Making the grade – tracking the spot crude oil market

SEPTEMBER 2020 CONTRACT

OSP $43.62

TOTAL EXCHANGE VOLUME 91,128 CONTRACTS

TOTAL DELIVERY 10.183 MILLION BARRELS

ADV 4,142 CONTRACTS

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Introduction

Crude oil trading in the spot market plays a key role in price discovery, helping both producers and refiners measure the relative strength of competing oil grades, plus a guide to the overall health of markets. Asia is playing an increasing role in spot market trading, particularly Chinese refiners who maintain a balance of term oil crude and spot barrels.

The term contract barrels guarantee security of supply and help to maintain long-standing relationships with major producers, whereas the spot market enables flexibility to vary purchases based on refining margins, outright price and market structure.

A spot market trade is typically a deal between buyer and seller, otherwise known as an over-the-counter (OTC) or bilateral transaction.

Typically, the trade will be priced as a differential against an underlying crude oil benchmark; either an Exchange-generated futures price such as Brent, WTI or Oman, a price generated by a Price Reporting Agency (PRA) such as Dubai, or as a differential versus the underlying Official Selling Price (OSP).

The Middle East spot market

Middle East National Oil Companies (NOCs) sell most of their production under annual term contracts on an OSP basis, which gives security of supply/demand to both buyer and sellers, plus allows producers a greater say in the final destination of its crude and prevent regional imbalances.

Oman is the only Middle East crude grade that is 100% freely traded, so can be bought and sold on the DME and also traded in the spot market. Oman typically trades at a premium to the OSP, which in turn is derived from the monthly average of Prices.

The advantage of trading Oman on DME is that performance is guaranteed by the Clearing House, whereas OTC trades being dependent on counterparties have bilateral credit arrangements, or facilitated through bank guarantees.

Upper Zakum, a medium sour crude and Murban, a light sweet grade, both from Abu Dhabi are also regularly traded in the spot market, particularly from sales by Abu Dhabi’s equity partners such as Exxon, BP and Total, usually at a differential to the underlying OSP. Likewise, Iraq’s Basra Light (a medium sour crude) is regularly sold via tender against the OSP. These spot transactions are closely monitored by Middle East NOCs as a guide to current demand and future market direction.

Chinese spot buying aids Q2 demand recovery

Asia is increasingly a key component of the global spot market for crude, particularly China where both the Major oil companies and independent refiners are avid consumers of spot crude oil – particularly the independent sector based in the Shandong region.

Chinese refiners played a huge role in absorbing the global crude oil overhang in during Q2, although often at steep discounts to the underlying benchmark.

In addition to Middle East grades China is also a major buyer of West African crude, North Sea, Americas and in May imported Siberian Light crude (Russian Black Sea) for the first time.

The Q2 buying spree from China’s State-owned entities and independents leads to record import volumes of over 13 million barrels per day in June, and prices in China are increasingly helping to determine global spot prices.

China’s INE sour crude futures contract was commanding a healthy premium over Brent and Oman throughout Q2, but that premium has since been eroded as ports and terminals struggle to absorb the record volumes. Around 50 very large crude carriers (VLCCs) were waiting to discharge crude into China in late July, including delays of up to a month, which is slowing down China’s recent record crude oil import rates.

INE sour crude allows for the delivery of a number of Middle East grades. Since April over 30 million barrels have been delivered through INE, including Basra Light, Oman and Upper Zakum.
2020 trends – heavy low sulfur crudes outperform light grades

Like underlying outright prices, the grades market has seen huge swings in differentials this year, as markets adapted to the initial covid-19 supply/demand uncertainty.

As well as price volatility, Refiners had to adapt to the introduction of IMO 2020, which changed the bunker fuel landscape by cutting the sulfur content in shipping fuel from 3.5% sulfur to 0.5% sulfur. Low sulfur (referred to as sweet) crudes were the immediate beneficiaries, particularly the heavier grades (API gravity of under 30) which are ideal for producing 0.5% sulfur bunker fuel.

For example, heavy sweets such as Australian Van Gogh and Pyrenees were trading at high double-digit premiums to physical Dated Brent. Lula from Brazil is another grade favored by Chinese refiners and premiums into China were as high as $8-$9/b over Brent earlier in the year, but have now settled back to around parity with Brent.

However, light sweet crudes sold into Asia such as Murban, North Sea Forties and US WTI Midland have not fared so well, as these grades have been impacted by the demand contraction in gasoline and jet demand.

Additionally, lighter grades also produce more naphtha, which is used either as a gasoline blending component or in the industrial sector. At the peak of the Q2 demand destruction, lighter crudes such as WTI Midland were trading as low as $10/b under Brent futures for delivery into China.

For much of this year medium sour Oman crude has been trading above the light sweet Brent, reversing the long term trend of Brent commanding a premium over its heavier counterparts, although in early August Brent moved back above Oman.

Summary

While futures prices are the dominant instrument in oil price transparency, the spot market provides a valuable tool in price discovery and tracking the relative spreads between competing crude grades.

This recent volatility did highlight a number of high profile cases where long standing market participants were impacted by unhedged OTC positions leading to bankruptcy and civil claims.

This is a key advantage to utilizing Exchange Traded Futures instruments which are protected by margin payments and guaranteed by a Clearing House.

This year has seen some of the most dramatic pricing swings in crude pricing history but while oil markets have calmed down in the third quarter, few would rule out a return to further volatility going forward.