East of Suez Oil Perspectives

Renaissance Energy Advisors

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OPEC's market intervention: drivers and implications

Dated Brent rallied this week on the news of OPEC+'s "surprise cut". After a low US$71.84/b in mid-March, Dated flat price surged to US$85.5/b on Monday 3 April.

Fig. 1: Dated Brent v CFD Structure (US$/b)

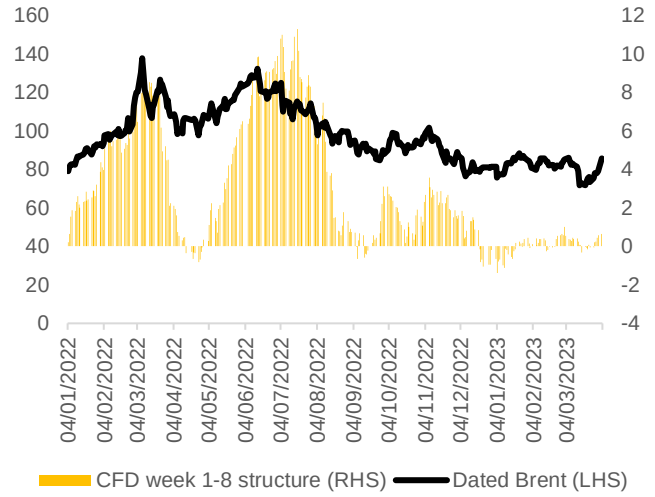
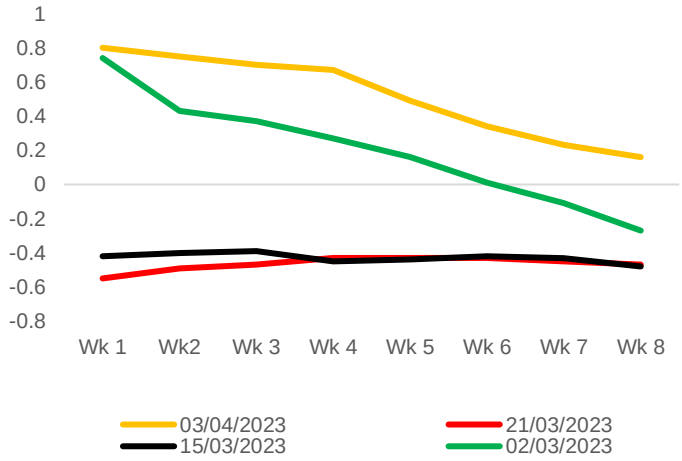


Fig. 2: Brent Contract for Difference (CFD) curves (US$/b)



Source: REA, S&P Commodity Insights

OPEC+'s paper cuts (including Russia's pre-existing 500kb/d cuts) amount to around 1.6m b/d; while Russian output losses were already baked in by the market prior to the announcement, the significance of the cuts rests with the fact that they are being made by OPEC members producing at or near capacity. In total, we expect the real physical cuts to amount to around 900kb/d.

Table One: OPEC+ voluntary cuts (kb/d)

	Current Target	Voluntary cut	Voluntary Production (May-Dec 23)	Q1 23 production
Saudi Arabia	10,478	500	9,978	10,350
Russia	10,478	500	9,978	9,910
Iraq	4,431	211	4,220	4,383
UAE	3,019	144	2,875	3,100
Kuwait	2,676	128	2,548	2,650
Algeria	1,007	48	959	989
Kazakhstan	1,628	78	1,550	1,670
Oman	841	40	801	840

This is now OPEC's second major market intervention in the space of six months. Back in October 2022, China was still in lockdown, Russian supply remained relatively resilient, and stocks were building – in retrospect, the cuts now seem prescient.

Can the same be said for the current course of action? The current cuts take place against the backdrop of a seasonal upswing in demand (with OPEC itself having previously forecast global oil demand growth of 1.75m b/d between July-Dec 23) and a delicate macro environment. Having front-run its own meeting and made its decision during the weekend when markets were closed, the surprise element of the cuts were key. What else can be said for the drivers behind the move? We see several factors:

- **OPEC floor price defence:** the reality remains that OPEC *has* the ability to exercise its market power in a way it could not in previous cycles. With the US having failed to execute on its pledge to replenish SPR stocks when WTI was trading between US$68-72/b, OPEC has asserted its role as the key price formation actor in the market, willing to defend a floor price of US$80/b. This market power is also reinforced by: the lower price elasticity of US short-cycle shale, the limits of US SPR intervention this year; greater OPEC+ cohesion to trim output given the supply chain pressures facing Russian oil and the fact most members are pumping near capacity (ex-UAE).

