FUTURES INSIGHTS

Issue 42 - April 2023

New market dynamics bring arbitrage hedging into focus

Crude oil markets have undergone a number of shakeups in the post-pandemic trading environment, including the re-routing of sanctions-hit Russia oil and a rebound in US exports, while OPEC+ takes on the complex role of balancing markets.

Global crude oil markets in 2023 have again shown signs of excessive volatility, not least because of the banking crisis during March, while EU sanctions and the G7 price cap has led to a major re-routing of Russian crude exports.

However, medium sour crudes, the mainstay of Middle East production and a staple for many refiners across Asia have led the price recovery, comfortably outpacing the North Sea Brent benchmark.

Oman futures trading on the Dubai Mercantile Exchange (DME), the primary Middle East oil futures contract, is at around parity to Brent futures, while the spread between Oman and the US WTI benchmark has become a key measure of competitive values of crude grades sold into Asia.

The broader reset in crude oil markets has been highlighted by volatility in spreads between various types of crude oil, meaning that traders and risk managers need to pay close attention not just outright price movements, but the price relationship between the different grades.

Perhaps the starkest price movement has been the realignment of medium sour grades versus light sweet crude, as East of Suez markets continues grow in prominence as almost all of the new oil demand over recent years is from the Middle East and Asia.

Shipping analytics company Kpler calculated that some 70% of crude produced by OPEC+ members, which includes the core OPEC group along with other producers such as Russia, is sold to customers in Asia, up from just over 60% in 2017.

Demand

Concerns that demand would slow down in 2023 led OPEC+ to announce a production cut of some 2 million barrels per day of crude late last year, although with most members of producer alliance from outside of the Middle East already struggling to meet quotas, realized cuts were nearer to 1million bpd.

This was followed up in early April when a number of OPEC+ members, primarily from the Middle East, announced further combined production cuts of 1.15 million bpd for the remainder of the year.

But while analysts have increasingly turned bearish on Western economies, Asia and particularly China, is still showing firm signs of demand recovery.

By February of this year, demand in China had already increased by 900,000 bpd from year-ago levels and further strong growth is expected to continue.

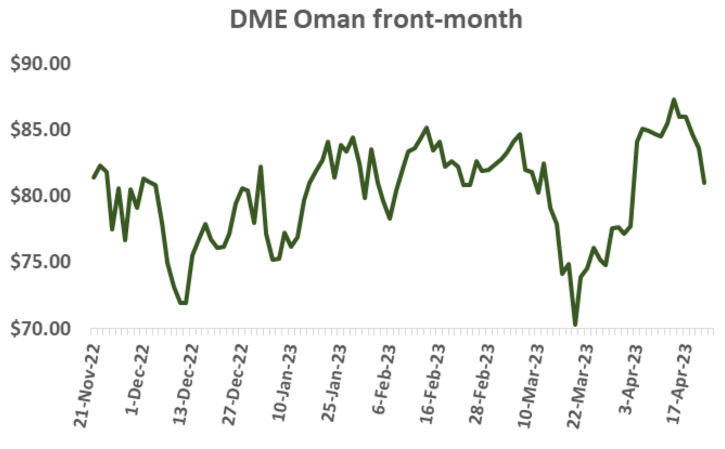
Both OPEC the International Energy Agency expect global crude and liquids demand to reach almost102 million bpd this year, led by China, along with firm growth in jet fuel demand.

Reflecting solid demand for physical barrels across the Asian market, the Dubai Mercantile Exchange delivered 63.77 million barrels of Omani crude via its exchange delivery mechanism in the first quarter of 2023, up 18% from the 54.01 million barrels in the same period in 2022.

Russia

However, despite the ramp up in Chinese demand, Middle East producers have had to compete with a flood of re-routed oil sold into Asia, with Russia now regularly the largest monthly supplier of crude oil into both China and India.

While Russian oil is not barred from sales into countries outside of Europe and the G7, it is sold at heavy discounts with an official price ceiling of $60/b, which could give saving of up to $20/b versus similar grades such as Oman or Abu Dhabi’s Upper Zakum.



US production

Another major dynamic has been the post-pandemic rebound in US crude production and exports, which in turn has seen new trends emerge as global oil flows shift.

