

## Oil Price Benchmarks in International Trade

### GIACOMO LUCIANI urges Gulf producers to be more proactive in creating a market for their crude

Speaking at the inaugural session of the World Future Energy Summit in Abu Dhabi, Chinese Prime Minister Wen Jiabao, was quoted as saying: ‘To stabilise the oil and natural gas market, we may consider establishing, under the G20 framework, a global energy market governance mechanism that involves energy suppliers, consumers and transit countries.’ (...) ‘We need to formulate ... binding international rules through consultation and dialogue, and set up multilateral coordination mechanisms covering forecast and early warning, price coordination, financial regulation and emergency response.’ (emphasis added)

On the same day, the Saudi Minister of Petroleum, Ali Naimi in an interview with CNN said: ‘Our wish and hope is we can stabilise this oil price and keep it at a level around \$100 a barrel. If we were able as producers and consumers to average \$100 I think the world economy would be in better shape.’ A few days later, the recently appointed Governor of SAMA – Saudi Arabia’s central bank – said that the Kingdom would offer excess oil production capacity if needed to balance oil prices, and that he expected prices to stay stable.

It is then evident that the issue of price ‘stability’ remains very much a concern of major importers and exporters alike – notwithstanding that, relatively speaking, prices have been rather stable since the spring of 2009. This should be no surprise, because relative stability is explained by contingent circumstances, and may not last long. A structurally unstable market may well display temporary stability.

Tight liquidity and credit conditions obviously are an obstacle to speculative

position taking, and the appetite for risk remains quite scarce. Lingering doubts about the strength and persistence of a global recovery cast a shadow on the otherwise prevailing narrative – which insists on investment on new oil production capacity being insufficient and supply being inevitably tight in the middle of the current decade.

Developments in the United States – the rapid increase in ‘light tight’ production and the macroscopic dislocation of WTI, which has only partially been reabsorbed – also discouraged the formation of a new price wave, although their significance for global supply/demand equilibrium is manifestly limited.

Yet it is not difficult to see how either geopolitical developments (sanctions on Iran, even if there is no attempt at closing the Strait of Hormuz; or a worsening of security conditions in Iraq, leading to an evaporation of the prospect that Iraqi production may soon significantly increase); or simply a consolidation of growth in the United States and enough of a continuation in China, may again convince the market that oil prices have only one direction to go, and that is upwards. Then expectations will turn into self-fulfilling predictions, and investors will push prices up, waiting for others to let them climb further.

The inadequacy of policy instrumentation proposed in order to achieve price stability borders on the incredible. Ali Naimi has no other tool in his box except issuing declarations: ‘Our wish and hope...’, but no indication whatsoever of steps to be taken to obtain the desired result. Even the intent of the Minister has largely been misunderstood in the press, that read it as a target, a minimum

level of prices acceptable to the Saudis, up from the \$75/b that King Abdullah had described as ‘fair’ three years earlier. In fact, the Saudi Minister cannot ignore that the King’s ‘fair’ price has been exceeded systematically since early 2010; and even his desired price of \$100/b is lower than the front month Brent price has been for most days in the past year.

At the opposite extreme, the Chinese Premier’s suggestion that the G20 moves to establish ‘binding international rules’ ‘covering forecast and early warning, price coordination, financial regulation and emergency response’ demonstrates little understanding of the functioning of oil markets.

In fact, it would be possible, through a package of coordinated policy initiatives, to achieve greater stability and predictability in oil prices; but the exercise must be rooted in the reality of the oil market as it exists today, introducing gradual change rather than imposing political or administrative controls.

The most obvious weakness of the current market organisation is its reliance on two benchmarks – WTI and Brent – whose validity for global oil price discovery has been continually eroding, and is now highly questionable.

In the case of WTI, insufficient pipeline capacity to pump crude oil out of Cushing has led to a prolonged disconnect between the two markers. Although the situation has improved after it was announced that the flow of the Seaway pipeline is to be reversed, this is hardly a longer-term solution, considering that production in the Midwestern states is expected to increase significantly. At the time of writing, the net impact of President Obama’s rejection of the

Keystone pipeline project is not yet clear. In any case, it is now evident that the price of light, sweet crude for delivery at Cushing is influenced by inland US logistics much more than by global demand and supply. One can hardly see how the Nymex contract may continue to serve as price discovery or hedging tool for seaborne crude oils, whether imported into the United States or traded between non-US parties.

