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Asian Premium of Crude Oil and Importance on Development of Oil Market in Northeast Asia

Yoshiki Ogawa

The Institute of Energy Economics, Japan

International Workshop on

“Cooperative Measures in Northeast Asian Petroleum Sector: Focusing on Asian Premium”

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- **Asian Premium of Crude Oil and Its Impacts**

Movements of Asian Premium of Crude Oil

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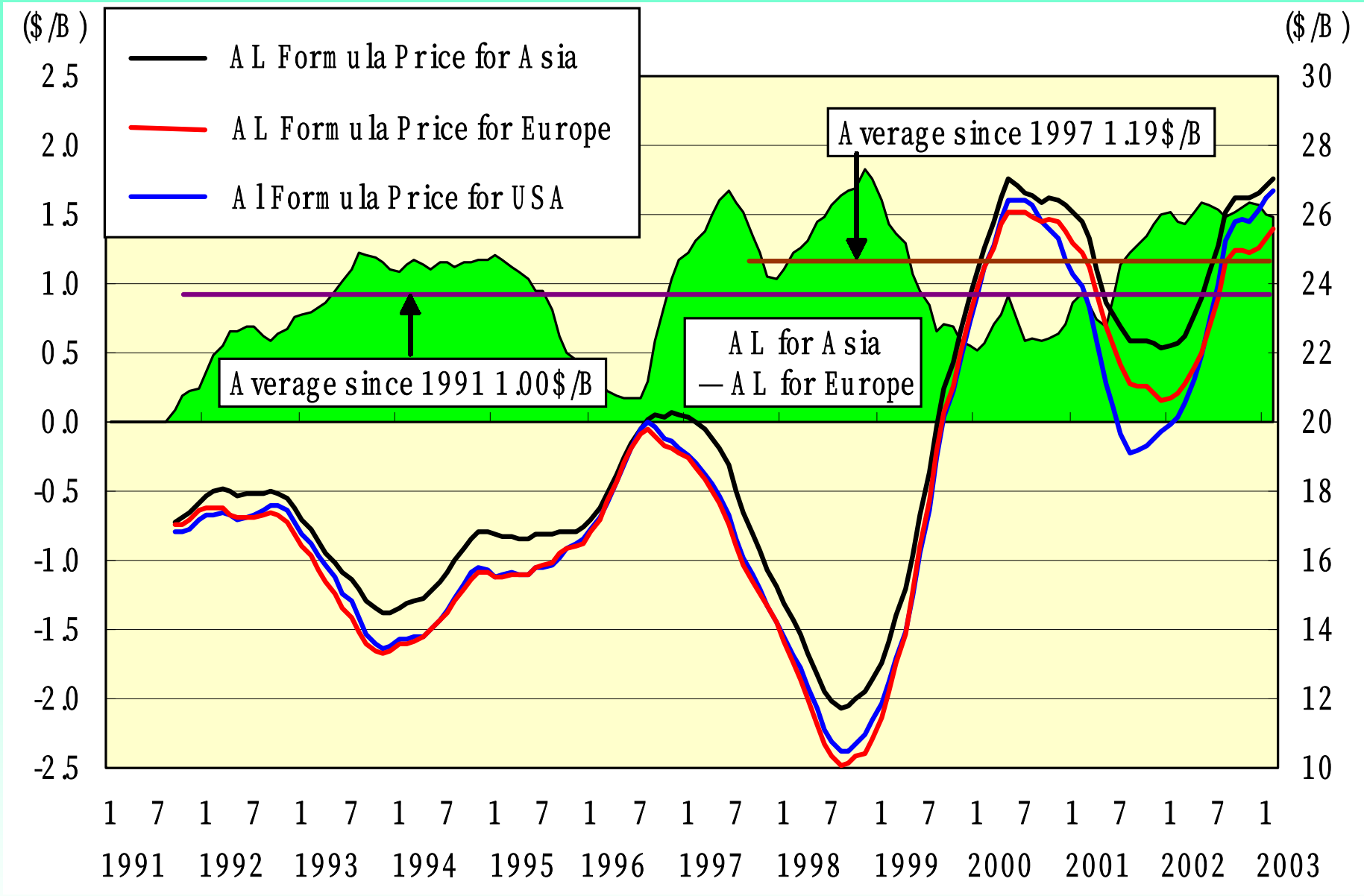

Asian Premium of LNG

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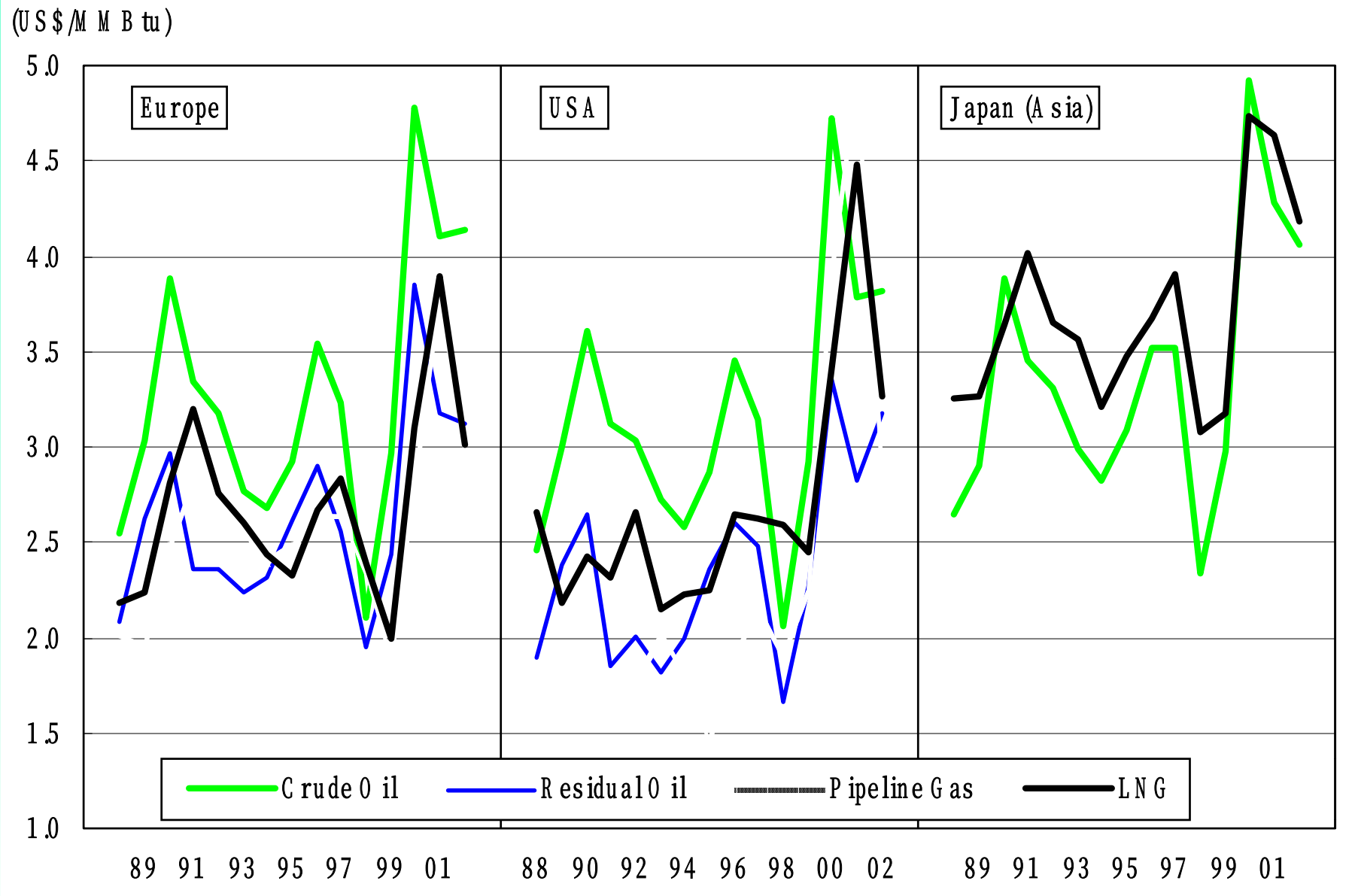

