Towards a Middle East Trading Ecosystem

OWAIN JOHNSON

DME Oman is emerging as a powerful third benchmark for global crude oil trade alongside WTI and Brent. The recent sharp upturn in trading volumes on the Exchange has been in part driven by improvements in the way the DME operates but is also due to two powerful additional factors: regulatory headwinds that are encouraging market participants to opt for regulated futures benchmarks and, secondly, a drive from Asia to establish its own crude oil benchmark.

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The DME is also benefiting from the development of a genuine trading hub in the United Arab Emirates, with a large number of trading houses and brokers establishing operations in Dubai. The Dubai–Abu Dhabi corridor is already well established as a regional financing hub, while substantial investments in infrastructure in Fujairah and the upcoming Ras Markaz Crude Oil Park in Oman are providing the physical underpinning that will support the further development of the Gulf markets.

The Mideast Gulf has traditionally been considered solely as a supplier of unprocessed hydrocarbons in the form of crude oil and LNG. Domestic markets were traditionally short of refined products but until recently were relatively small. However, in recent years the region's import–export dynamics have been changing rapidly and this is leading to the development of different trading practices and to a need for new benchmarks.

Domestic demand for energy in the Gulf Cooperation Council (GCC) countries is booming as populations grow sharply. GCC population growth is 3.2 per cent per annum compared with the global average of 1.2 per cent. The population growth is exacerbated by high energy demand use in the GCC, with the population of the Gulf poised to surpass the USA as the world's most intensive users of electricity.

The need to supply a booming domestic market has led national oil companies (NOCs) in the region to invest heavily in the development of refining capacity. Between 2014 and 2017 an additional 1.6 mb/d of refining capacity is expected to come on stream, according to consultants Facts Global Energy.

This additional capacity should convert the region in the medium term into an export hub for some refined products as well as enabling some crude oil exports to be diverted into the domestic refining complex. These new dynamics are also presenting trading opportunities to NOCs, leading to the establishment of firms such as Oman Trading International and Saudi Aramco Products Trading Company.

A Post-Dubai World

As the GCC grows in importance as a trading hub and as activity increases on what has been termed the New Silk Road between the Middle East and the north Asian economies, the significance of the region having its own pricing points has also grown.

The Mideast Gulf has traditionally used either Singapore or Rotterdam-based pricing for its refined products markets while for crude oil, regional players have used assessments of Middle East crude oil established by predominantly Singapore-based traders and assessed by the price reporting agency Platts.

It is hard to imagine that this reliance on external pricing can long survive the development of a vibrant trading scene in the Middle East. The supply–demand balance for fuel oil at Fujairah, for example, is so different to that in Singapore that relying on pricing from Asia as a basis for trade means that

differentials have to be constantly adjusted to bring outright prices into line with where the outright market in Fujairah is trading.

Of all of the pricing benchmarks in the Middle East, the Dubai crude oil assessment is perhaps the most vulnerable to the new trends in both regulation and the development of an indigenous trading ecosystem within the Middle East. The Dubai assessment process suffers from both low levels of trading activity and from very low numbers of participants, with many segments of the crude oil market not represented in price determination.

New Contenders Emerge

Many parties, including ourselves at DME, are positioning themselves for a post-Dubai world and the issue of the 'third benchmark' – the Asian equivalent of WTI and Brent – has become a staple discussion point for boardrooms and industry conferences alike.

DME is currently the leading contender as it has a track record of six years and enjoys the support of the world's largest commodity exchange, the CME Group, and of Oman, which is the largest non-OPEC producer in the Gulf. The DME's price settlement process – the average of all trade taking place at 4.25–4.30 p.m. Singapore time – also involves a large number of participants (some 65 firms have participated at the time of writing) from multiple market segments. By comparison, the Dubai pricing mechanism can have as few as two or three participants and regularly does not trade at all.

Rarely a month passes at present without another candidate being mentioned as a potential replacement for Platts Dubai. The Shanghai Futures Exchange is planning a medium-sour futures contract, which is likely to launch in 2014, while Iraq, Russia, and Malaysia have all expressed interest to a greater or lesser extent in seeing their crude oil streams used as the underpinning for a futures market that could provide a new oil benchmark for Asia.

No doubt more will emerge, but it is illustrative to note that all of the various options share two core characteristics: they are based on physical delivery and they mostly expect to incorporate a pricing mechanism that is listed on a futures exchange.

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It would appear that the current regulatory environment makes the emergence of a new benchmark that is not regulated, or is based on voluntary submissions, look improbable. Where such benchmarks are already in use, they will likely remain in place. But it is hard to imagine that an emerging energy commodities market would adopt such indices where a more regulatory-friendly alternative is available.

Physical Convergence

Convergence with the underlying physical market is clearly crucial to ensuring the long-term success of an oil futures benchmark.

Oman futures converge smoothly with the physical market. In fact, DME delivers between 12 and 16 million barrels of Oman Blend crude oil every month, the largest physical delivery of any energy contract in the world. This is equivalent to around half of all Omani production.

We can see from the recent contortions in the Brent futures market the difficulty of smoothly operating a financially settled oil futures market when the settlement index is forced to constantly evolve. Oman and WTI have avoided this by settling directly to physical delivery, rather than outsourcing the delivery process. Both Oman and WTI are also fortunate in this sense that they both benefit from rising underlying production, unlike the North Sea complex which continues to experience dramatic production declines that require frequent revisions to underlying contract specifications.

The Brent mechanism will eventually run out of options in regard to North Sea solutions to maintain its benchmark status, while the uncompetitive position of the European refining industry – as highlighted by the recent industrial dispute and near closure of the UK's Grangemouth refinery – puts a further question mark against that particular corner of the North Atlantic as a major oil trading hub, capable of producing relevant benchmarks for a global market.

Future Prospects

The recent upturn in Oman futures volumes are in part a result of improved marketing to the energy trading community, but DME is also benefiting from factors outside its control. The regulatory push from OTC to listed futures, and the increased scrutiny on unregulated benchmarks relying on voluntary reporting, are all providing wind in DME's sails.

There are a number of other benchmarks that could emerge in the Middle East and Asia in order to fill the need for a globally relevant third benchmark alongside WTI and Brent. All share the common specifications of physical support and exchange listing. This would appear to be the future for the benchmarks upon which the energy industry relies – tight regulation and a tight convergence with the underlying physical market.

Petroleum Development Oman and its dozen or so partners have made great strides to increase production in recent years, utilizing the latest enhanced-recovery techniques and developing new fields. Omani oil production hit a peak of 970,000 b/d at the turn of the century, and is on course to hit a second peak with production in September 2013 back to 950,000 b/d, of which around 750,000 b/d is available for export.

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Oman is also strategically positioned outside of the Strait of Hormuz, the transit point for over a third of the world's seagoing crude oil which is often

cited as the world's most vulnerable chokepoint. As such, Oman would escape any geopolitical friction that could disrupt the flow of oil through the narrow body of water, further enhancing Oman Blend's benchmark status.

The Oman Blend is the most widely traded and transparent crude oil grade in the Mideast region, supporting not only an active futures contract but also a healthy secondary market where cargoes are regularly sold and resold. Oman has overtaken Dubai on almost all of the key metrics regarding production, trading, and transparency, as the Dubai crude oil stream is now reduced to just four cargoes per month. In fact Oman is now largely the mainstay of the Dubai pricing mechanism and is a ready-made replacement for the legacy benchmark as it eases its way into retirement. ■