Shifting trade flows: Middle East strategies for market share in Asia

Middle East crude will keep its Asian stronghold in the long run. GCC countries will look to expand on their existing downstream portfolio in Asia, while Iran, Iraq and the UAE rely on attractive upstream concessions involving Asian partners. But global competition remains stiff. Producers continue to channel their exports to the East and the Middle East will need to adopt more creative strategies to secure its market share.

Sometime in 2017, consumers in Vietnam will begin buying petroleum products sourced from Kuwaiti crude and processed at the Nghi Son refinery and Petrochemical Complex in Thanh Hoa province. The new plant, under construction since October 2013, will process 200k b/d of crude, yielding diesel, gasoline, jet fuel and LPG for the local market. Its capacity is small by global standards, but Nghi Son is significant for the world’s oil market, representing another example of Middle Eastern crude oil exporters’ strategy to expand downstream access to Asia’s ever-growing customer base as shifts in trading patterns consolidate.

The big exporters of the Middle East have long seen their future in Asia, the main source for future global oil demand growth. To consolidate their foothold in this key market, they have used three main techniques: establishing downstream joint ventures, such as that at Nghi Son involving PetroVietnam, Japan’s Idemitsu and Kuwait Petroleum International; granting concessions to Asian investors in Middle Eastern upstream plays; and, more recently, pricing their crude exports competitively to Asia.

Latin America’s rising exports are also heading to Asia in greater volumes. The continent’s shipments increased to 3.9m b/d in 2014, up from 3.6m b/d in 2010. But during the same period, sales to the US fell by 600k b/d to 1.6m b/d. Exports to Asia, by contrast, more than doubled to 1.6m b/d, as refineries there developed capacity to handle heavier grades such as Venezuelan crude.

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<th>Market share in Asia</th>
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<td><strong>2010</strong></td>
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<td>Middle East</td>
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Source: BP

**Pivot east**

Shifts in global oil trade patterns have been underway for several years as the centre of consumption growth moves from OECD to non-OECD – but the rise of US tight oil production has catalysed and accelerated this transition. US net imports in 2010 stood at 9.7m b/d. By August 2015, net imports were just 5.2m b/d, despite a modest rise in consumption during this period.

This had profound consequences for global trade flows. West Africa’s exporters, historically reliant on US East Coast buyers, were most exposed as their barrels were backed out of the US and left to swing between the Atlantic and Pacific basins. Angola and Nigeria exported just 343k b/d to the US in 2014 compared with 1.7m b/d in 2010. The extra barrels created an arbitrage between Europe and Asia. West African exports to Asia rose from 1.5m b/d in 2010 to 2.1m b/d in 2014; while those to Europe increased by 700k b/d to 1.6m b/d in the same period.

Former Soviet Union countries (mainly Russia) have also increasingly targeted Asia. Total exports rose to 8.9m b/d in 2014, compared with 8.5m b/d in 2010. While exports to Europe remained stable (at around 6m b/d), those to Asia rose from 1.3m to 1.8m b/d in 2014. The expansion of the Chinese segment of Eastern Siberia Pacific Ocean pipeline from 300k b/d to 600k b/d by the end of this year will increase Russia’s share of China’s market.

**Competition in Asia**

The Middle East has not been immune to this shift in crude trade flows. Exports from the Middle East reached 19.8m b/d in 2014, up from 18.9m b/d four years earlier. But sales to Europe decreased from 2.4m b/d to 2.1m b/d in the face of lower demand growth and increased competition from Russia and West Africa. This has prompted some key exporters such as Saudi Arabia to market their crude in Europe more aggressively: Saudi Aramco recently sold its first cargos to Poland and Sweden in many years.

In the US, refineries still show healthy demand for heavy crude from the Middle East. But competition from Canadian barrels has been fierce with US imports from Canada reaching a historical high of 3.4m b/d in August 2015 while Saudi exports to the US have become more volatile, declining to 1m b/d in August 2015 from the high of 1.6m b/d in April last year.

Despite tougher competition and Asian refineries’ access to more diversified sources of supply, Middle East exports to Asia between 2010 and 2014 continued to grow, from 13.2m b/d to 13.9m b/d – thanks in part to strategic downstream joint ventures, long-term contracts, and competitive pricing. As oil trade increasingly shifts to Asia’s growing crude market, Middle East producers will remain determined to keep their volumes in Asia in the face of more competition.
In 2015, Asia-Pacific remained the main source of growth, increasing its demand by around 1 m b/d with India’s contribution equaling that of China, each adding 300k b/d. Looking ahead into 2016, Asian demand growth is likely to ease to around 900k b/d as Chinese economic growth slows down, but so will Asian oil production, which is expected to flat-line or even decrease marginally as current cuts in capital expenditure start affecting supplies in countries such as China.

China remains the key market for Middle Eastern exporters — and for most of them shipments to the country remain robust. Between 2013 and September 2015, Iraq increased its share of Chinese imports from 8% to 10%. Oman, the fourth-largest exporter of crude to China, has increased exports by 6% to 630k b/d. Kuwait added 100k b/d to its exports to China in the same period. In 2015, Saudi Arabia remained the top exporter to China, exporting more than 1 m b/d to the country between January and October (Russia temporarily overtook the kingdom in September).