- **OPEC acting as a circuit-breaker:** Saudi Oil Minister, Abdulaziz bin Salman (AbS) has been clear on multiple occasions that paper traders should avoid betting against the OPEC house. While this is fanciful given the outsized role of the financial oil market (50x larger than physical), OPEC was likely concerned by the dramatic drop in spec net length in the wake of the collapse of Silicon Valley Bank (SVB). The build-up of short positions in WTI during March also reinforced the view that the market was gripped by macro sentiment.

- **Geopolitical calculations cannot be ignored**: it cannot be denied that both Saudi and Russia hold a contemptuous view of the G7-inspired price caps. OPEC's latest move now adds further pressure to the operational efficacy of the price caps. The cuts now lower the discounts on moving marginal Russian barrels to Asia (particularly given the rising cost of re-optimising Russian flows).

Moving forward, we consider the following as key issues to watch:

1) **The Fed and OPEC:** With the Fed near the limit of what it can achieve via policy tightening before causing further stress in financial markets, OPEC's move is now likely to delay any Fed pivot (initially expected to take place in Q4 23).
2) **Dubai premium to Brent:** trading opportunities are likely to present themselves for Brent-Dubai swap dealers, particularly given the double-whammy of: OPEC cuts and lower Middle East exports later this year (due to higher Middle East runs in Saudi, Kuwait, and Iraq).
3) **China's role as a key swing buyer in the grey market set to grow in importance:** with Brent-Dubai spreads expected to narrow in Q3-Q4 23, China and India will likely increase uptake of Russian grades in the market – narrowing differentials for ESPO and Urals.

Key Market Highlights

- **Kurdish crude return likely to be less smooth than expected:** Flat prices were supported in late March by the abrupt shut-off of 450kb/d of Kurdish crude via Ceyhan. In 2022, the KRG netted around US$1bn/month from crude sales and it is clearly the biggest loser from the arbitration ruling in late March. It is no exaggeration to say that the KRG's independent oil policy is now effectively dead.

Fig.3: KRG crude exports by destination (kb/d)

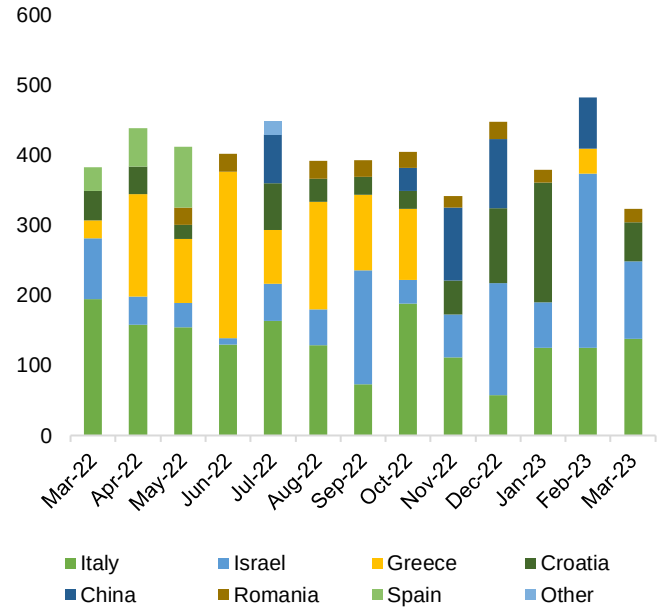
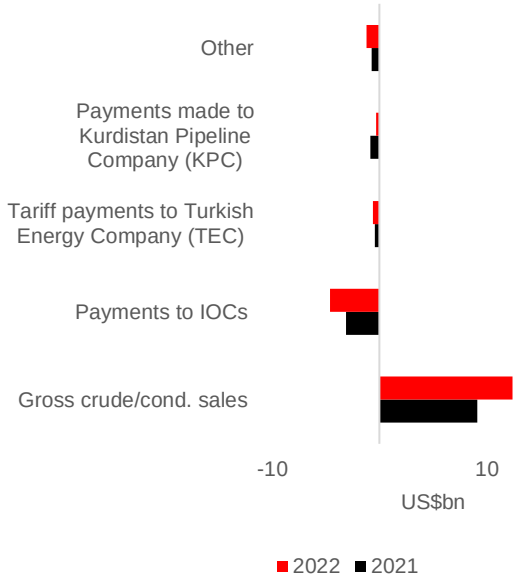


