PORTLAND MARKET REPORT

MARCH IN VIEW

IMPLICATIONS OF CHANGES IN THE REPORTING OF CRUDE OIL PRICES

It is either a brave or delusional man who thinks he can write an interesting article about oil price indices! But the reality is that there are some fairly chunky changes taking place in the way that crude oil prices are to be reported and these changes will affect not only the billions of dollars of commercial oil contracts executed every single day but also one of the key measures that the world has come to rely on with regards global economic health.

How the pricing of North Sea oil came to be such an important global economic benchmark is worthy of a whole article in itself but, suffice to say, North Sea oil is the marker price for oil traded around the world.

> "DECLINING OUTPUT IS SOMETIMES FALLING BELOW THE BASELINE"

When people refer to the oil price, what they are really talking about is North Sea oil and fully 70% of the world's production is priced off North Sea grades. The specific grade in question is commonly referred to as 'Brent', after the original 1970's field of the same name. In reality, the 'Brent' price is actually made up of several different North Sea crudes – including Brent – but also including Forties (UK sector), Oseberg, Ekofisk and Troll (all Norwegian sector). All of the 'Brent' grades have similar high quality, low-sulphur characteristics, which give them a higher market value than heavier, 'sourer' crudes from elsewhere. Furthermore, North Sea oil is sold direct to ship (FOB = Free on Board) for onward distribution around the world, making it a 'pure', free-market oil price, tainted by neither logistical complications nor political interference.

For the last 10 years though, 'Brent' has faced a growing existential crisis, born out of dwindling supply. As the North Sea oil fields mature, so production diminishes, which means far less 'Brent' can be bought and sold. Back in their heyday, the Brent fields were producing as much as 2m barrels per day (bpd), allowing multiple trades of the black gold on a daily basis. But the problem now is that declining output is sometimes falling below the baseline 1m bpd mark and in recent pandemic-struck months, volumes fell as low as 400,000 bpd (less than 0.5% of global oil production). If we deduct product sent by pipeline direct to the UK mainland, this leaves enough oil for barely 1 or 2 international trades per day – hardly the sign of a robust market, underpinning everything from oil, derivatives and gas contracts, to inflation indices and investment funds.

Which is why there is now the radical suggestion to include West Texas Intermediate (WTI) in the Brent pricing pot. From a technical perspective there is some sense in such a move, as WTI is a 'sweet', light crude (high quality), just like its North Sea counterparts. But, commercially speaking, this is a truly seismic proposal. Historically, WTI has been sold to the US inland market, which means it reflects a set of American commercial fundamentals that are frequently very different to the seaborne crudes of the North Sea that serve the rest of the world. Equally significant is the fact that, by including American oil in a North Sea price basket, by definition, that oil must be delivered to the North Sea region (a so-called 'CIF' price – Carriage, Insurance & Freight), as opposed to the current FOB nature of Brent sales.

The terminology may be confusing, but the outcome is very simple. An FOB cargo sold direct to ship represents a core product price, whereas a CIF North-West Europe price has to account for 2 'alien' factors. Firstly, it has to reflect the source of the crude (in this case, the USA market) and secondly, it has to include the cost of shipping from the USA to Europe. In both cases, divergence from North Sea economics is easily possible and very likely. If the US oil market goes haywire (for whatever reason), it doesn't necessarily follow that the world economy will follow suit. When it comes to freight, the obvious statement is that shipping adds cost, but also the freight markets themselves are notoriously volatile, which means further unpredictable dynamics are added to the price of (Brent) oil.

Seemingly then, the addition of US crude to a North Sea basket makes little sense, but the core conundrum of declining North Sea production still remains. Price regulators argue that, without a supplemental grade being added to the Brent basket, the North Sea can no longer justify its over-sized importance. They also argue that, since the US shale boom and resultant increases in American oil exports, WTI is already the mainstay of North West European oil trading, with over 450,000 barrels arriving in ARA (Antwerp-Rotterdam-Amsterdam) every day. And then there are the cynics who point out that a market friendly American crude is far more desirable than adding one of the Russian blends or, alternatively, relying on the Chinese dominated oil exchanges of the Middle East (eg, Dubai Mercantile Exchange).

That takes us back to WTI as the 'least worst option'. Of course, numerous interested parties will still want to have their say over the next few months. Producers, refiners and traders will have to decide what changes need to be made to supply contracts (some of which are 10-year term deals) and the commercial consequences of those changes. Then all eyes will turn to the paper market because, unless the likes of the Intercontinental Exchange (ICE) and New York Mercantile Exchange (NYMEX) agree to these changes, the trading liquidity that is the foundation of oil markets will be lost. And, all the while, you can expect HMRC and other tax authorities around the world to also take a very keen interest, as numerous Petroleum Revenue Taxes are calculated against Brent.

> "ONE OF THE KEY MEASURES THAT THE WORLD HAS COME TO RELY ON"

Expect this one to run for a while yet. Like the super-tankers that carry the oil, when it comes to pricing mechanisms, making directional changes is a slow and cumbersome process. Northing will happen before 2022 and quite possibly, the issue will be kicked further down the road to 2023.

For more pricing information, see page 22

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