Ups and Downs like Emergency Time — LPG Contract Price

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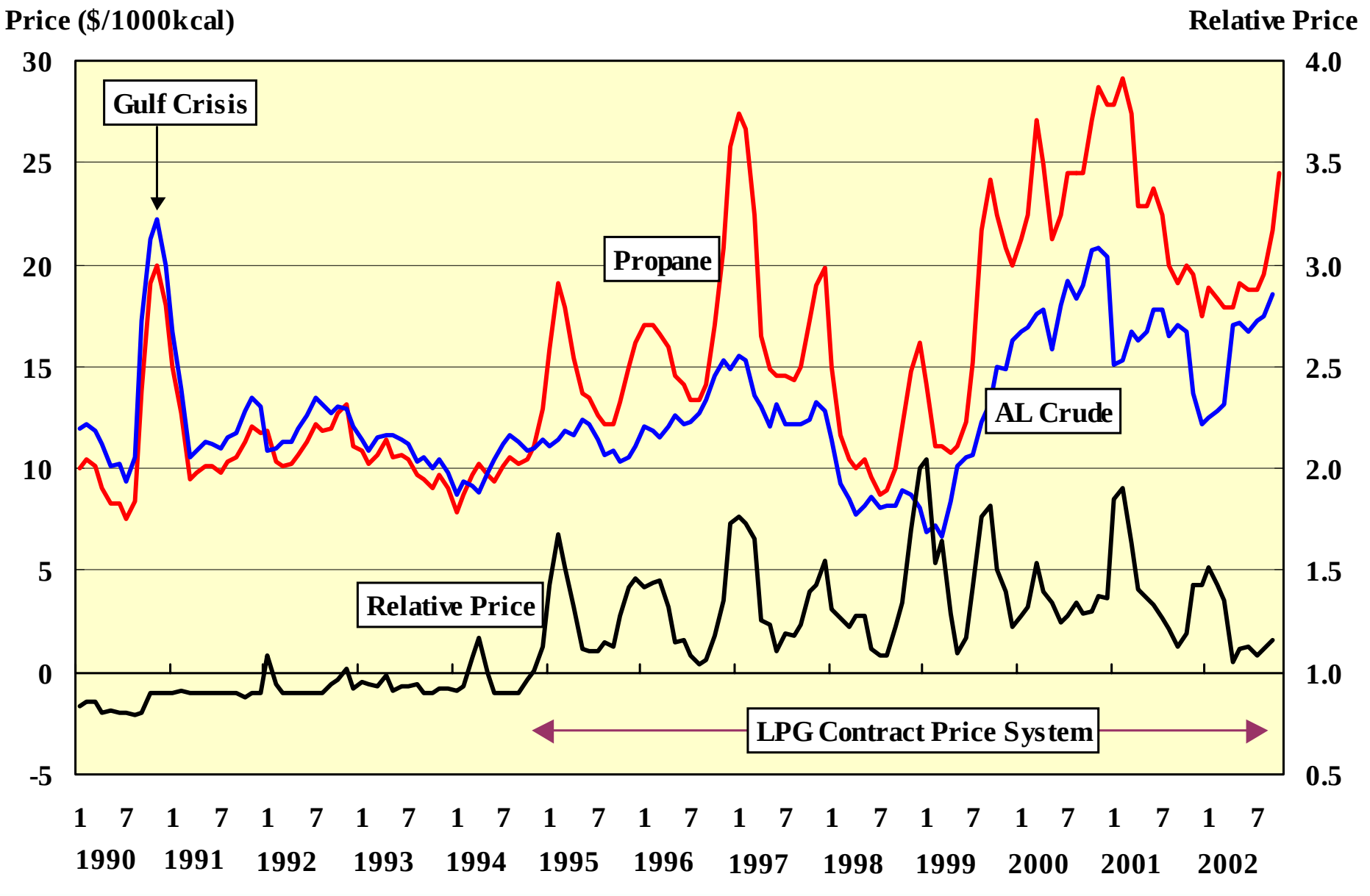

Income Transfer due to Asian Premium of Crude Oil

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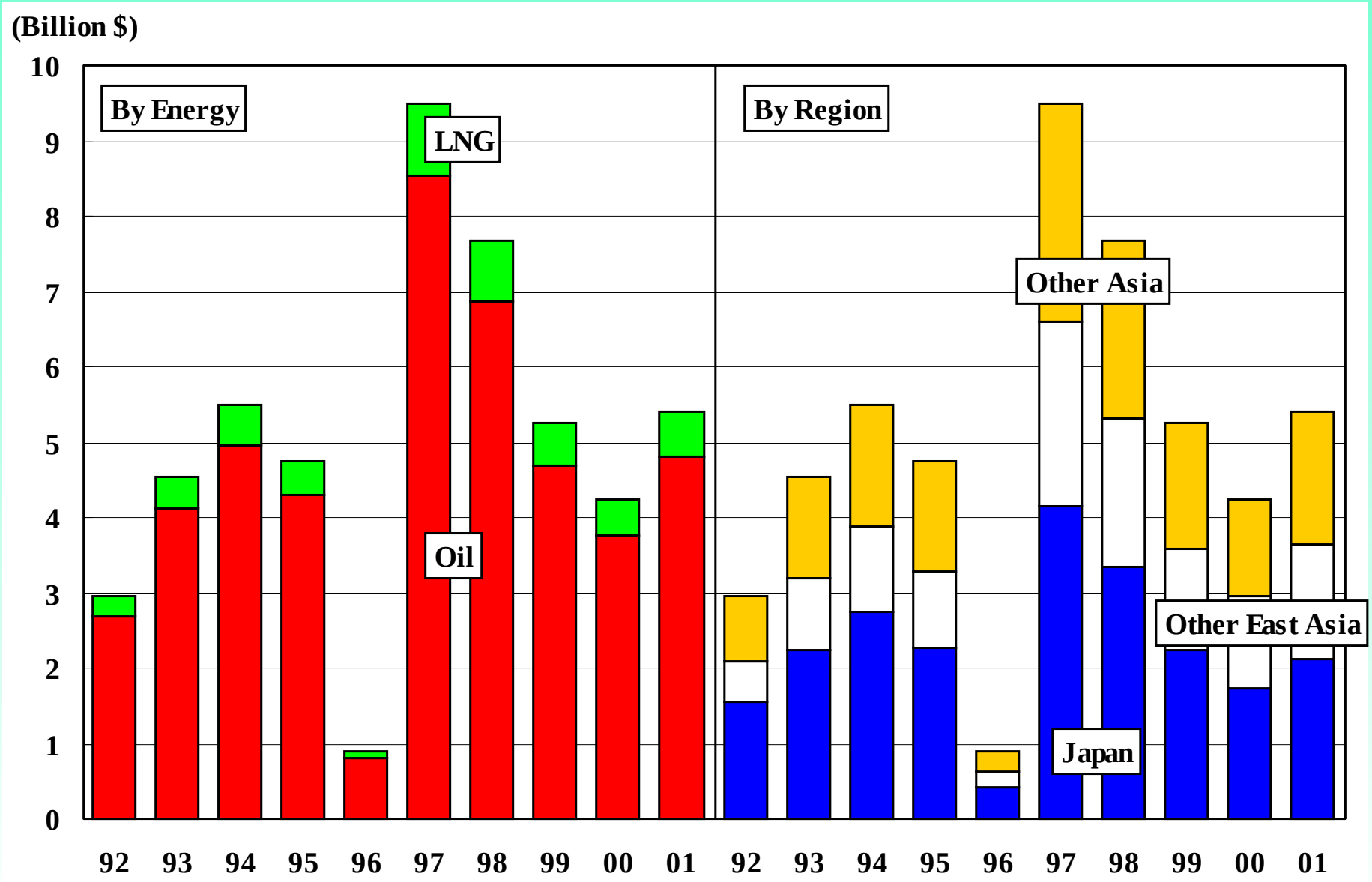

Asia Premium Having Large influences to International Competitiveness in Economy

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- **Additional income transfer of 5 to 10 billions $ from Asian consuming countries to oil producing countries**

- **Worsening refinery margin since 1999—recently expanded to minus value of about 1S/B**

  # reducing refinery margin due to demand slowdown and surplus refining capacity since 1997

  # minus refinery margin due to higher crude oil price since 1999

  # lowering refinery operation in Singapore, Korea and so on

- **Asia Premium is not limited to oil but exposed on whole energies**

  # Price of other energies such as LNG is raised through crude oil price

  # LNG has an original problem for Asian premium

  # LPG contract price showing ups and downs like emergency time – one-way force by producing countries

Viewpoints on Crude Oil Price Level in Asia

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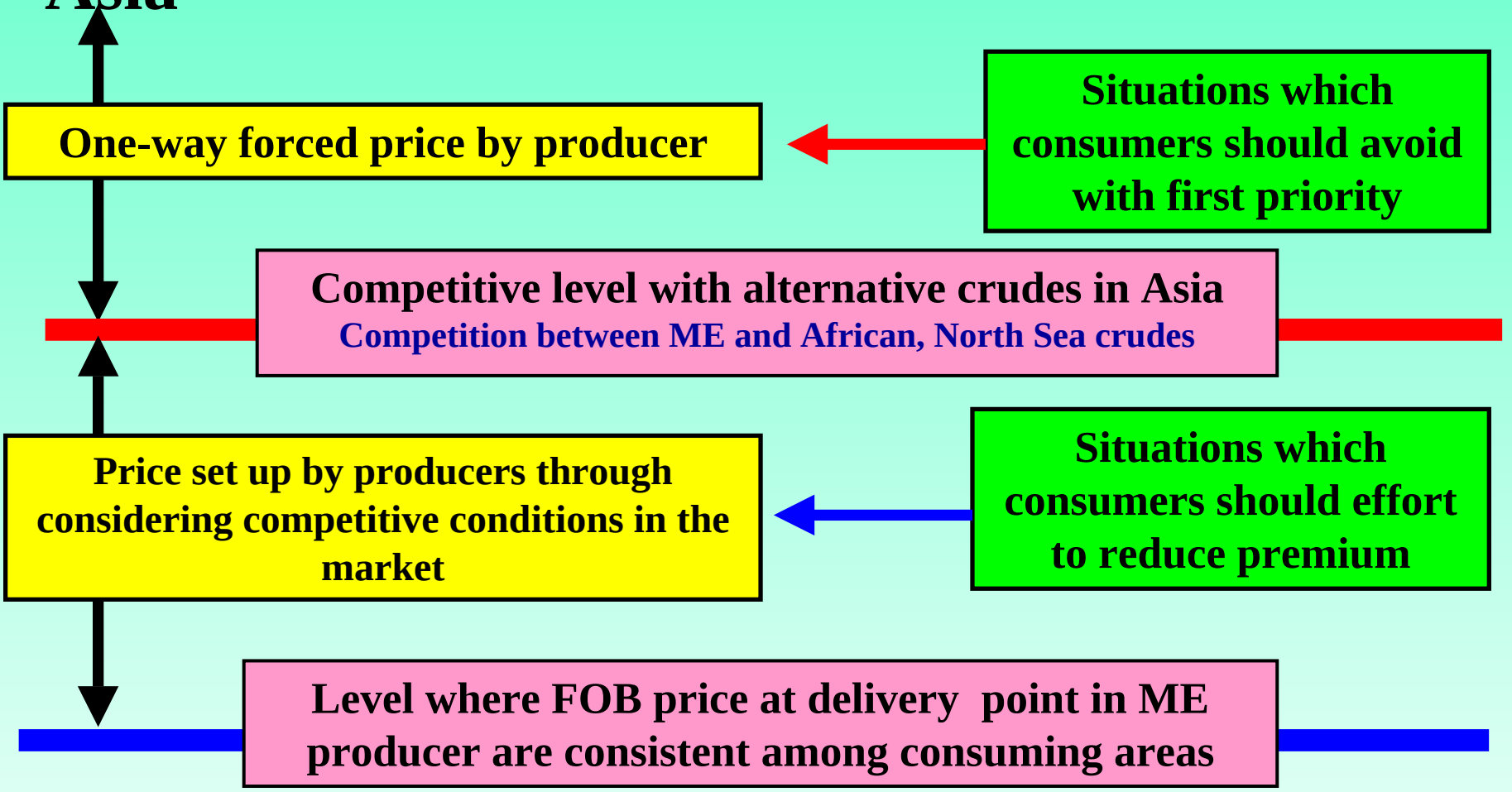

