East of Suez Oil Perspectives

Renaissance Energy Advisors

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Sweet-sour spreads in the spotlight

Since Saudi Arabia's announcement of a 1m b/d voluntary cut for the month of July (yesterday extended to Aug), ICE Brent has traded in a narrow range of US$73-77/b. While flat prices have flattered to deceive, much of the action this past month has taken place in the medium-sour market. June saw a near record trading month in the Dubai 'window', with over 1732 Dubai and Oman partials traded and total deliveries through the window mechanism reaching 72 Aug-loading cargoes. Unipec accounted for more than 70% of selling activity, the bulk made up of Oman cargoes. The Chinese trading unit is on course to deliver 40 Oman cargoes (equivalent to 20mb and around 70-80% of Oman's typical loading programme) and eight cargoes of Upper Zakum (as well as smaller volumes for Al-Shaheen and Murban). Despite the selling pressure, Dubai structure held up, supported by PetroChina and Totsa buying activity. For June as a whole, the cash Dubai to paper structure averaged $1.09/b, a small increase m-o-m.

While some in the market have read Unipec's trading behaviour as a sign of Chinese demand weakness, we do not agree. REA's sources suggest that Unipec had been building an aggressive trading strategy in the Dubai derivatives market[i] for several months and was using its physical portfolio to defend that position in the Dubai window. While June saw Dubai backwardation steepen, Brent and WTI registered a small contango during the month. June also saw the front-month Brent-Dubai exchange of futures for swaps (EFS) turn negative (albeit briefly) for the first time since late 2020.

Fig.1: Dubai/Oman physical convergence by grade (mb)

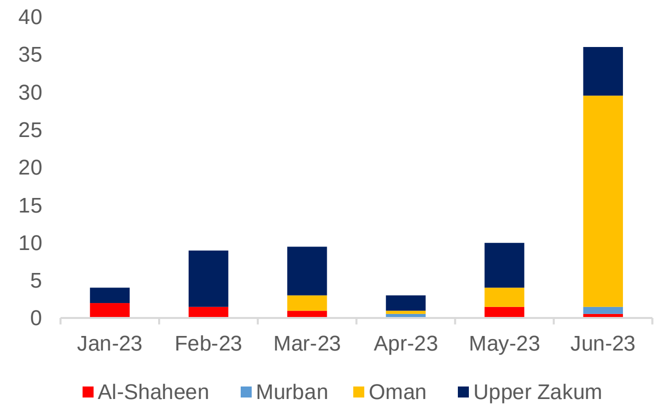
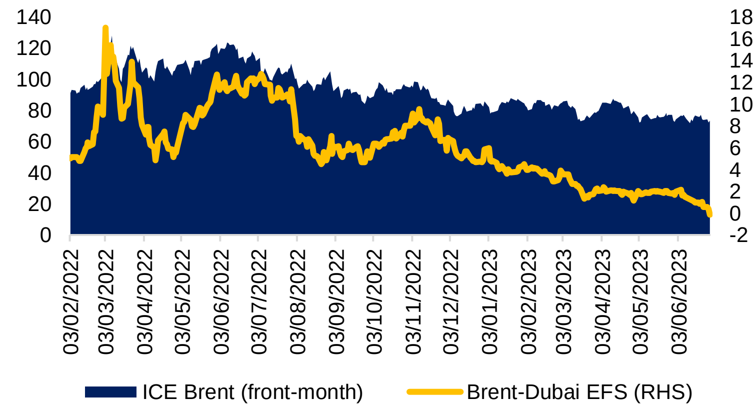


Fig. 2: Front-month ICE Brent and Brent-Dubai EFS (US$/b)



Source: REA, S&P Commodity Insights

Beyond Saudi's 1m b/d voluntary cut, tightening sweet-sour spreads have also been supported by robust HSFO cracks in Asia and a deterioration in naphtha margins. In the US, sweet-sour differentials have narrowed: US Mars narrowed its spread to Light Louisiana Sweet as US Gulf refiners swap out pricey Saudi crude for domestic medium-heavy crudes. Likewise, in Europe – where medium-sour price discovery has become more problematic since the loss of Urals – Johan Sverdrup differentials to North Sea Dated have inched upward (reaching just above US$1/b premium to Dated Brent in late Jun).