Fig. 4: KRG financial flows and net change (y-o-y)

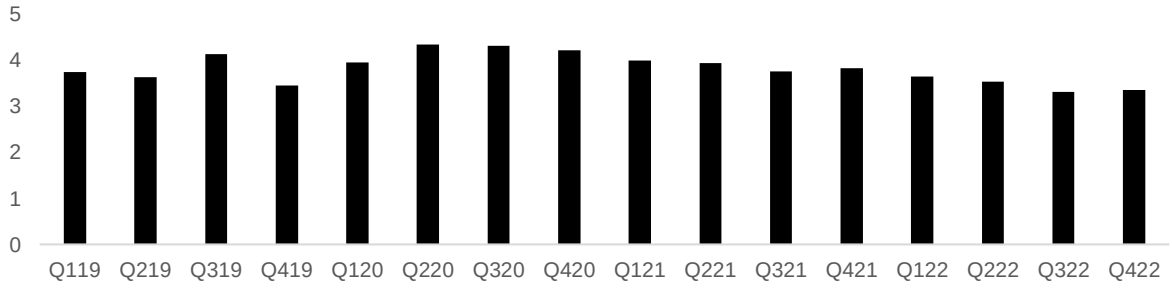


Source: REA, KPLER, MNR

At the time of writing, an interim deal has finally been struck to allow flows to resume. However, further issues will need to be ironed – in particular:

- **Details over SOMO's loading program for KBT (Kurdish Blend Test) cargoes remain unclear, with no certainty that prepaid cargoes will be allocated to trading houses**. The KRG has over US$3.5bn of prepayment obligations to a number of trading houses (key among them being Vitol, Trafigura, Rosneft and Petraco).

Fig. 5: KRG debt for oil prepayments (quarterly balance owed), US$bn



Source: REA, MNR

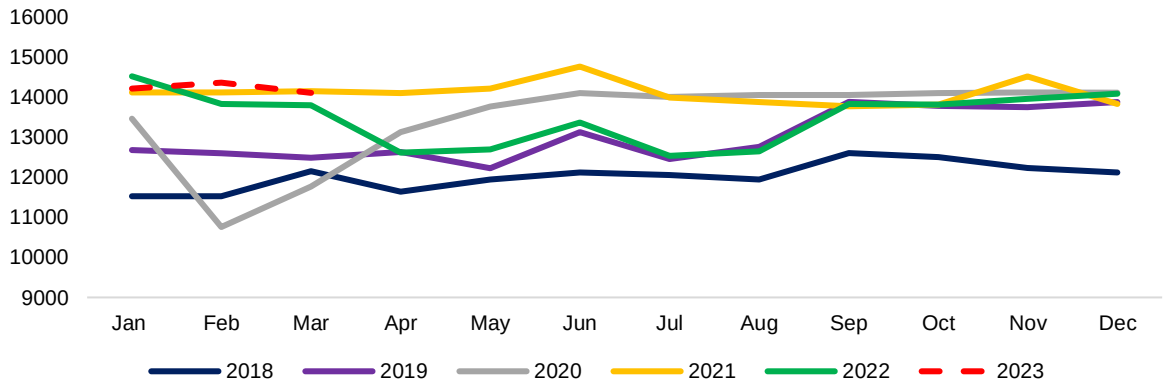
1) **The future position of the Kurdistan Pipeline Company (KPC), privately owned by Rosneft (60%) and KAR Group (40%):** another issue remains the new pipeline tariff fees paid to KPC under any new arrangement (KPC's profitability was driven on the differing tariff structure for KBT versus Kirkuk crude, with the latter being charged at a fee of around US$2/b).

