

Hedging Dated Brent

Brent CFDs (Contract For Difference) are short-term swaps, which are quoted typically for a full Monday-Friday week forward or a week spanning Wednesday to Tuesday, but which may also cover shorter or longer periods, for example a couple of days or a month.

Some confusion has been created in the past with regard to the term 'Contract for Difference', as essentially all swaps trades are generically a type of "contract for difference". They are all a means of trading the difference between a fixed price agreed between two counterparties, and a floating average or index price over the stated calendar period of the agreed contract.

Brent CFDs however, have a very specific definition, and one that unusually covers the differential between two different Platts' quotations. They are talked and traded up to six weeks ahead of the current date at any one time and represent the market differential in price between Dated Brent and the forward month cash contract, ie the forward month '15-day Brent' cash contract.

It is important to remember that the forward month cash contract continues to be quoted by Platts after the futures contract for the same month has expired. For example, on Oct 19, 2001, the first three months for Brent futures quoted on the International Petroleum Exchange (IPE) will be December 2001, January 2002 and February 2002, the November contract expiring Oct 16. However, the first three months for the 15-day Brent cash contract as quoted by Platts will be November 2001, December 2001 and January 2002. The November 15-day Brent cash contract will only expire Nov 9.

A large number of other crude prices are related, by means of a price differential, to Dated Brent. For example, prices for Norwegian Ekofisk, Nigerian Qua Ibo and Russian Urals are all expressed as differentials to Dated Brent. When a trader buys or sells a cargo of physical oil they will do so at a differential to Dated Brent. The differential to Dated Brent is fixed when the deal is done, but buyers and sellers are exposed to the floating price of Dated Brent, which will typically only be known when the cargo loads. Players in these markets are able to hedge the Dated Brent part of their exposure with Brent CFDs.

Declining production levels for Brent has necessarily impacted the liquidity of Dated Brent as a tradeable spot crude, and suspicions regarding the manipulation of its price have contributed to the desire of players, who are exposed to Brent price fluctuations, to use CFDs to shift or hedge this price exposure. Brent CFDs are one way for players with direct exposure to the price of Dated Brent to move their price exposure into the more liquid 15 Day Brent cash market.

CFDs may alternatively be seen as a speculative play on the very front of the Brent forward curve. As such their values are heavily influenced by short-term changes in the very inelastic levels of supply and demand for Brent crude at the front of the forward curve. Unless booked out, all 15-day Brent cash contracts eventually have to be settled with physical Brent cargoes so there is a gradual convergence between forward CFD values and the price of Dated Brent in the spot market.

Examples:

1. A trader decides to sell a Brent CFD for the week of Oct 22-26 at December minus 80cts/bbl. Over that week (assuming the trader runs the swap to maturity rather than trades out of it), if the mean of Dated Brent averages more than 80cts/bbl below the average for December '15 Day' cash cargo quotations, then the trader will make a profit. The buyer of the swap will have equal but opposite exposure to the differential, and will want the differential to narrow rather than widen.

2. Rather than use the CFD speculatively, it can be used as a hedge. If a trader sells a Urals cargo pricing in the Oct 22-26 week at a differential to Dated Brent, he will get less money if the price of Dated Brent falls, versus the relevant 15-day cash contract between the time the deal is done and when it prices in Oct 22-26. To lock in the value of Dated Brent at the time he sells the Urals cargo he can also sell the Oct 22-26 CFD at a fixed differential to the cash contract. If Dated Brent falls relative to the 15-day cash contract, he will at least partially recoup any loss via his sale of the CFD. Equally, if Dated Brent rises, relative to the 15-day contract, he will lose any gains made on the Dated Brent part of the price of the Urals cargo to the loss made on the CFD. The trader is still exposed to the level of the 15-day cash contract, but has locked in the value of Dated Brent, relative to that 15-day contract.

3. If a trader is long a 15-day cash cargo and it is approaching the time when the contract will have to be settled with a physical cargo, ie Dated Brent, then he may wish to hedge against any fall in the level of Dated Brent relative to the 15-day Brent cash contract. Typically, if the perception in the market is that Dated Brent is about to fall relative to the 15 Day Brent market, then the current market differential, at perhaps only 80cts/bbl below the December cash contract may be expressed as December minus 100cts/bbl in the CFD swap market. However, if a holder of a long 15 Day position does decide to sell this CFD, and the value at maturity of the CFD is December minus 150cts/bbl, then he will at least have eliminated 50cts/bbl of his potential losses. The concern is always between the relative values rather than their absolute levels.

Further sophistication in "Curve-lock" trading can be achieved by trading rolls between the individual CFD weeks. For example, by selling the Oct 22-26 week and buying the week of Dec 5-9, if the trader believes that the two relative values are likely to change (Dated Brent fall relative to the 15-day market) the most between those two periods.

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