As we move into H2, we note the following:

- **Macro concerns will continue to weigh in on paper positioning but a 'hard landing' this year remains unlikely, in our view:** while flat prices have been sensitive to the tightening monetary cycle that has set the stage for the most elevated real rate environment since the 2008 financial crisis, portfolios who have positioned for a 'hard landing' this year may be disappointed. While core inflation continues to remain stubborn – as global labour markets remain tight – US economic indicators have proved fairly resilient (supported by consumer confidence data, excess savings, and new home sales). Nevertheless, we note that as long as labour markets remain tight (accompanied by slow labour productivity gains), strong unit labour cost growth will continue to maintain underlying price pressures.

- **Fundamentals will assert themselves for the remainder of the year:** despite the slowdown in global PMIs and the lacklustre progress in China's industrial activity, the oil market currently remains well balanced. REA continues to see Chinese oil demand growth of 950kb/d this year. While Chinese gasoline demand has done most of the leg work in H123, there is still room to go to the end of this year (supported by jet fuel demand and a potential boost to gasoil usage from further stimulus packages in Q3 23). The bigger swing however for balances in the coming months will come from OPEC, particularly Saudi. Riyadh's extension of its voluntary 1m b/d cut through to August will tighten balances, in our view (notwithstanding concerns around Russian compliance).Market balances in June were impacted by the growing volume of Iranian crude leaving floating storage (with crude and condensate exports currently pegged at 1.6m b/d, further supported by aggressive discounting of Iranian Light on a delivered basis to China versus Urals); and the resilience of Russian crude exports (despite Moscow's pledge of a 500kb/d cut). With Chinese demand having further to go, in our view, and the potential for even further extensions to Saudi's cuts (beyond Aug), we forecast a market deficit of around 1.5m b/d in Q323.

- **Sweet-sour spreads set to remain in a narrow range:** while we expect a narrow Brent-Dubai EFS to encourage more arb flows to Asia from the Atlantic, we continue to see a tight sour crude market in the coming months. Notwithstanding Saudi's extension to its 1m b/d voluntary cut (which could continue throughout entire Q3), higher Middle East refining runs will also reduce sour crude export availability. Likewise, the likelihood of gas prices remaining softer y-o-y and the likelihood of naphtha margins remaining weak throughout 2023 are likely to prevent any major widening of sweet-sour differentials.

Unipec's Oman selling and the Dubai 'window'

Following Saudi's announcement of a 1m b/d cut in early June, Aramco increased its Asia OSPs for all grades. The July OSP differential for Arab Light and Heavy to Asia was increased by US$0.45/b. Beyond attempting to discourage incremental demand as the Saudi cuts take root, the OSPs reflected the uptick in seasonal domestic crude demand (particularly for Arab Heavy) as oil-fired generation is ramped up to meet peak power demand. Not surprisingly, Arab Light has so far proved to be the least competitive grade for Asian refiners (reflected by FCC margins in Singapore).