Crude oil price level which is not a handicap for Asia in international competitions of economy is required – Issues which ME producers should also consider

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2. Dubai Production Decrease and Necessity of Marker Crude Change

Production Decrease in Dubai, Marker Crude for Asia and the Points at Issue

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- **Production decrease to 150,000 B/D in 2002 from 420,000 B/D in 1987**
  - **# Steadily decreased Entering 1990s and accelerated since 1995**
  - **# Crude destination was limited to Asia since1991**
  - **# Rapid decrease in spot trading, Special buyers by bidding**
- **Dubai price formation completely losing reliability**
  - **# Low liquidity and transparency in spot price formation**
  - **# Assessment of Dubai price using Brent price and spread between Brent and Dubai**
  - **# Quotation price by Platt's considering spot and future**
  - **# problem of intentional price manipulation using defects of physical trading**

Difference between Marker Prices and Difference between adjustment factors

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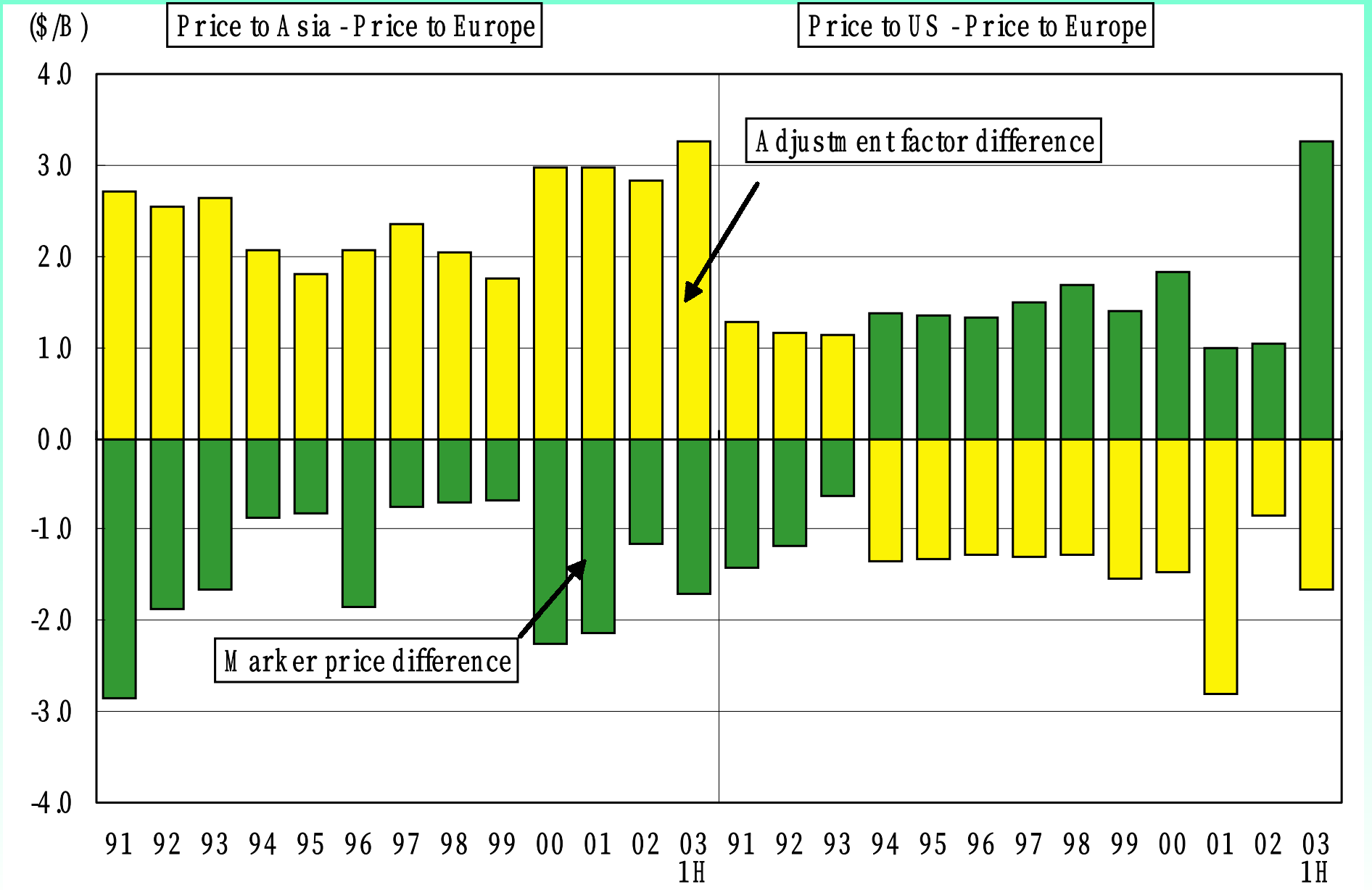

Adjustment Factor for Europe and Its Components

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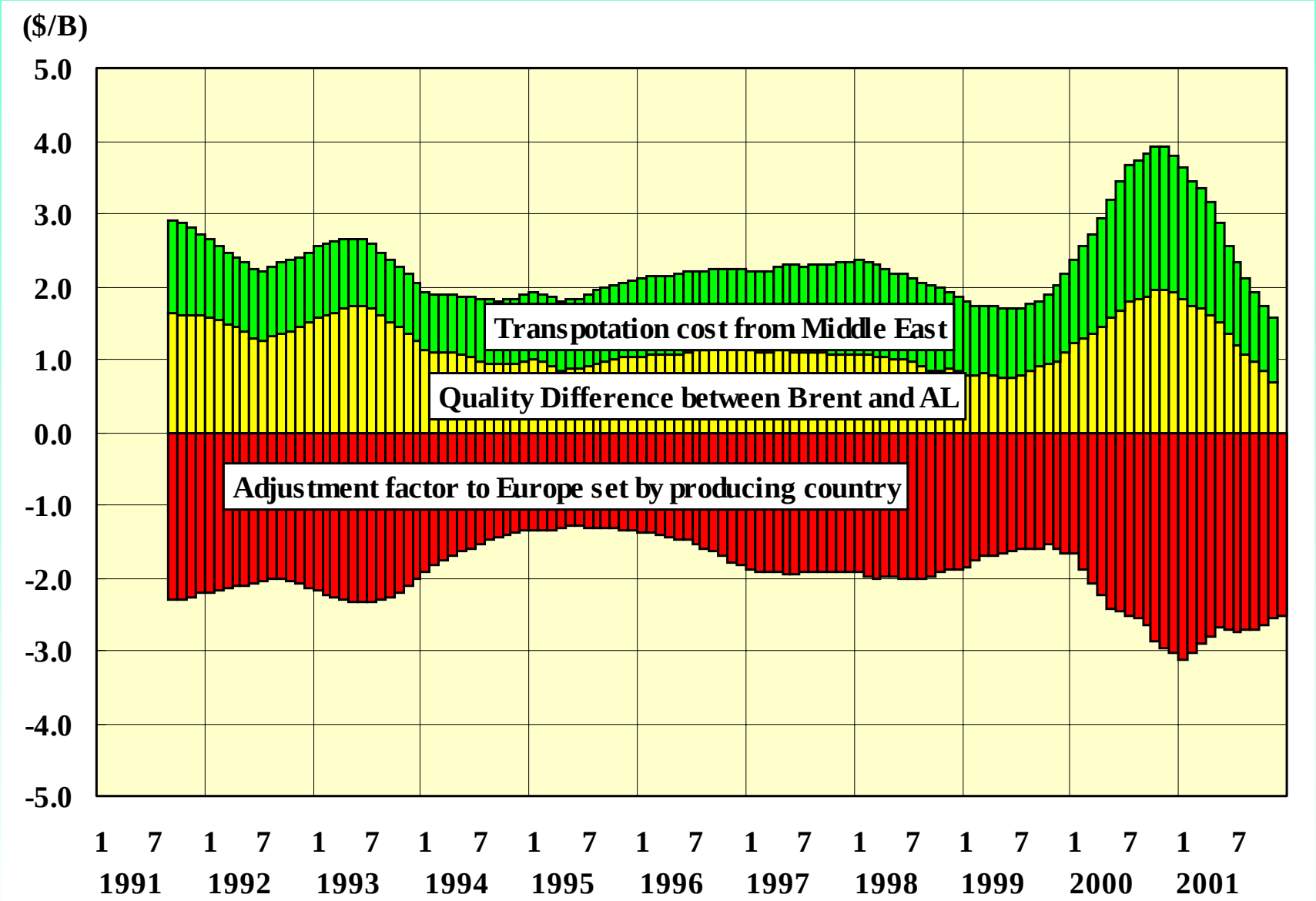