Brent has fared better, but the physical base of it, notwithstanding the enlargement of the pool to include Forties, Oseberg and Ekofisk, is dwindling. In addition, the trade is moving rapidly towards the East, and it is not at all clear why Gulf crude sold to China, Japan or Korea should be priced out of a North Atlantic base.

Yet a benchmark, once established, attracts liquidity; and liquidity attracts further liquidity. Such circularity creates an extraordinary inertia that makes it extremely difficult for one or more alternative benchmarks to arise and syphon liquidity away from established benchmarks, even if the latter are ailing and increasingly unreliable. Nevertheless, immortality cannot possibly exist even for benchmarks: sooner or later shifting equilibria and market realities will impose a realignment of the market around one or more new markers.

The issue therefore is whether it is preferable to keep patching up benchmarks whose validity for price discovery has almost completely waned, or to move in the direction of facilitating a transition.

How can a transition be sought? Obviously we should be looking for alternative benchmarks and move in the direction of designing a market based on them. There is no simple solution to this puzzle, but several alternatives can and should be explored. The community of predominantly physical traders should actively engage in this exercise.

Solutions that have been proposed include an Eastern Mediterranean base (e.g. Ceyhan, where Azeri, Iraqi and possibly Russian and Kazakh crude oils may converge, if the Samsun-Ceyhan pipeline is ever laid. Alternatively, Novorossiysk may be considered as a base for Russian, Kazakh and Azeri crude, although the lack of a by-pass offering an alternative to passage through the Turkish Straits is a major drawback. Furthermore, both of

these alternatives may still be too 'Western orientated'. The ESPO pipeline has been suggested as an alternative base for trading Eastern Siberian crude in the Far East. All of these possibilities may be worth exploring.

However, it is clear that the only longer-term solution to having a truly global marker is to base one on oil exports from the Gulf. The Gulf is and will remain the origin of the most important crude oil flows, serving markets all over the world. A stable global oil market can only be based on a Gulf marker.

That requires that the Gulf oil producers – Saudi Arabia first and foremost – accept that their oil be traded. They could take a 'permissive' attitude – simply scrapping destination restrictions, and allowing a secondary market to develop in their crude qualities. Or, and in my opinion preferably, they may take a more active stance, and design the rules on the basis of which they themselves, either individually or as a group (GCC), will create a market for their crude.

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The way in which this can be achieved is through controlled auctions for primary sales – i.e. the sales from the NOC of the relevant country to third party buyers. Auctions should be conducted at frequent intervals with no ex ante engagement as to the quantities that will be sold. The seller will receive bids for how much each buyer is ready to buy at which price, and will simultaneously decide on the quantities that are to be sold and at which price. Primary sales should preferably take place well in advance of the delivery date (perhaps three months forward) so that buyers will have an opportunity to trade on the secondary market until the oil is actually lifted.

If well implemented, this mechanism will give the major Gulf oil-producing countries the possibility to credibly influence prices. If applied too rigidly, the mechanism may even freeze prices for a

while, but this would not be wise on the part of the producers. They should rather allow market forces to emerge through the auctions and secondary trading, and constantly adjust prices, at the same time keeping variations under control.

The smooth functioning of a cleverly designed, Gulf based oil marker may further be enhanced by some other emerging trends. The most important is probably the tendency among Gulf NOCs to invest in refining both domestically and in key markets abroad, thus selling more of their oil as products rather than crude. Under the leadership of Khaled al Faleh, Saudi Aramco now envisages lifting its refining capacity to 8 mb/d, with a large share located in China. It is not by chance that the company has launched the Saudi Aramco Products Trading Company, which became operational in the early days of 2012. Products sales are necessarily much more closely related to specific demand conditions in the various national markets, and less vulnerable to the influence of financial variables.

Another key trend is the rising importance of Far Eastern markets – notably China. China can offer something that the free markets of the industrial countries cannot offer: demand security. The latter is very important for the Gulf producers, and the key to ensuring that sufficient investment will go into production capacity. We should not be surprised the day that we shall witness the birth of a 'China Medium Term Oil Price', in the context of long-term supply agreements that are already implicit in decisions concerning refinery investment localisation.

In other words, it is not at all to be excluded that the oil market might evolve in the direction of being less global and more regional – thus coming to more closely resemble the natural gas market. With WTI increasingly reflecting domestic US conditions, and trade between the Gulf and the Far East closely controlled by governments, multiple regional prices may well become the rule. Arbitrage would still be possible, but not to an extent that would eliminate differences.

The ensuing 'fragmentation' of oil prices may well increase the influence of fundamentals, encourage divergent expectations, and, in the end, lead to a more stable and predictable system of oil prices. ■