Fig. 3: Saudi Aramco Asia OSPs v Dubai/Oman (US/b)

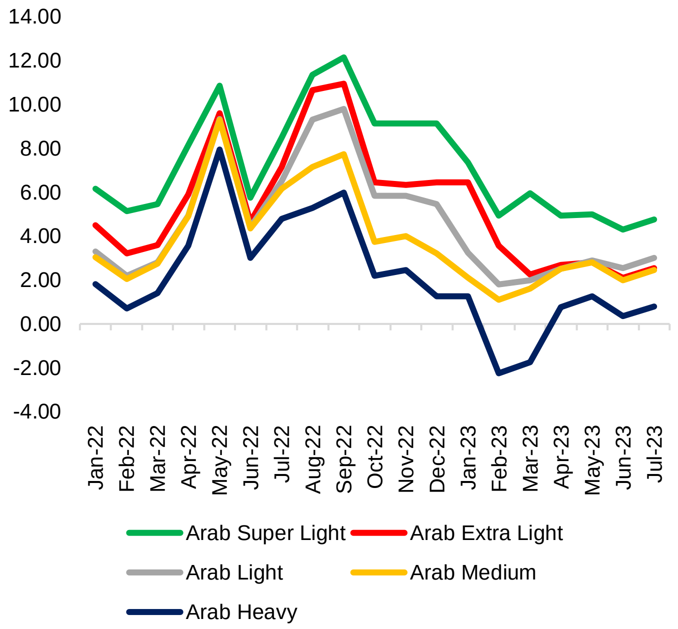
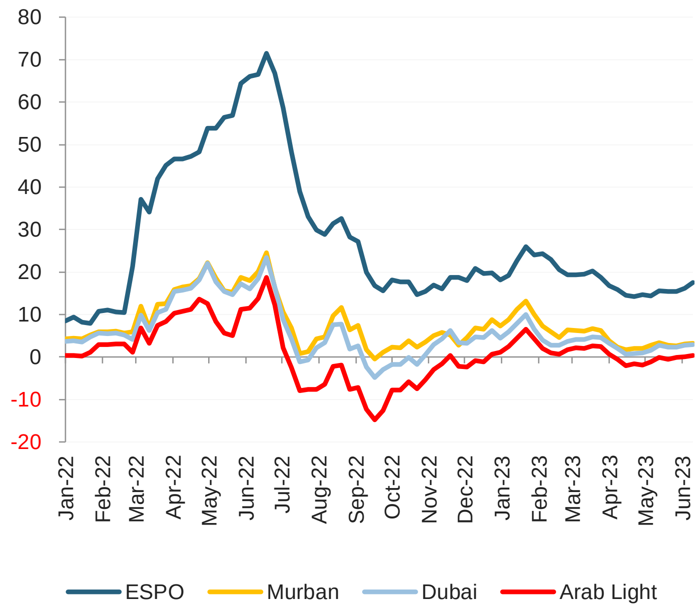


Fig.4: Singapore FCC refining margins (US$/b)



Source: REA, FGE, Saudi Aramco

In one of the busiest months on record, the Platts window saw over 1,700 partials traded, resulting in 72 August-loading cargoes reaching convergence. Upper Zakum has typically set the price of Dubai, but June trading for Aug-loading saw Oman set the pace for Dubai pricing activity. This was largely driven by Unipec selling activity. In a bid to keep a lid on Dubai structure, Unipec sold a record amount of Oman cargoes via the Dubai/Oman 'window'. The biggest counterparties to Unipec's Oman trades in June were PetroChina (10.5mb) and Totsa (15.5mb). Other participants included Glencore, Vitol, Reliance and Exxon (who will all deliver Aug-loading cargoes against window convergences in Aug; Trafigura, Equinor and Shell will also take deliveries).

Fig. 5: Dubai physical convergence (by grade)