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3. Change of Pricing for Asia and Reduction of Premium (Short-term Measures)

Short-term Measures for Reducing Asian Premium

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1. **Procurement Expansion of Alternative Crude Oil from Areas besides Middle East**

2. **Change of Pricing for Asia such as Change of Marker Crude**

Import Expansion of African and North Sea Crude Oils

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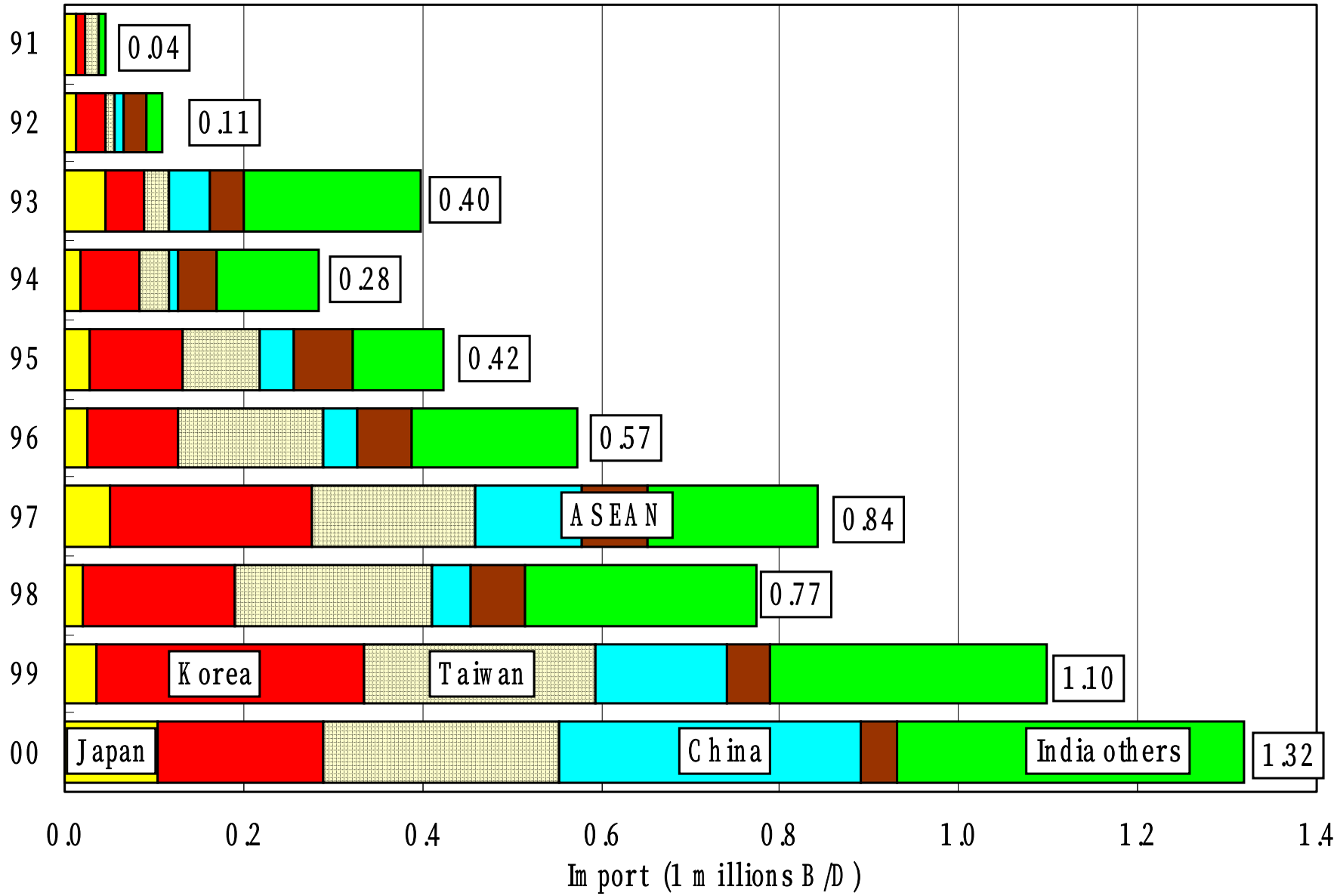

Procurement of African and North Sea Crudes and Its Problems

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- **Procurement Expansion of African and North Sea Crudes in 1990**

  # In Korea and Taiwan, expanded due to the strengthening of sulfur regulations in diesel oil and residual oil -- Desired postpone for full-scale introduction of desulfurization

  # In China, expanded due to refinery limitation with pursuing crude similar to domestic one

  # In ASEAN and India, expanded due to insufficient clacking with pursuing lighter crudes

  # These crude oils is needed even if price is higher than ME crude oils

- **Problems for procurement of African and North Sea Crude**

  # Not work effective because of limited amount possible to procure

  # Necessary measures to compensate higher cost of long distance transport

  # Necessary ship allocation due to the small size of each oil field

Not be effective measures in short-term, considering these points

Alternative Candidates of Marker Crudes for Asia

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Alternative Candidates	Strong/Weak Points
Idealistic crude	
Daqing crude	● Although China is a large consumer market, the oil market is under administrative control and is not free. ● Spot exports are limited and the market is localized, ruling out dealings with U.S. and European traders. ● Greatly differ in properties from Middle Eastern crude oil.
Arabian light	● Large in production scale, allowing trading on a global scale. Can represent M.E. crude for Asian market. ● Saudi Arabia bans spot trading to keep prices from falling. Destinations for exports are restricted. ● Saudi Arabia monopolizes sellers' market.
Price index for M.E. crude	● It is necessary to expand oil products trading in East Asia and streamline spot trading market. ● It is necessary to streamline products futures trading market and to post price index for M.E. crude. ● Streamlining of various aspects is necessary, making its immediate realization difficult.
Realistic crude	
Oman	● Spot trading to some extent already exists. Larger in production scale than Dubai crude. ● Shell holds 40 percent concession interests, leading to apprehension of price manipulation by Shell.
IPE Brent	● Large-scale trading in international market. High liquidity of market and high transparency of prices. ● Having marker crude in common, the verification of price differentials for European market becomes easy. ● Price fluctuations reflecting supply and demand in U.S./European markets constitute new risks. None of actual trading in Asian market.,

Oman Price Almost Coincident with Dubai Price

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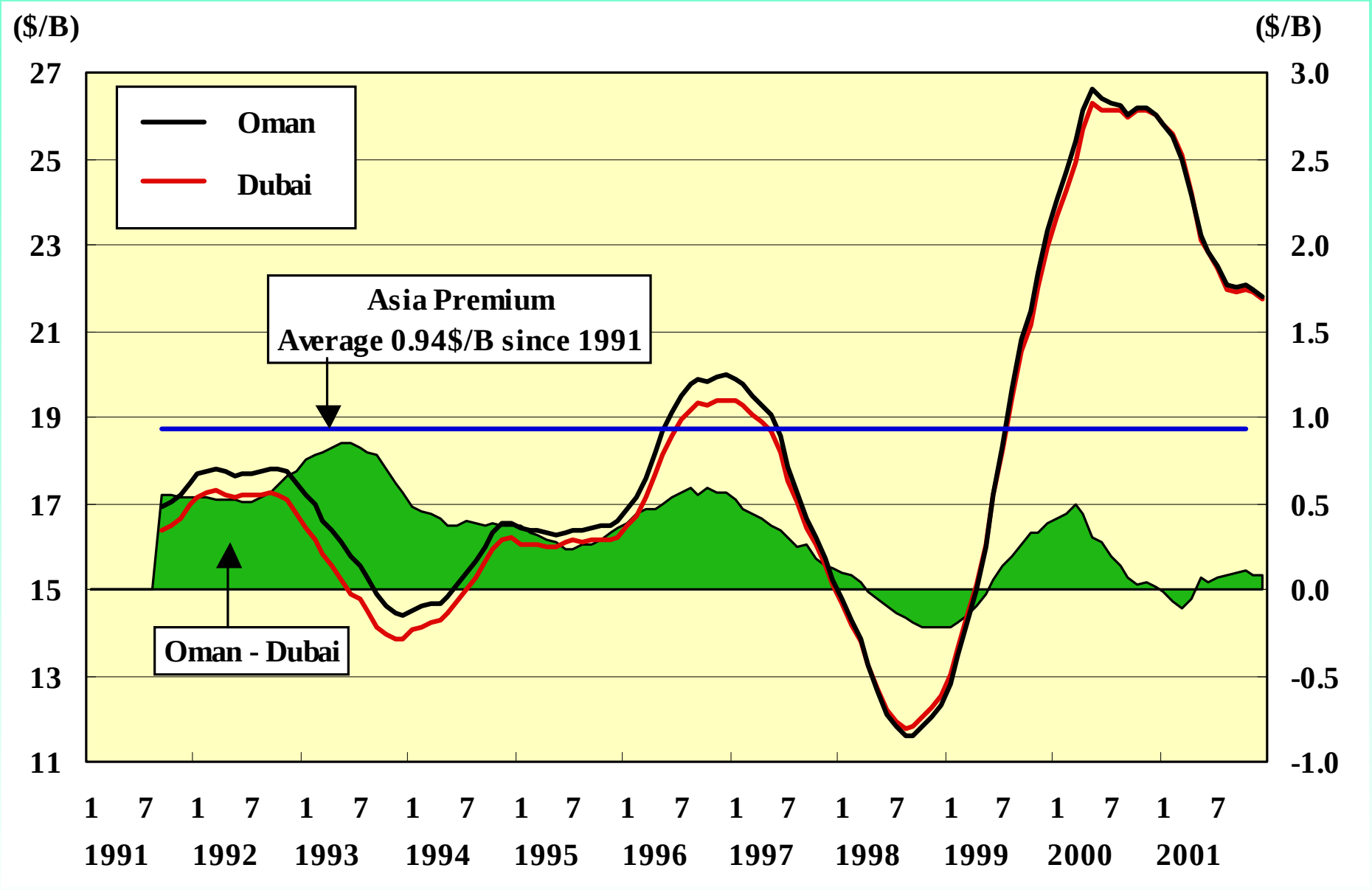