2) **KRG's attempted shift away from Dated Brent:** with the KRG having already tried to implement new changes to its pricing formula for producers (shifting away from Dated Brent to an arguably more opaque formula), SOMO will need to revise the pricing formulae for KBT cargoes as well as exit the pricing options the KRG offered trading houses as part of deals signed in 2014-15. It also remains to be seen how the repricing of KBT in line with market conditions will now impact Med refiner procurement decisions, given the lower legal risk attached to Kurdish crude.

China: Great expectations

- **Chinese refinery runs set to fall:** with refinery maintenance season underway in China (set to impact around 650kb/d of Chinese capacity), runs fell to around 14.05m b/d in March (from an average of around 14.4m b/d between Jan-Feb).

Fig. 6: Chinese refinery runs (kb/d)



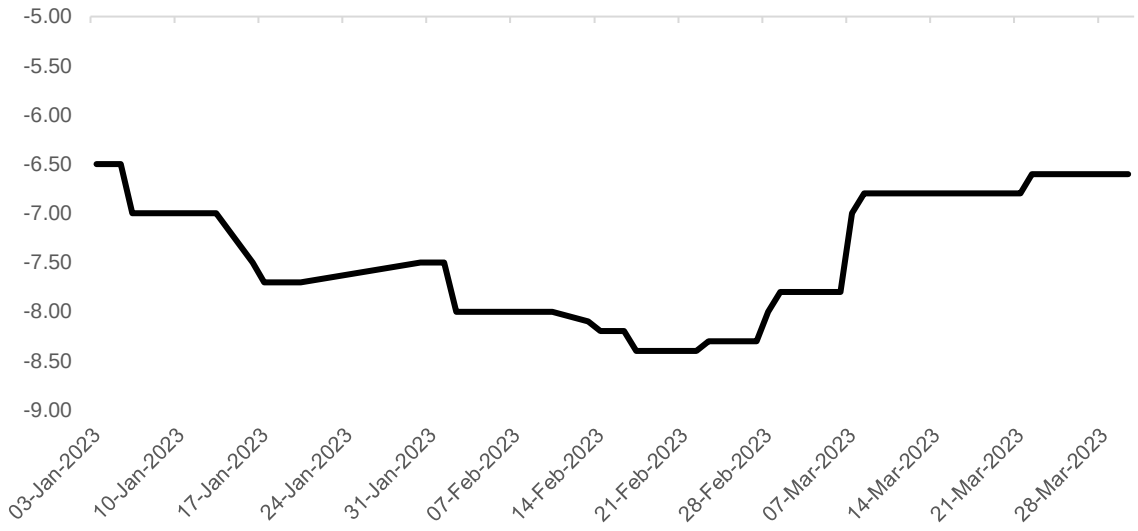
Source: REA

REA's view on Chinese oil demand for 2023 remains in a range of 700-800kb/d, approx.. 200kb/d lower than IEA forecasts. Despite the improvement in jet demand in China and rising internal flight numbers, international travel continues to remains weak. Sinopec – a key middle distillate supplier to south and east China market – has also revised upward its clean product export plans.

- **China's role as swing buyer in the grey market:** one of the key features of the oil market since Russia's invasion has been the role of China as the key swing buyer in the "grey" market. This swing status affords Beijing both geopolitical leverage and some pricing power. For example, Upper Zakum's strong premium to Dubai during Jan-Feb was partly driven by state-owned refiners shunning ESPO and Urals cargoes; this reversed in March, with April's ESPO program clearing quickly on the back of Unipec activity. We expect OPEC's cuts to play a role in reinforcing China's swing status, particularly once Chinese refiners exit

maintenance and opt to increase purchases of Urals and ESPO, helping narrow differentials for Russian crude.

