

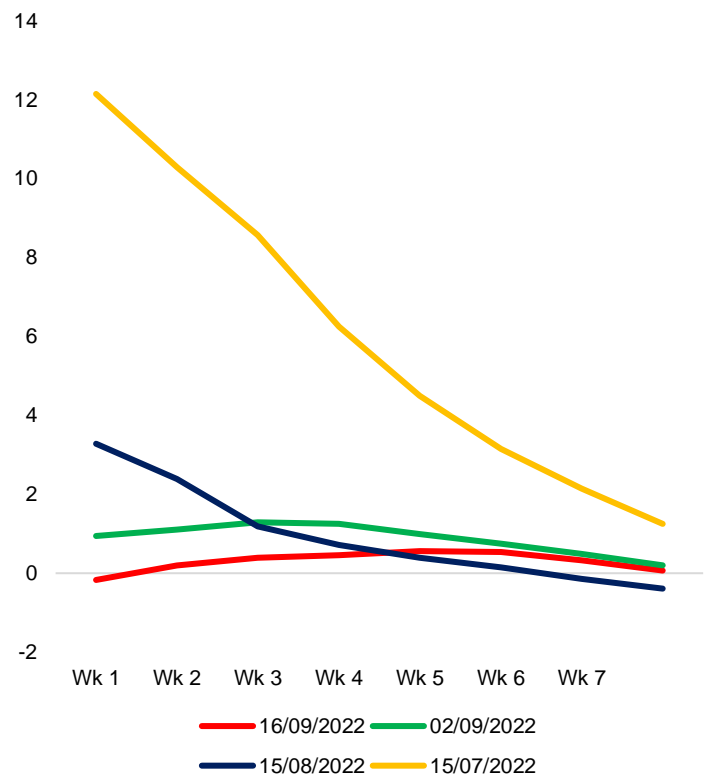
Key Market Highlights

Since July, flat prices and physical differentials have weakened with ICE Brent futures shedding around US\$30-35/b from its mid-year peak. Brent CFDs have also flipped into contango and refining margins have weakened, with gasoline cracks exhibiting the biggest fall. With current pricing reflecting cyclical demand headwinds such as US Fed tightening, China’s zero covid-policy, and EM Sovereign credit risk, the market also recognises that Russian production and exports have largely held up so far. Ongoing US SPR draws have also played their part, with record US exports heading to the Atlantic. Despite this, we continue to see a floor price set at US\$85-90/b, driven by several factors: OPEC+ policy geared toward protecting a floor price, limit potential for countries outside Saudi and UAE to increase production, ongoing output issues in WAF countries and Libya, no sign of a deal with Iran and ongoing uncertainty around expectations of Russian output disruptions as the EU embargo comes into force by year-end.

Fig. 1: ICE Brent front-month (US\$/b)



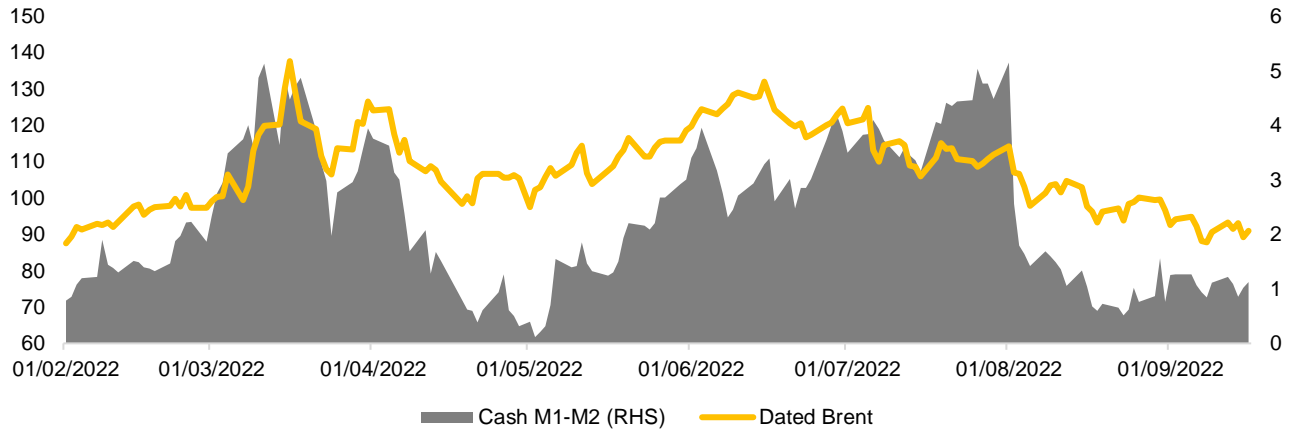
Fig. 2: Brent Contract for Differences (US\$/b)



