

Which is the Right Oil Benchmark for China?

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Like so many commodities, world demand for crude oil these days is largely driven by China. The country has had around 9% GDP growth for nearly 30 years. That means a bigger middle class with more consumers driving cars. In a column in the Financial Times last month, Nick Butler wrote about how this demand is driving international prices:

It would be silly to reduce a complex system to a single answer but what stands out at the moment and for the foreseeable future is the absolutely critical role of China... Since 1990 China has increased its energy use threefold and on the basis of a fairly cautious projection GDP growth rate of less than 6 per cent per annum that will double again by 2035.

Butler goes on to note that on the production side, China is getting most of its oil from the Middle East, and that 85% of the oil that passes through the strait of Hormuz goes east to China.

Notwithstanding these important long-term issues, another area worth our attention when thinking about China's energy usage is the issue of oil price benchmarks and their respective prices. China still needs to incorporate its clear desire to buy oil at a competitive price with its current antiquated practices taking the Brent-premium in the solar-plexus and then asking for seconds.

China is the one consuming country in Asia that seems to have a serious interest in seeing competition determine their price of oil versus a passive receipt through a pricing formula tied to Brent. This means it reflects the anomalies integral to Brent, including its production issues and confusing commercial practices versus straight-forward fundamentals of oil supply and demand in Asia.

Those are two distinct things but China, in spite of its stated desire for a competitive price, is still basically tied to anomalies, so there is room for improvement.

The first reason is production. As Jan-Hein Jesse of Josco Energy Finance and Strategy and an expert for the International Energy Agency recently mentioned in a Featured Report for CME Group:

North Sea Brent crude production has halved over the past decade, shrinking to slightly more than 1 million barrels a day currently and on track to drop to half that level by 2020.

It's not difficult to see why it's a problem for China to be relying on a benchmark that does not reflect its fundamentals. The nation will soon — about 2020 by Jesse's estimate — overtake

the United States as the world's biggest importer of oil. For China to tie itself, even indirectly, to a benchmark whose prices tend to reflect its own shrinking production — even as global production increases — could have the impact of slowing its economy and that of its trade partners.

Jesse presented at the S&P Dow Jones Commodity Seminar in London on September 20, where he touched on whether China will continue to rely on current practice.

China has alternatives. To start with, there are established other benchmarks. Based on fundamentals, China can adopt and participate in Dubai Mercantile Exchange's Oman futures contracts, which are both liquid and serve as a robust hedge for Asia.

And if China truly is interested in allowing global competition to determine the price they pay for oil, in addition to Oman, West Texas Intermediate is well positioned to provide that. The U.S. oil patch, which includes WTI, is experiencing none of the production problems associated with Brent. In fact, the U.S. and WTI are experiencing significant increases in production levels, and making more of its oil available to waterborne markets due to developments like the reversal of the Seaway pipeline, and increased rail transport.

Last, and definitely not least, China plans to introduce a new reference contract, based squarely on Asian fundamentals. This is a very serious undertaking and we fully support it. It will be a welcome improvement from direct or indirect ties to Brent and we believe it will complement the Oman contract.

Jesse hints at these alternatives when he suggests the important relationship between China, Saudi Arabia and the U.S. in the coming years.

China, Saudi Arabia, and the U.S. have to cooperate in managing the oil market in such way that it fosters world economic growth for everyone, that the market functions well and stays global and open, that high prices are avoided, that financial flows do not create global imbalances or unwanted currency devaluation.

It seems a declining product with questionable transparency in the North Sea does not fit into this relationship, or to the ends it seeks to produce.

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