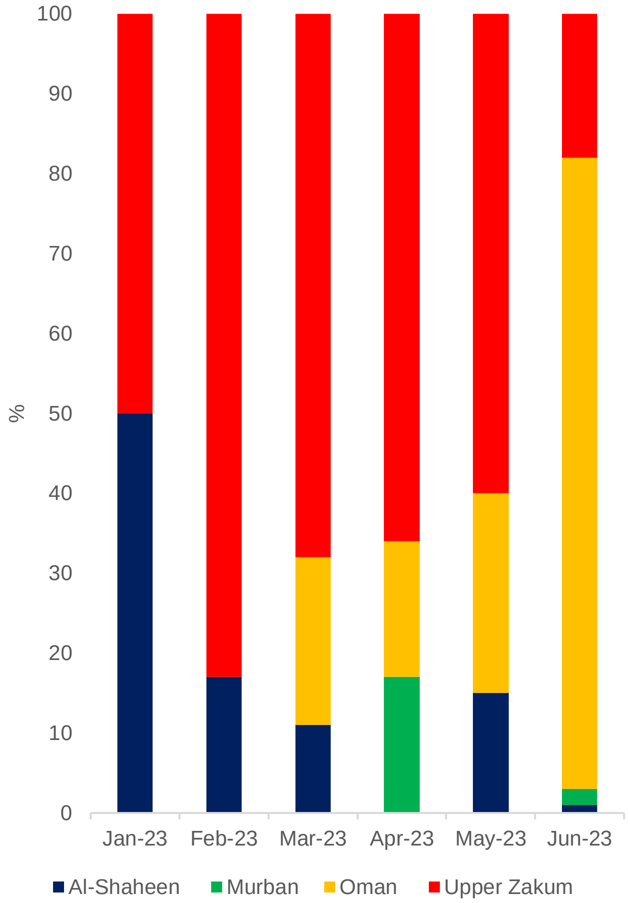
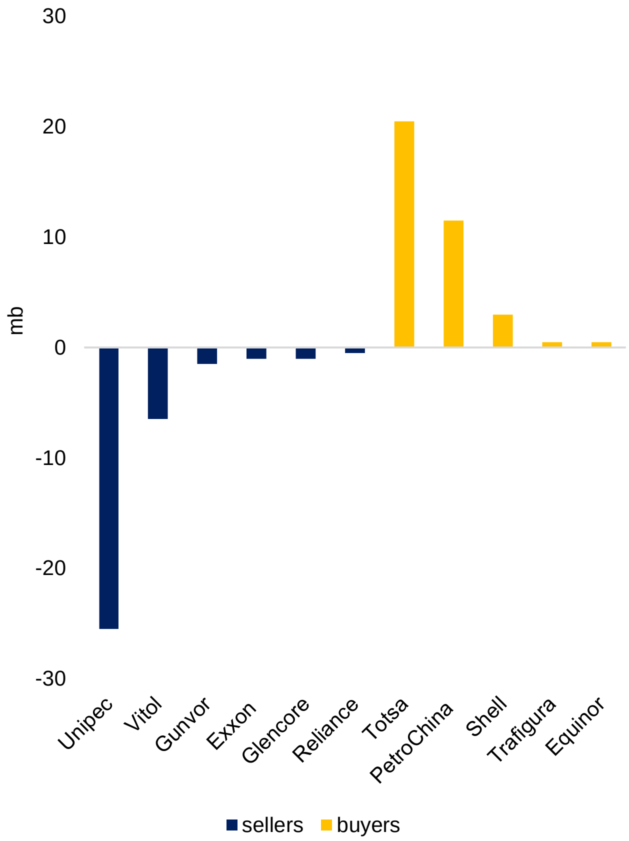


Fig. 6: Buyers and sellers in Dubai/Oman window (physical convergence, Aug-loading), mb