Source: REA, ICE, S&P Global Commodity Insights

- The cooling of flat prices has been justified by a deterioration in global growth:** last month saw manufacturing PMIs decline in Europe, US and China. Consensus GDP forecasts for 2023 were also downgraded. Crude imports into China last month were down 1m b/d year-on-year. On the supply-side, despite losses in Nigeria and Russia, these were offset by supply gains, particularly Saudi which saw output at a record 11m b/d and the UAE as well as Libya. US SPR releases also continued apace.

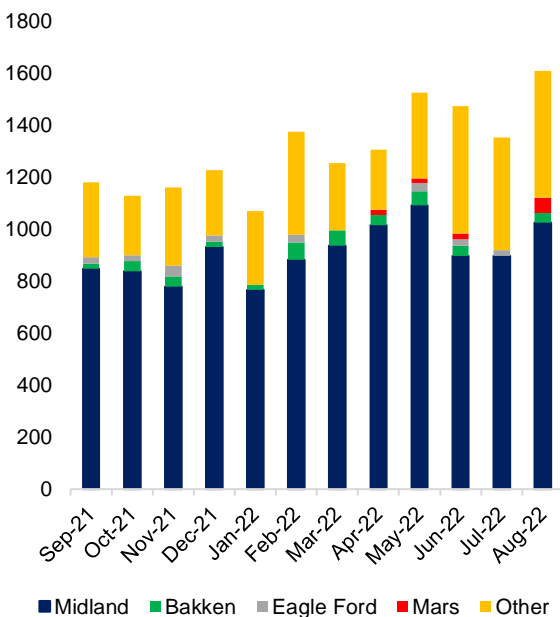
Fig 3: Dated Brent v Cash M1-M2 (US\$/b)



Source: REA, S&P Global Commodity Insights

- Physical differentials in the North Sea have also weakened considerably as both gasoline margins collapsed and steady SPR draws supported the economics of US flows to Europe. The widening of WTI-Brent and the fall in gasoline margins also put pressure on WAF differentials and clearing rates were further slowed down by China softness.

Fig. 4: US exports to Europe by grade (kbd)



Source: REA, KPLER, S&P Global Commodity Insights

Fig. 5: NWE refined product cracks to Dated Brent (US\$/b)

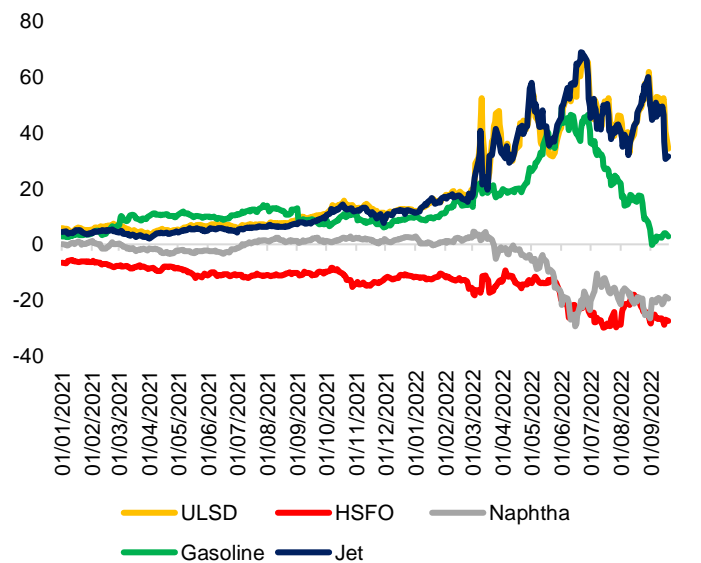


Fig. 6: North Sea diffs to Dated Brent (US\$/b)