Fig. 7: ESPO ex-Ship Des Shandong v ICE Brent (US$/b)

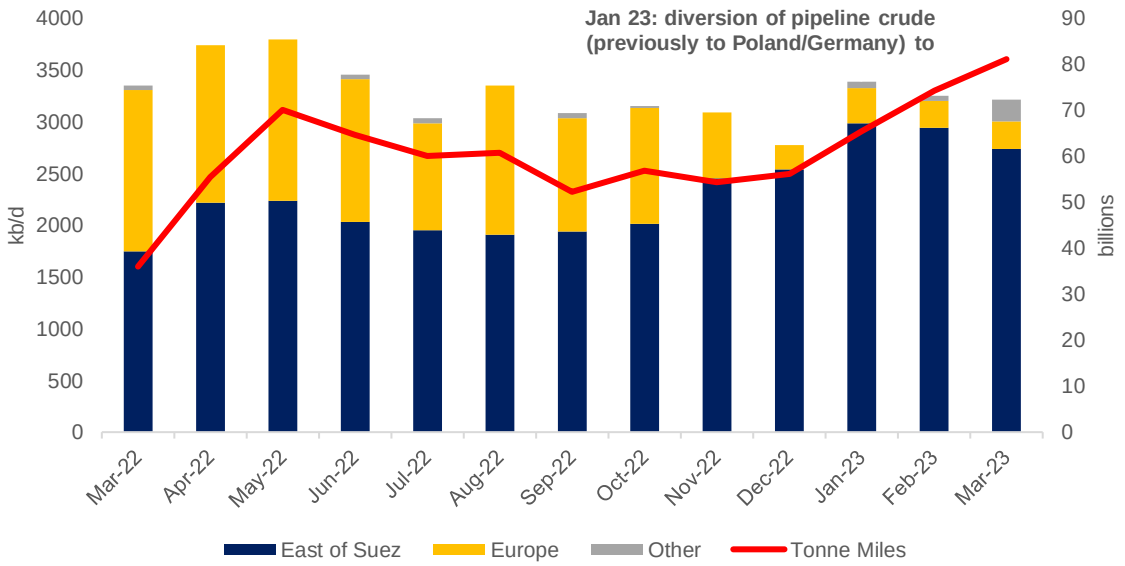


Source: Argus

Russia's oil supply chain in focus

- **Pressures start building on Russia's supply chain:** more than a year since Russia's invasion of Ukraine, Russia's oil production and exports have remained fairly resilient. The re-routing of Russian crude from Europe to East of Suez markets has come with a transformation in tonne-mile demand, an increase in STS activity and growing volumes of Russian oil on water (with the % of unknown destination growing m-o-m). The volume of Russian crude (primarily Urals) and products (particularly naphtha) held in storage in Singapore has also swelled in recent weeks.

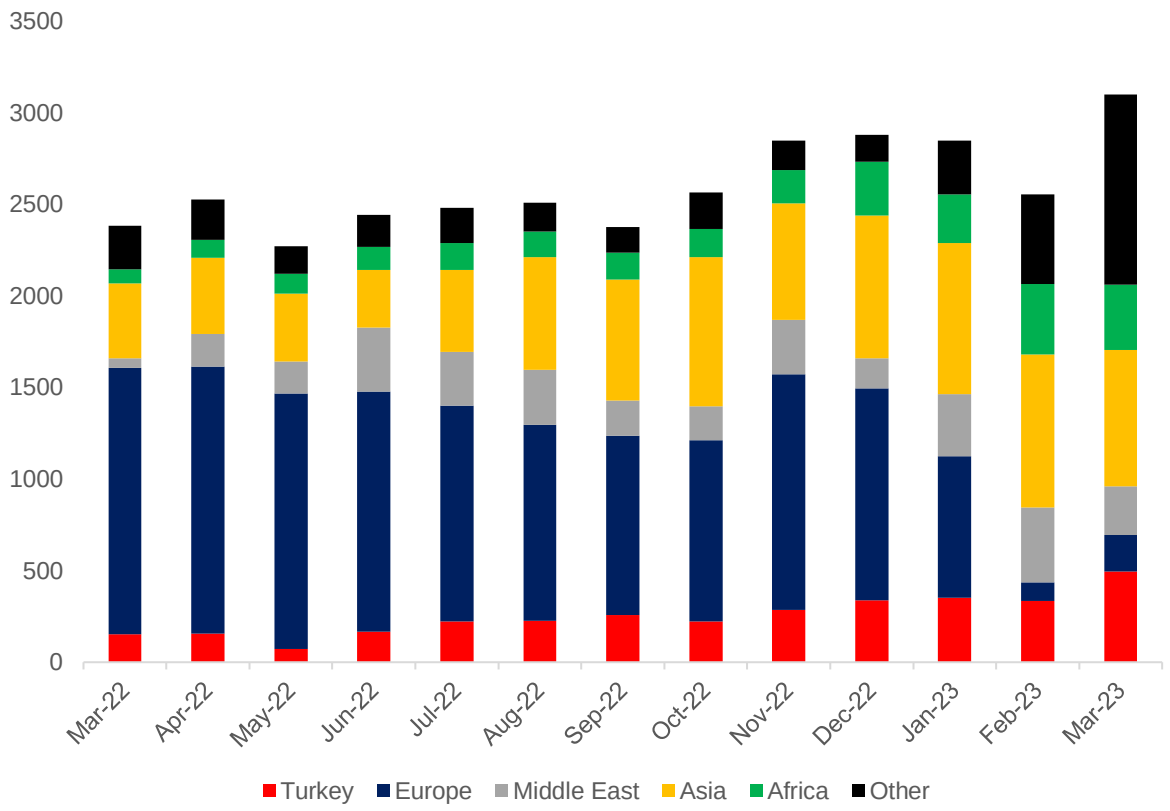
Fig. 8: Russian seaborne crude exports and tonne-miles (RHS), kb/d