Proposal (1) : Pricing Based on Brent

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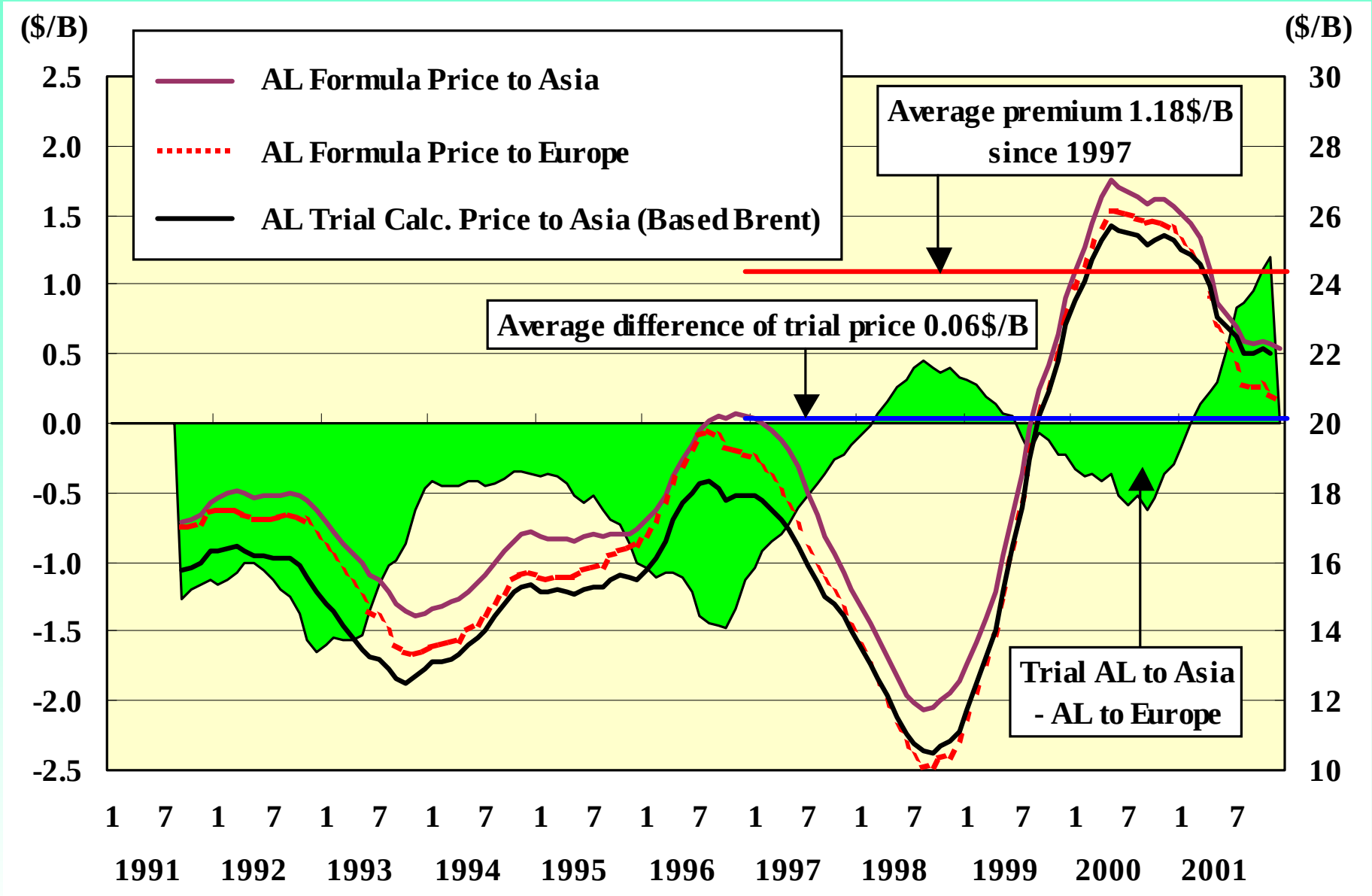

Problems in Pricing Proposal (1)

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- **Price formation not reflecting oil supply-demand in Asia**

  # Brent price is formed with reflecting oil supply-demand in Europe

  # Easy to be influenced by special problems in US oil supply-demand

  # Not always consistent with oil supply-demand environments in Asia

- **Problems of price manipulation due to production decrease in Brent**

  # The existence of price manipulation such as notorious squeeze

  # Twin market relation between physical spot / forward and IPE future

Proposal (2) : Pricing Based on the Average of Europe and US Formula

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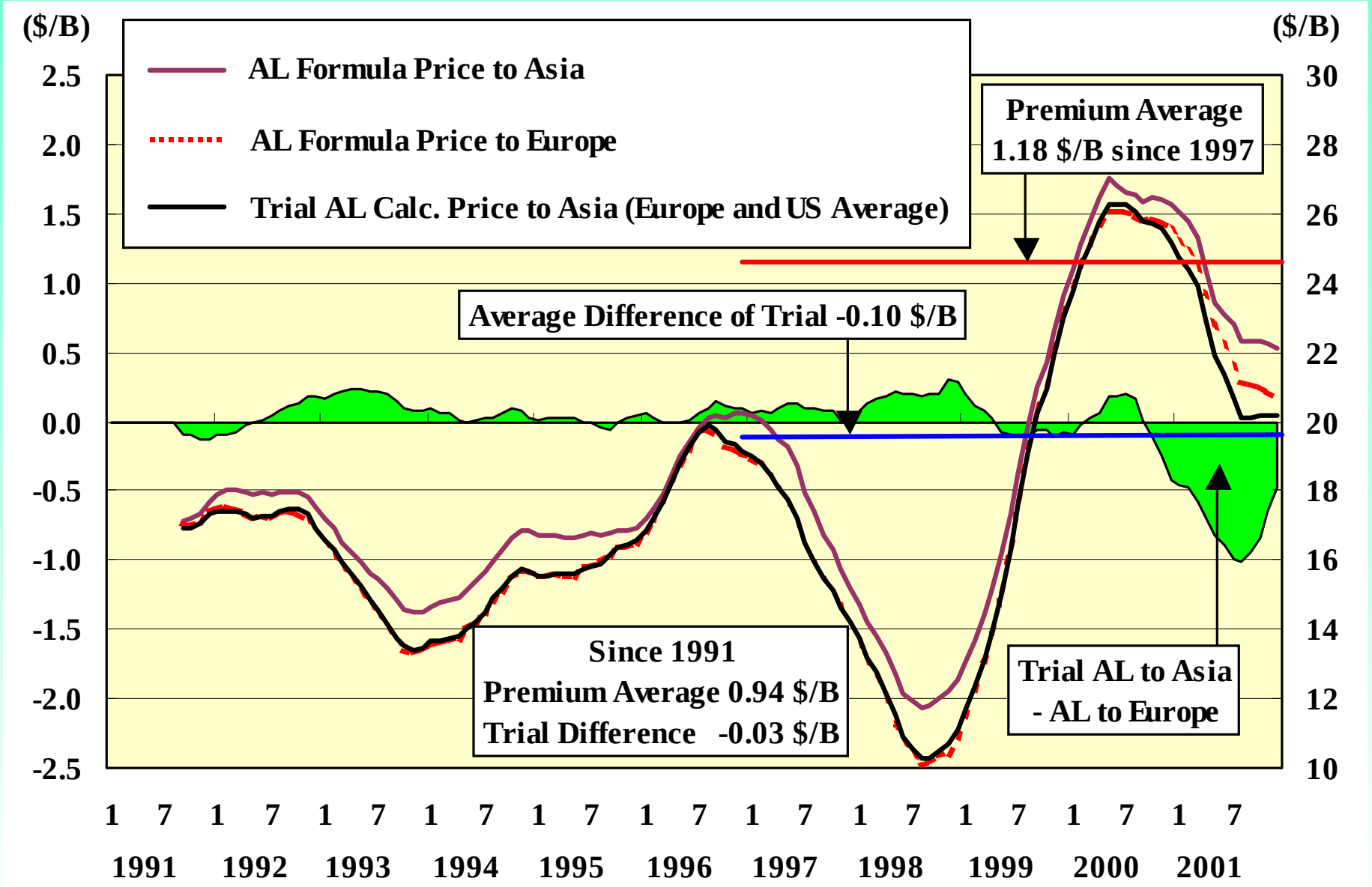