**GCC relies on its Asian downstream**

Downstream strategies in Asia have played a pivotal role, providing an outlet for GCC oil in this key region. This is particularly the case for Saudi Arabia. In China, the kingdom is a partner in the 240k b/d Fujian refinery that was configured to process Saudi Arab Light. In Japan, Saudi Arabia is a shareholder in the 400k b/d Showa Shell refineries. In South Korea, the kingdom has a stake in S-Oil’s 670k b/d refinery. All told, it gives Aramco access to Asian refining capacity of roughly 1.3m b/d. This may yet increase: Aramco may buy a stake in a Chinese National Petroleum Corporation (CNPC) refinery along with retail assets. In India, it has signed preliminary deals covering future possible downstream partnerships.

Saudi Aramco has also leased storage tanks in Japan’s Okinawa port, where the company has reportedly stored roughly 6 million barrels. This will allow greater flexibility to supply the Asian market when demand gaps appear.

Kuwait, meanwhile, has pursued downstream openings in Asia too. For now, its international refining capacity is restricted to Europe. But Kuwait has plans to sell its Rotterdam refinery and focus its European activities on marketing and its retail network, consisting of 4,000 filling stations.

But on top of its Nghi Son refinery project in Vietnam, Kuwait has signed memoranda of understanding with Indonesia and China covering potential downstream partnerships. Investment decisions have not yet been made.

**Oman, which has a stake in India’s 120k b/d Bina refinery, also has an interest in the Qingdao Lidong Chemical Company in China. Reports suggest that Oman hopes to establish a joint-venture refinery in Indonesia.**

**While others offer upstream concessions**

Investment in upstream assets is also part of Middle East producers’ strategy to secure their Asian customer base. The doubling of Iraq’s exports to China in the past three years is in large part due to Chinese investment in the country since 2007. This has included whole ownership of assets or equity investments; and has provided China with 470k b/d of equity oil.

As Iran’s upstream reopens, Asian investors will compete for a strong position in that country too. Tehran plans to replace its older buy-back contracts with more attractive terms, including fewer restrictions on cost recovery and booking of reserves.

China’s CNPC is thought likely to take on the giant Azadegan North field where it has already done some work, while Sinopec is likely to operate the Yadavaran field.
The UAE has taken a similar approach to consolidate its share of Asia’s market, which accounts for more than 90% of its exports. The end of the 75-year Adco concession in 2014 has been replaced with a new 40-year concession. It will involve many Asian companies (and France’s Total), Japan’s Inpex and South Korea’s GS Energy have already secured equity shares. The new consortium will be called on to increase production from 1.6m b/d to 1.8m b/d, accounting for more than 50% of total UAE production.

**Competitive pricing**

Competitive pricing has been the other main tactic to push higher volumes of crude into Asian markets. Iraqi crude exports have risen sharply this year and to sell these increased volumes, State Oil Marketing Organisation (SOMO) has been discounting its cargoes to Asia. The splitting of its crude stream to heavy and light has also helped by addressing some traders’ concerns about the quality of its exports. Iran has also discounted its oil sold into Asia; for October, November and December loadings, it narrowed the premium of its light crude over Saudi Arab Light to just $0.15/b.

Aggressive pricing in the past 18 months has triggered discounts from other Middle East producers, including Saudi Arabia and Kuwait. Middle Eastern exporters have also offered attractive payment schemes to buyers in Asia. Under these agreements, Iraq, Kuwait, and Iran have given some of their Asian customers – typically cash-squeezed Indian refiners – a grace period of 60 to 90 days to pay for crude imports, equivalent to a $0.50-0.75 discount per barrel.

**Middle East will retain market share**

Competition for Asian markets is intensifying. But the growing presence of Russian, West African and South American oil in Asia should not be exaggerated. Short-term gains for such exporters can be expected as trade patterns continue to evolve and Asia seeks to diversify its supply sources. But this should not be seen as a threat to the Middle East’s exporters or their position in Asia’s ever-growing market. Middle Eastern producers such as Saudi Arabia, the UAE and Kuwait sit on some of the world’s largest reserves, operate some of its cheapest wells and have a historical record of being a reliable source of supply despite many geopolitical shocks.

As Asian oil demand continues to grow and as current cuts in capital expenditure start affecting supply growth outside the Middle East, the key Middle Eastern exporters such as Saudi Arabia, Kuwait, UAE, Oman, Iran and Iraq, some with very ambitious plans to increase productive capacity, will consolidate their role as the main suppliers to Asia.

But in face of shifting global trade patterns and tougher competition, Middle Eastern oil exporters will continue to resort to creative strategies to press home these advantages and retain their market share in Asia. Iraq and Iran will rely on competitive pricing and attractive upstream contracts to entice Asian players.

For Kuwait and Saudi Arabia, where the upstream sector is closed to foreign investment, securing a large downstream portfolio in Asia is part of a long-term strategy to consolidate their share in a key market. While competition is proving to be tough, strategies currently being pursued can result in long-term gains and further consolidate Asian-Middle East energy ties.