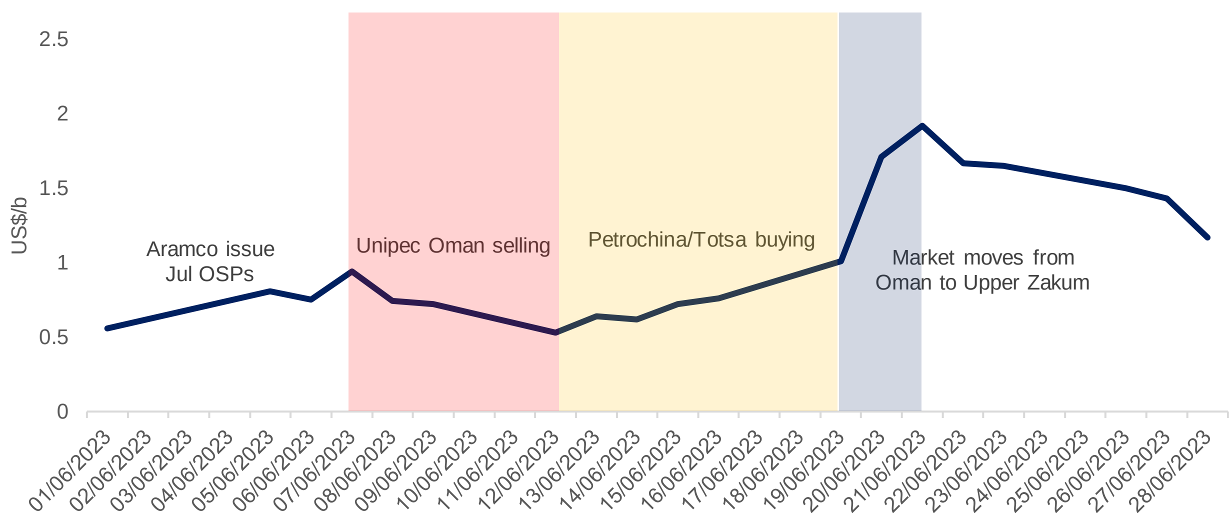


Source: REA, DME, S&P Commodity Insights

It has been suggested that Unipec's aggressive selling activity was driven by a softening in Chinese demand. We disagree. REA's trading sources suggest that for several months Unipec had been building a short position in the Dubai swaps market; while Unipec's selling may have given the market the impression that the Oman market was weak, the trading major was likely using its physical portfolio to cover its position in the derivatives market. It should be noted that several other companies, including Glencore, Vitol, Reliance, Gunvor and Exxon also nominated Oman cargoes to buyers in the Platts window.

Fig. 7 shows that in the first half of June, Unipec's aggressive Oman selling had started putting pressure on Dubai structure; however, by mid-June, its hand was shown when cargoes for Oman trade switched to Upper Zakum. By then, the market had begun to realise that Oman physical liquidity was drying up, driving a surge in Dubai structure (which reached almost US$2/b on 21 June). The pushback to Unipec selling was also supported by Saudi term buyers seeking to enter the spot market to cover their physical requirements (made more acute by some refiners in Asia coming out of maintenance/turnarounds).

Fig. 7: Dubai M1-M3 spread (US$/b)

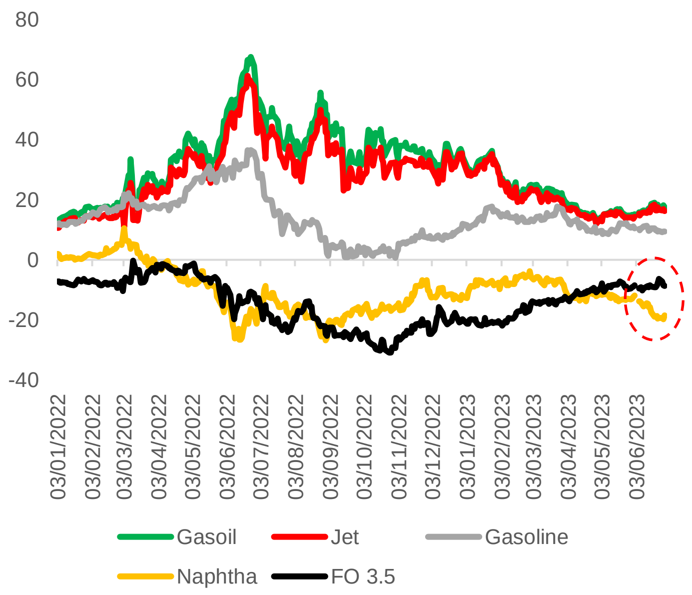


Source: REA, S&P Commodity Insights

Some opportunistic buying did take root as a result of Unipec's actions. Early in the cycle, Rongsheng bought Oman for Aug-loading at a premium of US$0.20-0.30/b v Dubai. Likewise, ChinaOil was another player who piggybacked on Unipec selling activity, picking up a cargo of Oman in the OTC market.