Problems in Pricing Proposal (2)

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- **Price formation not reflecting oil supply-demand in Asia**

  # Brent price is formed with reflecting oil supply-demand in Europe
  # WTI price is formed with reflecting oil supply-demand in US
  Easy to be influenced by US special problems such as pipeline
  # Not always consistent with oil supply-demand environments in Asia

- **Complicated price formation not based on marker**

  # Monthly average of formula prices is required by type of crude
  # Apprehension to Complicated method not based on common marker
  # Difficult to check suitability of price setting

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4. Importance of Oil Product Market Preparation in Asia and Unity among Consuming Countries

Product Price Difference between Singapore and Rotterdam

(Singapore price – Rotterdam price)

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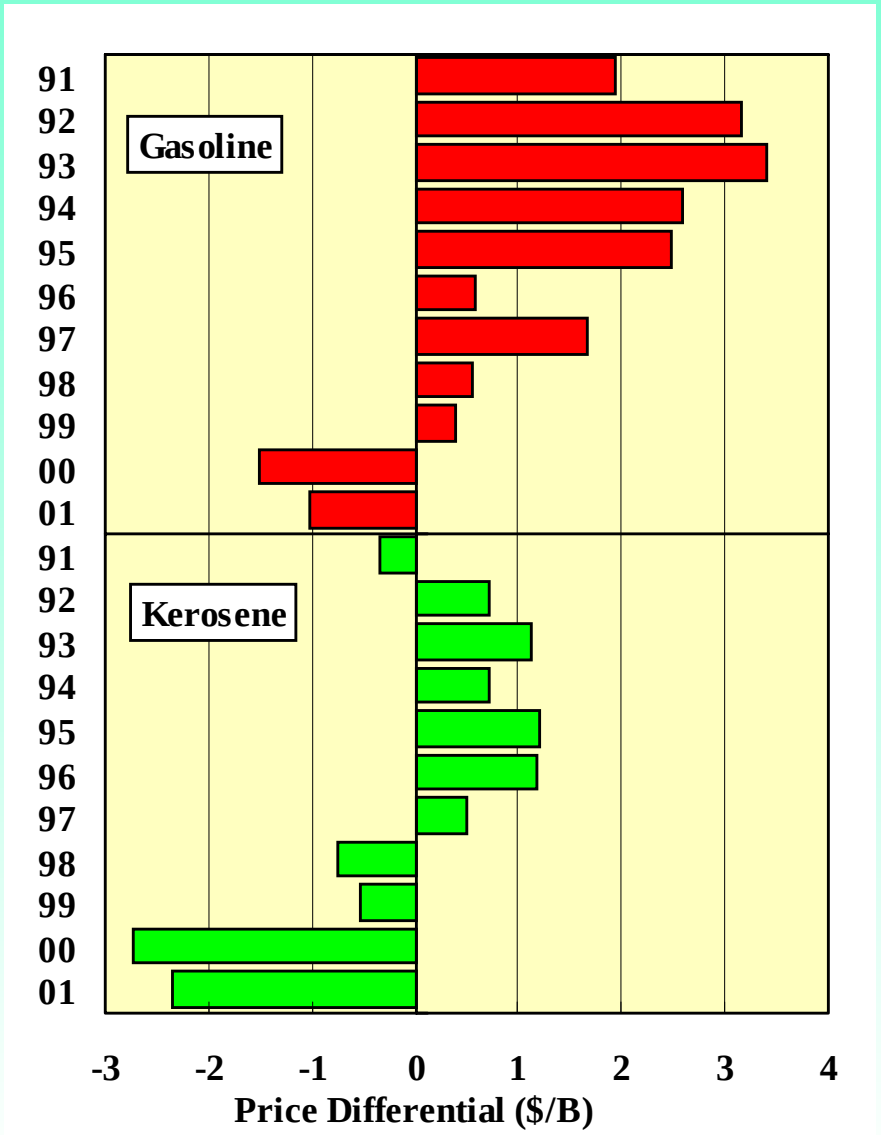

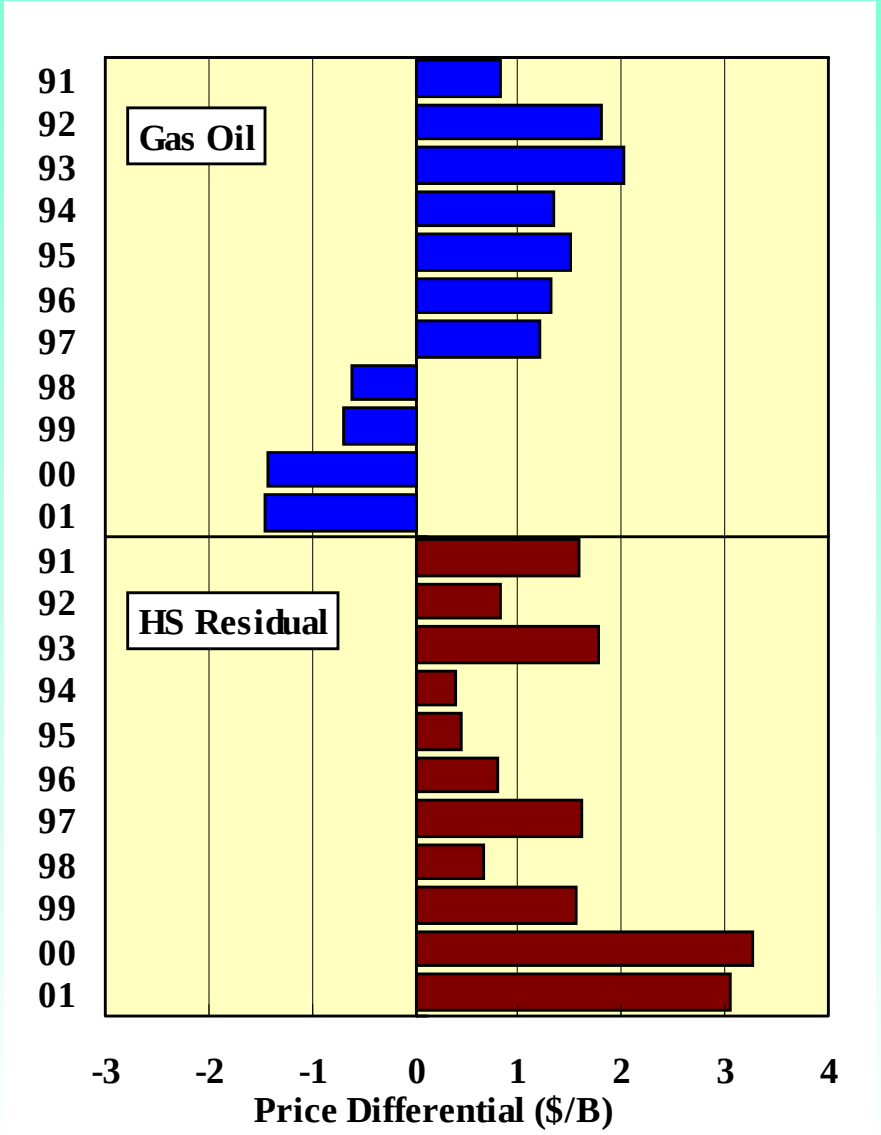

Characteristics of Asian Market and Differences from European/U.S. Markets

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	Asian Oil Market	European/U.S. Markets
Crude	+ Futures trading market remains underdeveloped. + Price transparency is low. + Middle Eastern crude is predominantly used. Imports of West African crude are increasing. + No locally produced crude is used as a marker crude.	+ Futures trading market is fully mature. + Price transparency is high. + Use of Middle Eastern crude is limited. A variety of competitive crude exist. + Locally produced crude is adopted as a marker crude.
Products	+ Regulations are in force and necessity for risk management is small. + Singapore is the only international market. + Trading is done primarily in large-scale cargoes. + Product price is formed by adding cost to crude oil price.	+ Free market in which keen competition is carried on. + Spot product trading market is developed in a country and in a region. + A variety of trading in cargoes, barges, etc. + Product price is formed by spot and futures trading. Crude oil prices and product prices mutually influence each other.