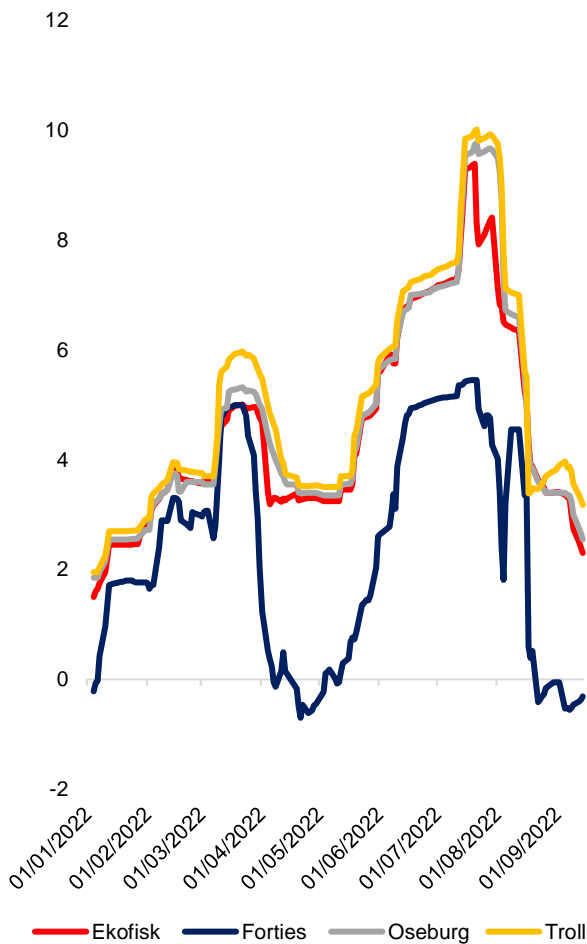
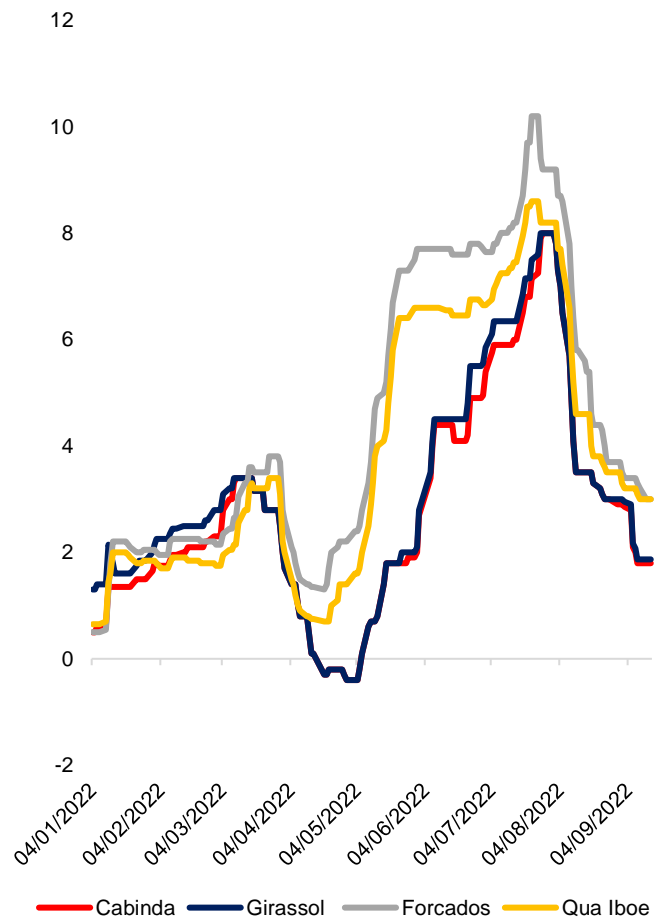


Fig. 7: WAF diffs to Dated Brent (US\$/b)



Source: REA, S&P Global Commodity Insights

- **Arbitrage flows from the US to Asia also increased, putting pressure on Murban valuations:** August saw refiners across Asia (particularly South Korea and Thailand) purchase around 15mb of WTI for Nov-arrival, putting pressure on spot demand for light crude from the Middle East. IFAD Murban’s premium to Dubai fell in August by US\$5.5/b m-o-m. IFAD Murban’s softening premium and narrowing against the medium-sour market provided traders with an opportunity to deliver the grade into the Dubai partials market. In mid-August, Totsa delivered an Oct-loading Murban cargo to Trafigura. Even taking into account Platts’ Quality Premium (QP) for Murban, traders had an incentive to buy from the exchange and sell into the partials market. The narrowing of Murban to Dubai was also reflected in Upper Zakum pricing for October-loading cargoes, with ADNOC increasing its premium to IFAD Murban by US\$1.15/b. Concerns are mounting within ADNOC around Upper Zakum pricing as customer feedback has considered the grade to be overpriced in the market of late. Much revolves around the use of IFAD Murban as the basis for pricing Upper Zakum (given its volatility and challenges with liquidity and physical delivery). Nevertheless, August did see some improvements (see: **Fig. 11**).

