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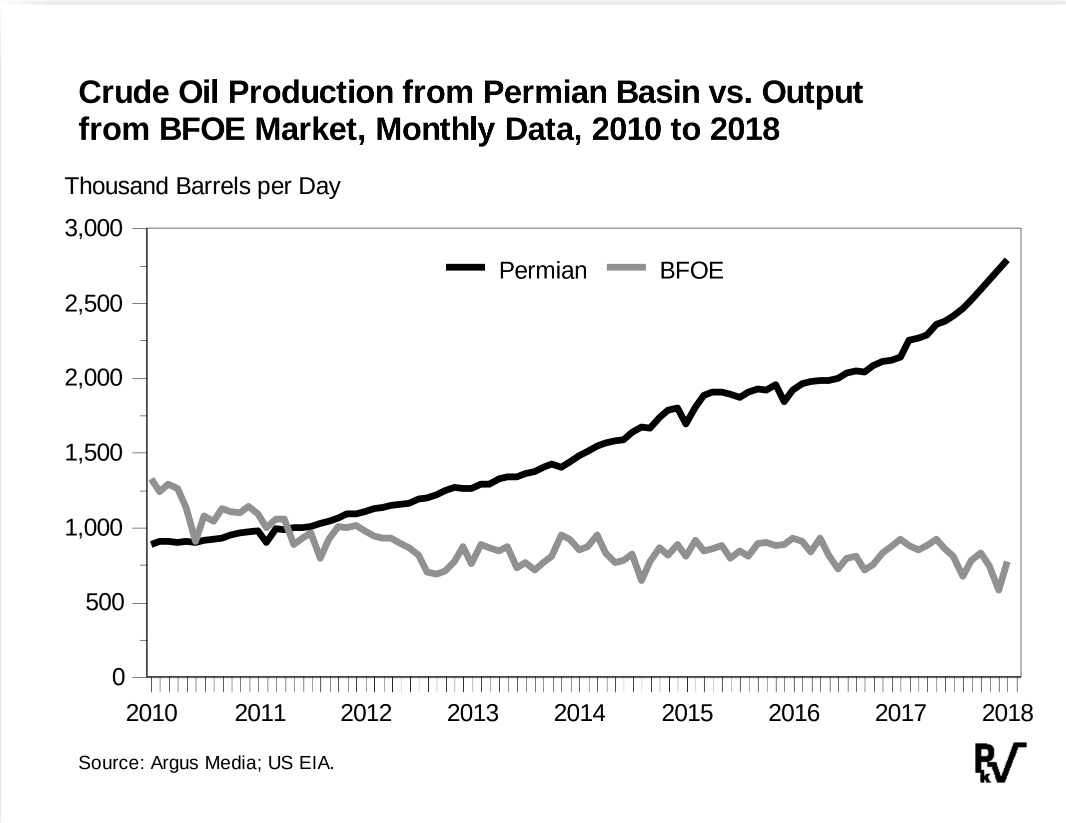
Brent Is Dated



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Summary

The market for Brent crude oil in all its dimensions was an improbable price benchmark for the global crude oil trade. For most commodities, the price of the variety produced in the largest amounts is used as the benchmark. This is true, for example, for wheat, coffee, and corn. It is also the case with many other commodities.

Brent is not and never has been the crude oil produced in the greatest amounts. At its height, Brent production represented less than two percent of global crude supply. In contrast, Arabica coffee—the benchmark for coffee trade—accounts for more than sixty percent of global production. The key types of wheat used in the CME contract for the grain account for one hundred percent of US production.

Brent is an anomaly. Yet for thirty years, estimates of its price determined what buyers paid and sellers received for perhaps two-thirds of the oil moving in global trade. The price of "Brent Blend," technically the mix bought and sold, was maintained as a benchmark through the development of various trading tools, the oil industry's efforts, and the hard work by price-reporting agencies (PRAs). Futures markets were developed and linked through cash settlement to the Brent Blend. Traders in the industry agreed to trade cargos in a forward market. "Partial cargos" of fifty thousand barrels were introduced to boost market liquidity.

It is a system that survived because it worked for the sellers and buyers of crude. While senior executives of the major oil companies might once have wished the market had never been created, their successors embraced it warmly.

Today, however, Brent's usefulness is over. The volume of Brent crude produced from the North Sea has shrunk to a trickle, as our cover graph illustrates. Volumes of the other crudes now considered part of the "Brent Blend" and used to increase the size of the market surveyed by the PRAs are also in decline. Alone, Brent constitutes less that 0.05 percent of global production. The output of the four BFOE crudes[1] surveyed by the PRAs to establish the Brent price represent less than 0.8 percent of world output. The North Sea market remains very modest in the global oil scheme.

The North Sea market is being replaced by newly developed crude markets in the United States. The shift began after Congress repealed legislation that prohibited exports of domestically produced crude, a ban dating back to Richard Nixon's administration. The reversal occurred because technology has morphed the United States from an old, tired, depleted oil province into one of the world's largest producers. By 2020, the country will be the world's largest producer.

The technology, fracking, has generated very large and growing streams of light sweet crude oils much like Brent and other North Sea crudes. Entrepreneurs in an extraordinarily competitive market have rapidly added the transportation and storage networks that facilitate the operation of well-organized commodity markets. The total supply from this new market already represents six to eight percent of world production and, by 2020, may represent twenty percent if the volumes flowing from Canada to the Gulf Coast are included.

[1] Brent, Forties, Oseberg, and Ekofisk.

This expanding market is also highly competitive. The US production surge is being driven by over one hundred different companies, which include the traditional integrated oil majors and some very small operators. The level of competition as measured by the number of firms active is very like the oil business during the boom times in the 1920s and 1930s. Then, as today, any businessman with adequate capital and access to land could hire the services required to become an oil producer. Such competitive markets are the ones that oil barons such as John D. Rockefeller dreaded.

Today's market is bolstered by sophisticated enterprises that provide the transportation, storage, and marketing expertise required in the modern oil world. In addition, two liquid, well-capitalized futures markets enable participants to hedge future revenues.

The US Gulf Coast market has become a complete competitive commodity market. Today, the growth of this market is being led by the surge in West Texas Intermediate (WTI) crude delivered to Houston. The WTI volumes alone now exceed the total oil produced in the North Sea. These volumes could easily double in the next year or two as new pipelines to Houston are constructed and more wells are drilled in the Permian.

These developments will end Brent's days as a global crude oil price benchmark, especially as larger and larger volumes of light sweet crude flow from the Gulf to European refiners. Brent today is dated. Its time has passed.