Importance of Oil Market Preparation in Asia

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- **Oil market not prepared in Northeast Asia, large consuming area**

  # Large consuming area with oil demand of 12 millions B/D which is a similar size to Europe/US
  # Oil market is not prepared in the center of large consuming area
  # Singapore market is a just intermediate position for northeast Asia
  # Necessary to send information signals reflecting energy competitive relations in large consuming area

- **Required conditions for preparation of oil product market in Asia**

  # Streamlining and expansion of oil product trades within Asian region
  # Deregulation and privatization of oil industries in Asian Consuming Countries
  # Unification for quality standard of oil products in Asia

Unity among Consuming Countries and Negotiations with Oil Producing Countries

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- **Unity among Asian consuming countries**

  # Important to make a common perception among Asian consuming countries and to unite in various stages such as policy, government and private sector

  # Deliberation on response measures through ASEAN+3 meeting

  # Necessary to intensify negotiation power through unity among consuming countries

- **Negotiation with oil producing countries**

  # Important to have opinion exchanges with oil producing countries through dialogues between producers and consumers such as IEF

  # Important to have an energy dialogue between East-West Asian countries whose interdependent relations will be tight in the long-term

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5. Spot Trading of Middle East Crude and Elimination of Asian Premium (Middle- or Long-term Measures)

Proposal (3) : Pricing Based on AL Spot Prices

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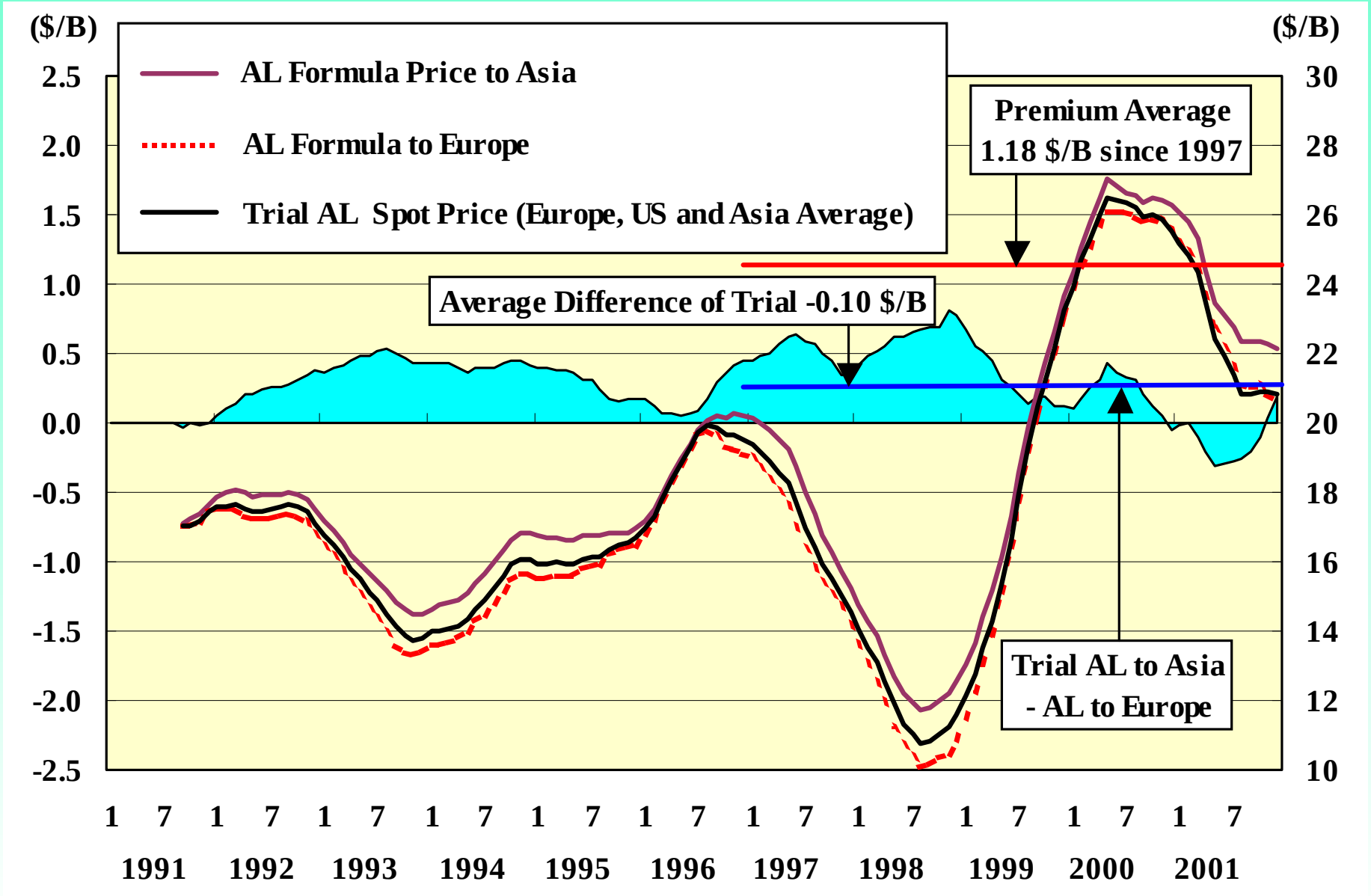

Problems in Pricing Proposal (3)

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- **Negative attitude of oil producing countries to spot trading**
  - # Not hope to repeat price collapse of crude oil in 1986
  - # Spiral price drops due to the guarantee of refining margin in netback selling
  - # Restriction of destination change and Inhibition of spot trading
  - # Can not expect change of this attitude in the short-term

- **Changes in oil supply-demand environment after 15 years passed**
  - # Reduction of surplus crude oil production capacities from 1986
  - # Small possibility of one-way price drop even if starting spot trading of ME crudes
  - # Difficult to make a price stabilization using marginal crudes

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6. Global Links of Oil Market and Stabilization of Crude Oil Price (Conclusion)

Global Links of Oil Markets

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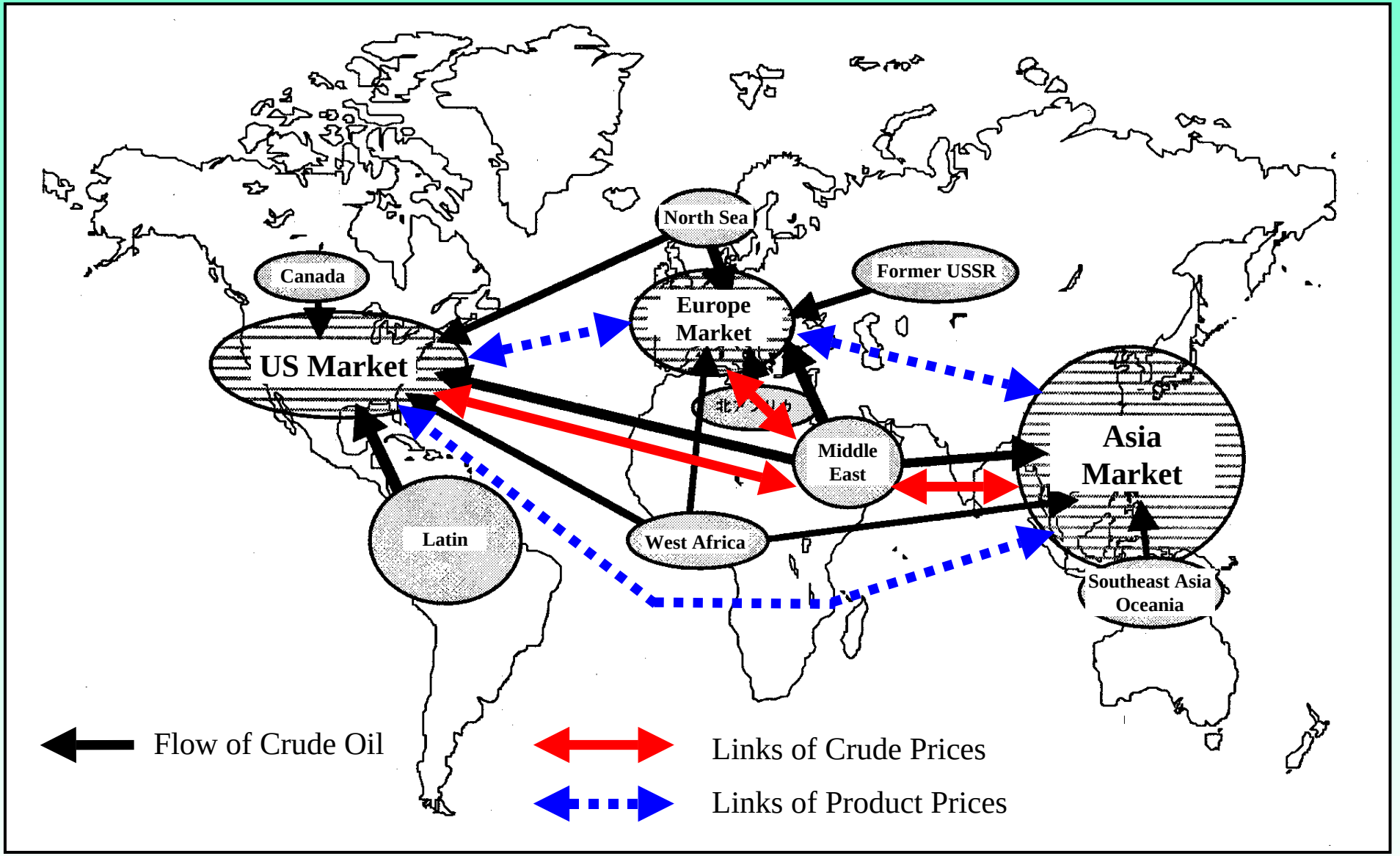