Fig. 8: IFAD Murban v Dubai (US\$/b)

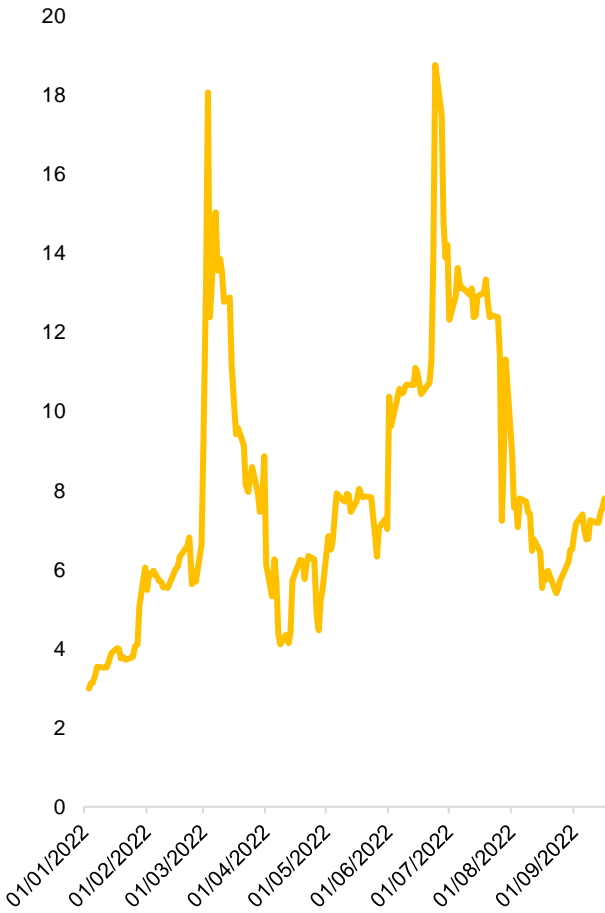


Fig. 9: Dubai v DME Oman (US\$/b)

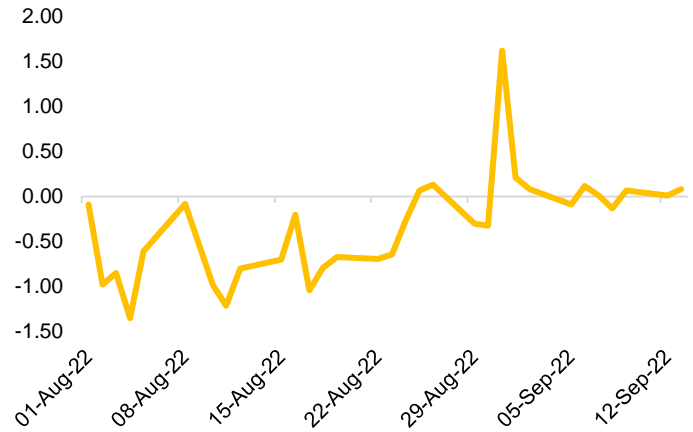
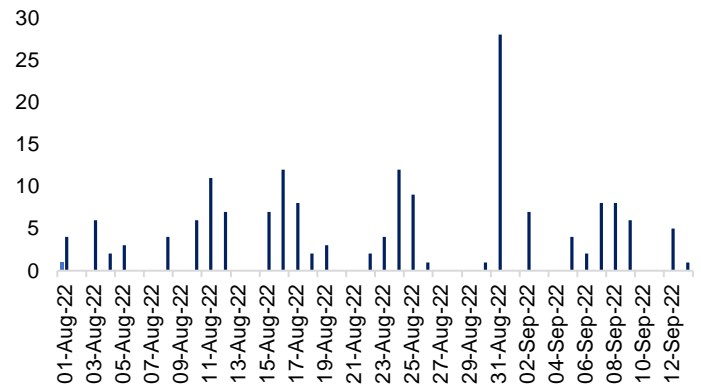
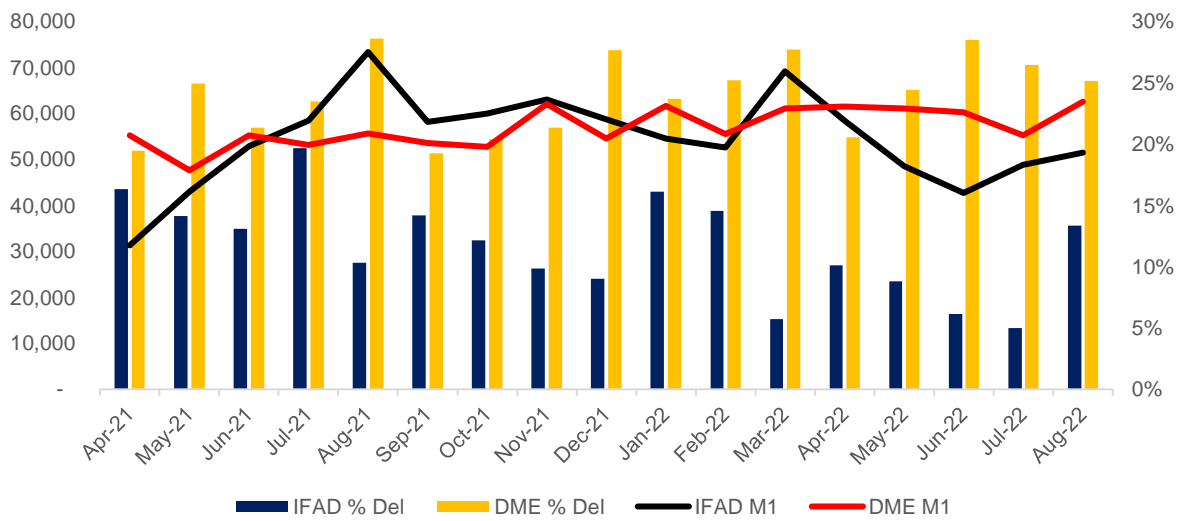