Source: REA, KPLER

- So far, Russian product exports have largely held up, with an uptick in March (due to Feb cargoes having been affected by weather and refiners boosting runs ahead of maintenance). The Spring maintenance season will see around 850kb/d of refining capacity planned to be shut-in through to end-May. Runs are expected to drop by 520-550kb/d throughout Apr-May (leaving total runs at around 5.25m b/d throughout the period). While Russia has been able to find new buyers (increasing sales to Turkey and North Africa), we note that the volume of tankers loading products without a destination has been growing in recent weeks.

Fig. 9: Russia oil product exports by destination (kb/d)



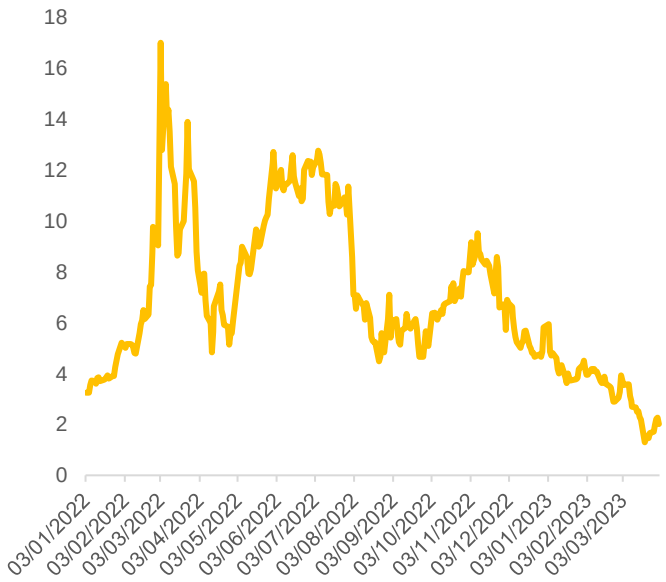
Source: REA, KPLER

East of Suez medium-sour market in focus

- The medium-sour market for Apr-loading cargoes saw Middle East spot cargoes under some pressure from a narrowing Brent-Dubai spread (supported by French refinery strikes), providing Asian refiners opportunities to procure Dated Brent linked cargoes; the cash Dubai to Dubai paper structure averaged US$1.65/b, falling US$0.38/b m-o-m. Partly the slowdown in prompt buying has been due to refinery maintenance (particularly among independent refiners). Another key feature of the March cycle was the narrowing of Brent-Dubai EFS, which is now near US$2/b.

Fig. 10: Dubai M1-M3 (US$/b)

Fig. 11: Brent-Dubai EFS (US$/b)



Source: REA, S&P Commodity Insights

- Rongsheng was more active during March's cycle compared to Feb. The Chinese refiner picked up several cargoes of Upper Zakum at premiums of US$1-1.5/b vs Dubai. The increased buying has been supported by Rongsheng's improved petrochemical margins in China.