Violent Fluctuations of Crude Oil Price since 1996

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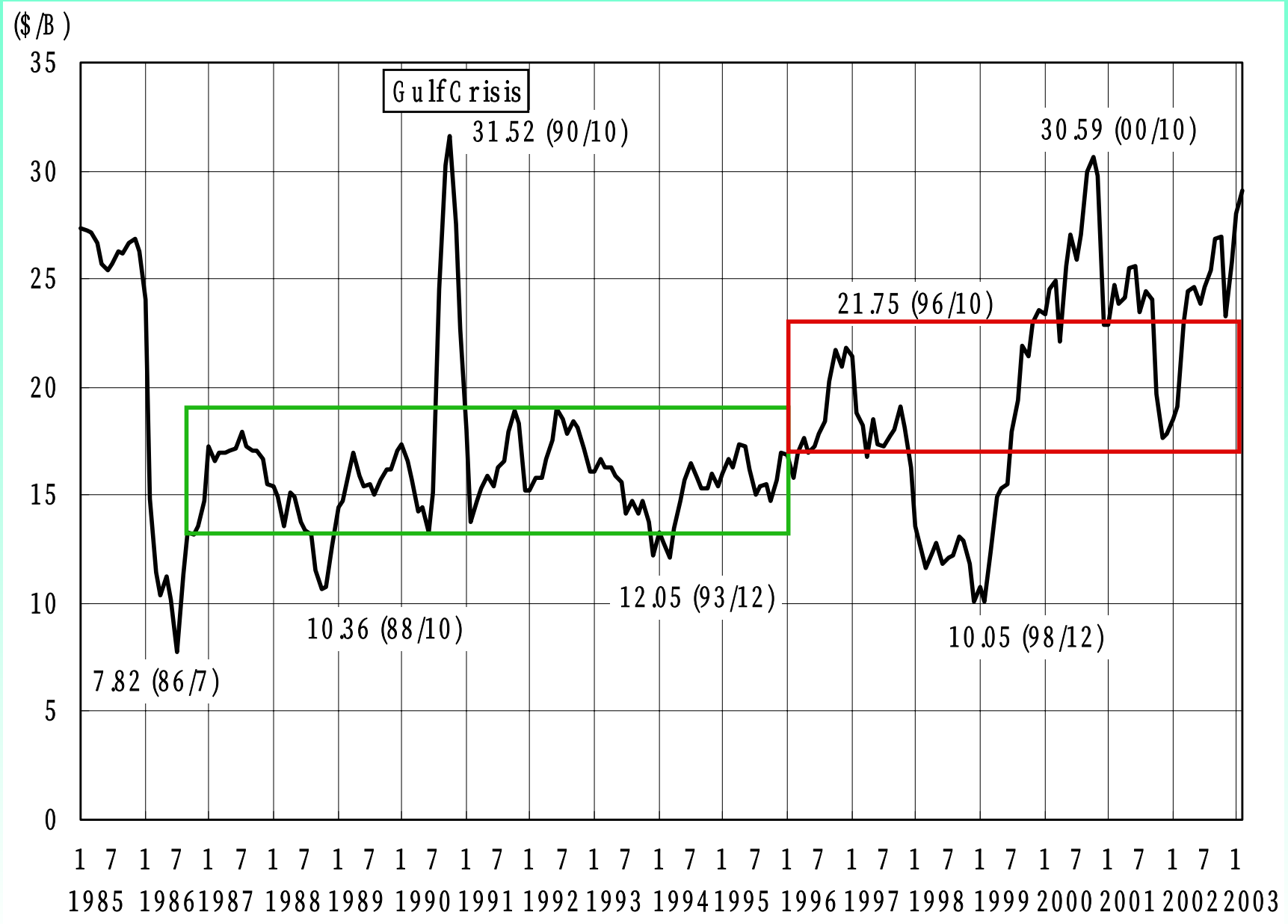

Expected Range of Crude Oil Price in Short-term

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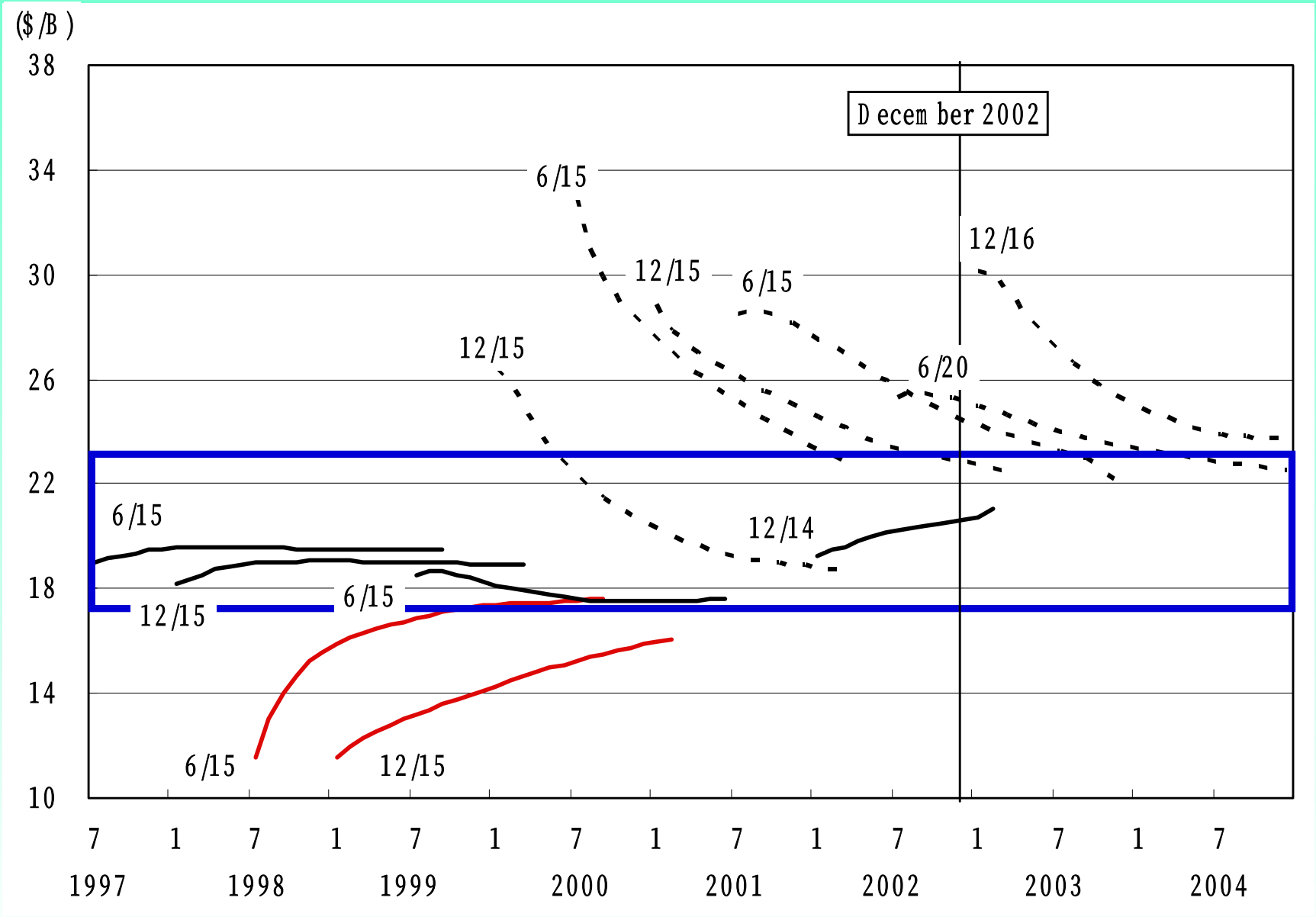

(Source) Made from Data on NYMEX Oil Futures in Wall Street Journal

Too High OPEC Price Band

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Crude oil price level (range), $/bbl	Oil-producing & oil-consuming countries' responses
$7-13 (average $10)	● Lowest level, below which neither OPEC nor non-OPEC want to see oil prices fall. ● At lower prices, OPEC and non-OPEC strengthen unity to defend price level desperately. ● Oil-producing countries' response to crash in oil prices in 1986 and 1998.
$12-18 (average $15)	● Concerted action by OPEC and non-OPEC to maintain crude oil prices. ● Alert zone for oil-producing countries (non-OPEC's response in 2001). ● Price level at which non-OPEC is encouraged to begin development of new oil reserves.
$17-23 (average $20)	● Price level at which non-OPEC assumes profit-taking positions. ● Russia's move in recent months, non-OPEC's behavior in the past. ● Price level at which non-oil alternative energy sources' entry into energy market begins.
$22-28 (average $25)	● Price level that OPEC wants to maintain. ● To maintain the price level, production cuts by OPEC alone is necessary. ● Development of crude oil and non-oil alternative energy sources become activated.
$27-33 (average $30)	● Price level at which all oil-consuming countries become united in criticizing high oil prices. ● Animated discussions about releasing oil stockpiles for emergency use. ● Oil-consuming countries' response in 2000 to crude oil prices which remained at high levels

Spot Trading of Middle East Crudes and Stabilization of Crude Oil Price

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- **Factors affecting violent fluctuations of crude prices**

  # Too high OPEC price band and production controls
  # Weakened supply cushions such as insufficient refining capacities and low level of oil inventory
  # Overshooting reactions in future market and bottlenecks in spot market
  # Reflection of marginal supply-demand by marginal price marker

- **Formation of marker price by spot trading of ME crudes**

  # ME crudes are the mainstream reflecting global supply-demand balance
  # Without direct interventions, spot trading is consistent with production controls
  # Stabilization of crude prices is serious subject also for oil producers

Some room to suggest the adoption of spot trading to oil producers from the viewpoint of stabilization of crude prices?

Middle and Long-term Subjects aiming at Reducing Asian Premium

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- **Preparation of oil product markets in northeast Asia and Asia**

  # Streamlining and expansion of oil markets in various consuming areas
  # Formation of the linkages of oil markets between Asia and Europe/US

- **Developments of alternative crudes except ME crudes**

  # Procurement of increasing crude oils in the West of Suez such as West African crudes
  # Developments of neighboring oil resources such as Sakhalin and east Siberia
  # Developments of liquid fuels (GTL) from coal and natural gas

- **Further reinforcement of flexibilities in consuming areas**

  # Flexible combinations of crude oil processing and oil product import/ export
  # Reinforcement of flexibilities in fuel selection in consumer sides