oil major ExxonMobil and trading house Sempra subsequently floated a fresh proposal, intended as a solution to the BP/Shell standoff, which applied penalties for delivery of alternative grades. ExxonMobil suggested that sellers with the option to deliver either Oseberg or Forties into the new BFO contract instead of Brent pay a penalty of 5 cts/bbl, and Sempra made a similar proposal but with the penalty at 20-30 cts/bbl.

Norway's Statoil on July 10 became the first trader to offer on a Brent-Forties-Oseberg (BFO) basis in the crude forward market. Trading company Phibro sold the first full cargo of BFO to BP, with a 20-day nomination. Trading activity was sporadic through August as the industry struggled to come to terms with the new contract; for a while, it appeared that liquidity had suffered from the multiple different contractual bases that had been proposed. After BP on August 19 announced that it would follow the 21-day procedure, a broad consensus for the Platts proposal then rapidly emerged. Within days, ExxonMobil became the first company to nominate a physical crude cargo into a 21-day Brent-Forties-Oseberg (BFO) forward position.

London's International Petroleum Exchange announced on Sep 5 that it would switch the basis of the mechanism it uses to establish its monthly Brent index settlement to reflect the new Brent-Forties-Oseberg (BFO) North Sea crude contract, with immediate effect. The October IPE Brent contract was the first monthly contract to be settled using the new methodology. The New York Mercantile Exchange said it was using Platts' new 21-day Brent-Forties-Oseberg (BFO) assessment for the expiration of

its Brent contract "by default", because Platts' monthly Brent index determines the NYMEX Brent contract settlement.

Separately, publisher Petroleum Argus announced on Sep 18 - two months after Platts changed its methodology - that it would publish forward and dated Brent-Forties-Oseberg assessments from Sep 23.

Impact of the change

Platts retained the term Brent in its crude assessment tables. Key Brent over-the-counter derivatives moved seamlessly to reflect the changes in the underlying assessment methodology. Weekly and monthly Brent Contracts for Difference and Dated-to-frontline swaps, which use Dated Brent as one of their two index prices, reflected the new Dated Brent methodology without any need for changes to the wording on contracts, which can be written a number of years forward. "In a legal sense, nothing has changed. There is still a Dated and an IPE," one prominent Brent player said.

In terms of price impact, the goal of eliminating price distortion appears also to have been largely achieved. Platts has tracked the impact of the methodology change on key components of the North Sea crude market, and our preliminary conclusion is that prices now reflect better North Sea fundamentals. Volatility has declined, and spread relationships have become more steady.

Critics of the BFO concept feared that the new benchmark would lead directionally to markets being in contango. Platts was confident that BFO would reflect actual North Sea fundamentals and markets would be in contango when there was surplus and in backwardation where the market was tight. In the six months since BFO was implemented, the benchmark has reflected a contango because of the surplus early in the year, and backwardation by the year end as tightness followed additional Saudi cuts and problems in Venezuela. Interestingly, in the tight market, all North Sea grades rose and not only Brent as was the situation in the past.

Platts pro-active role in reshaping the benchmark was controversial, as it was in the case of Dubai. People said, "Platts is a publisher. It should not tell the industry what to do." Yet the problem of declining production of benchmark crudes was one that the industry had failed for years to solve itself.

Platts market coverage is based on the principle that prices can be discovered through a process of market examination and analysis, and that commodities have implicit values, even when they are not being traded. A Platts assessment reflects the level at which a commodity has traded, or could trade. Platts takes a similar approach to each market, talking to as many participants as possible and seeking to confirm all information published.

The key to being effective in this assessment role is that Platts is completely independent. All reporters sign a code of ethics document which prevents them getting involved in the markets they cover, so there are no conflicts of interest. So when Platts delivers what the market needs - impartial, transparent information; benchmarks for contract settlements; fast updates on market conditions and real-time news - the industry is sure that they are coming from a source that is unbiased.