- The Basrah market also saw a relatively healthy pickup in demand. Prior to SOMO's allocations, Petronas sold a 2mmb Basrah Medium (BM) pre-program cargo to Vitol at a premium of US$0.80/b v OSP. Other trades discussed with REA included a 2mmb BM cargo sold by CNOOC to Totsa at a premium of US$0.80/b – a trade mirrored by BP who sold a cargo of BM to Trafigura at US$0.80/b v OSP.

Aramco OSP pricing

- REA expects Aramco to increase its OSP differential for Arab Light heading to Asia for May-loading by US$0.15/b. We expect Arab Heavy's OSP to strengthen by US$1/b, driven by 1) Russia's refinery maintenance tightening up HSFO balances; 2) increased demand in the Middle East as the region prepares for summer power generation season.

Fig. 12: Asia oil product cracks v Dubai (US$/b)

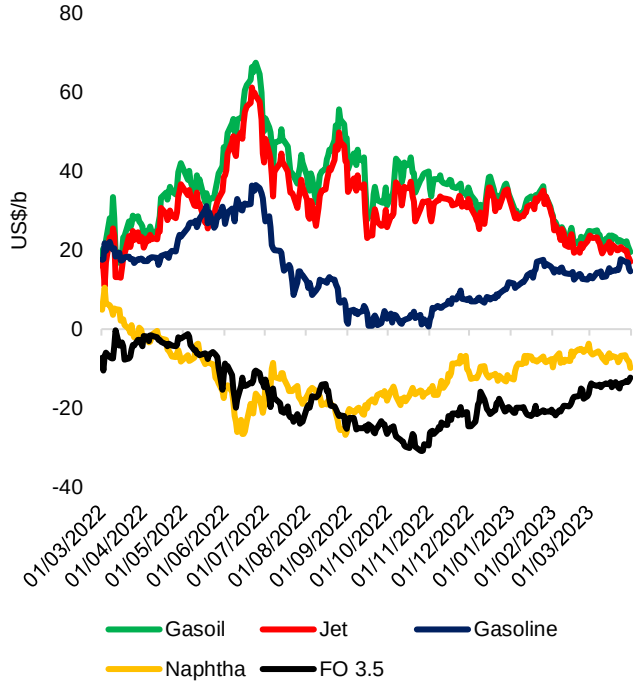
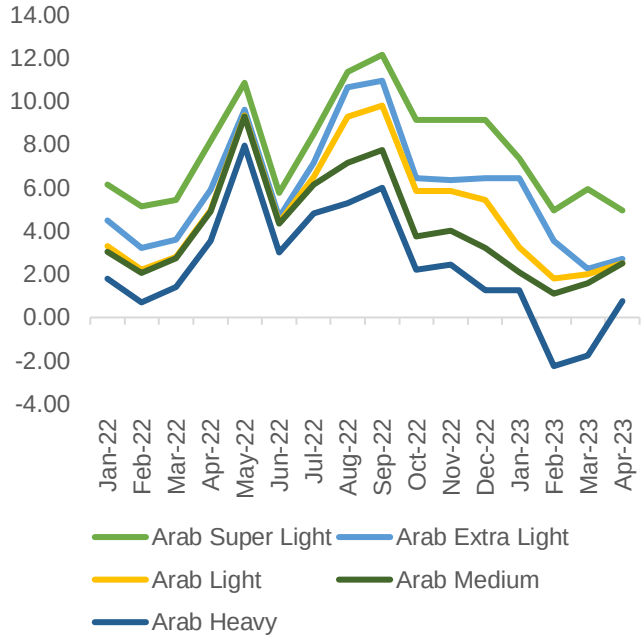


Fig. 13: Saudi Aramco OSPs (Asia) v DME Oman/Dubai average, US$/b



Source: REA, S&P Commodity Insights

We also expect Brent-Dubai EFS to narrow substantially in Q3-Q4 on the back of both Middle East refining projects (tightening up the Dubai market due to lower crude exports) and OPEC's recently announced production cuts.

To receive further insights from REA and discuss any questions highlighted in this note, please contact:

Ahmed.mehdi@renaissance-energyadvisors.com