US crude exports had already recovered back to record volumes in 2022 of around 3.6 million bpd, as European refiners chased replacements barrels for lost Russian crude, while a record release of 180 million barrels of crude from the US Strategic Petroleum Reserve also freed up additional volumes for export.

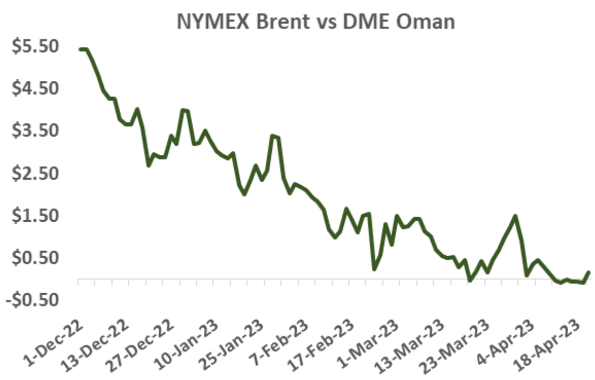
This year has regularly seen US exports in the 4-5 million bpd range, with similar volumes of over 1.5 million bpd shipped to both Europe and Asia.

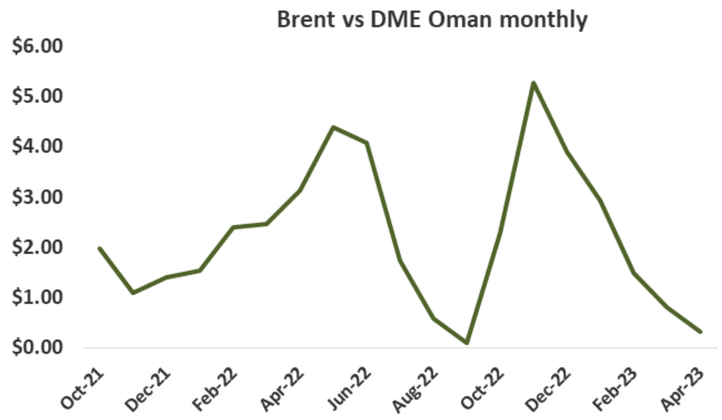
Soaring US oil production in recent years has largely been light sweet crude from shale basins such as Permian and Eagle Ford, and while domestic refineries US have stepped up purchases of lighter grades, there is only so much that can be processed as many North American refineries were configured to handle heavier barrels from the US Gulf.

Production from the Permian Basin alone is expected to ramp up to around 5.7 million bpd in 2023, which is second only to Saudi Arabia among OPEC members, although some analysts say overall exports could ease, particularly if the US starts a buy-back program to restock the SPR.

The pivot to lighter grades means US refiners are still structurally short of heavier crudes, with the deficit of over 500,000 bpd made up from imports, primarily OPEC+ producers. However, in complex arbitrage flows linked to logistics, North America has increased the sale of heavier barrels to Europe, adding in another shift for oil hedgers to consider.

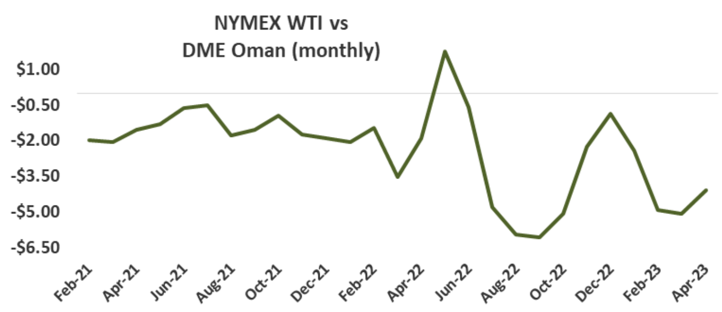
Historically, light sweet Brent crude has traded at a premium versus Oman, but new market dynamics have crunched NYMEX Brent versus DME Oman to near parity during April, having started the year at around +$3.50/b.





Benchmark NYMEX WTI futures traded on CME have typically traded at a discount to both Oman and Brent in recent years, although US pricing now reflects both domestic and export values.

As such, NYMEX WTI is increasingly a global reference price, rather than just for US and Atlantic crude flows, while the WTI/DME Oman spread is a key indicator of competitive crude values for sales into the Asian market.



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