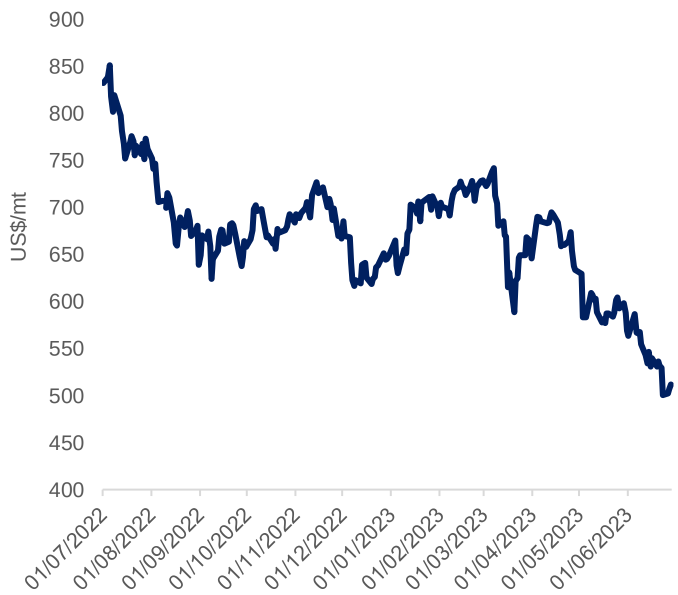
In the end, the 'window' did its job: accurately reflecting the tradeable value of medium-sour crude, which has not only been strengthened by Saudi's 1m b/d cut but also robust HSFO cracks in Asia. Conversely, naphtha cracks have underperformed, driven by an increase in Russian naphtha flows to Asia-Pacific and some overcapacity in China.

Fig.8: Asian oil product cracks v Dubai (US$/b)



Source: REA, S&P Commodity Insights

Fig. 9: Naphtha (min 70%) C+F Japan Cargo $/mt



Other indicators of a firmer sour crude market were seen in the trade for Aug-loading Basrah cargoes. CNOOC sold a 1mb Basrah Medium equity cargo to Petraco at OSP +US$1/b; likewise, Shell was heard to have sold a 1mb Basrah Medium cargo to Tupras at US$0.80-1/b over OSP. Iraq has restarted production of its heaviest field, Qayarah (30kb/d), where cargoes have recently been sold to Unipec via tender. Elsewhere, Totsa is heard to be advancing negotiations with SOMO to increase its Iraq equity portfolio, part of the US$27bn TotalEnergies-Iraq deal (first inked in 2021).

In our view, Unipec's behaviour was not a sign of softer Chinese fundamentals. While China's industrial demand has failed to meet bullish expectations (reflected in some diesel inventory builds), we note that summer demand could still surprise to the upside (given rising temperatures and power demand). Likewise, we do not yet see any evidence of any major pressures on Chinese diesel balances. The story remains similar for gasoline. In our view, the uptick in gasoline exports seen by China in May-Jun was likely driven by refiners increasing gasoline yields due to naphtha margin pressures (as petrochemicals margins have sunk). Overall, it is too early to say that China has disappointed.

For the remainder of this week, attention will be focused on Aramco OSPs for Aug-loading (coinciding with this week's OPEC seminar, due to be held on 5-6 July). Our view is that Aramco OSPs to Asia will again be increased, particularly for Arab Light.

[1] Dubai derivatives venues include ICE, TOCOM and trade via OTC.

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