Fig. 10: Dubai partials traded



Source: REA, S&P Global Commodity Insights

Fig. 11: IFAD and DME M1 volume versus % to delivery



Source: REA

- **ADNOC is reviewing current OSP methodologies for Upper Zakum and its link to Murban:** Platts Dubai already exists in the market and UZ is already a deliverable grade in the basket. With the prospect of a new pricing mechanism, feedback from the market has been mixed, with concerns around the challenge of attracting liquidity in an already overstretched derivatives market in the region.
- **While demand has weakened in China, we expect spot purchases to pick up in Sept-Oct:** August saw Dubai cash/futures (M1-M3) average US\$4.9/b (down US\$4.38 m-o-m), with current Dubai cash/futures at around US\$6/b. We expect to see some improvement over the coming weeks as Chinese refiners come back into the spot market, particularly Shenghong which has already started trial runs for its new 320kbd refinery. With no term contract in place, the refiner has so far relied largely on a diet of Upper Zakum. Al-Shaheen spot premiums also improved this month where Qatar Energy sold two cargoes of ALS at premiums of between US\$5-5.5/b versus Dubai in its monthly tender (sold to Exxon and Vitol). Elsewhere, Murban valuations have also been supported with healthier Japanese buying, with the most recent deal in mid-Sept for a Murban cargo at a premium of US\$7-7.50/b.

Fig. 12: Dubai M1-M3 (US\$/b)



Fig. 13: ALS v Dubai (US\$/b)



Source: REA, S&P Global Commodity Insights

The Russia wildcard: reflections on a proposed Russia price cap

What has been touted ‘Russian resilience’ in oil markets stems from the fact that despite refiner self-sanctioning, various bans in place on the import of Russian-origin crude (e.g., US, UK, Australia), crude production and exports from Russia have largely held up – so far. In April 2022, Russian production fell by around 1m b/d but swiftly recovered in May and June. Last month, Russian production fell by around 2% m-o-m to 10.6m b/d, around 4% below its pre-war level output.

Part of this decline in output is related to the decline in total Russian gas production which has had a knock-on effect on condensate output. As we move toward the planned EU ban on Russian crude (Dec 5) and products (Feb 23), estimates have started to emerge on expected losses for Russian output in 2023 – a key wildcard for balances next year. Estimates have so far ranged from the IEA’s 1.9m b/d to other figures heard by REA of up to 2.5-3m b/d.

Our estimate for Russian output losses remains lower (around 1-1.3m b/d), primarily driven by challenges Russia will face in re-directing Europe-bound flows to Asia. Certainly, there remain some pockets of demand for Russian crude into 2023 (Turkey/Med, China and potentially more Indian purchases), but overall, it will be difficult to absorb all of Russia’s Europe-bound cargoes. On products, we see more a case of reshuffling than outright shut-ins taking root. With Europe set to take in more Middle East and North American diesel in 2023, Russia will likely reshuffle flows previously destined for Europe to Latin America (e.g., Brazil and Ecuador) and Africa. In short, we expect the disruption to be driven by crude, rather than products.

Mind the cap

The extent of Russian output losses also depends on the shape and implementation of a proposed G7 price cap.

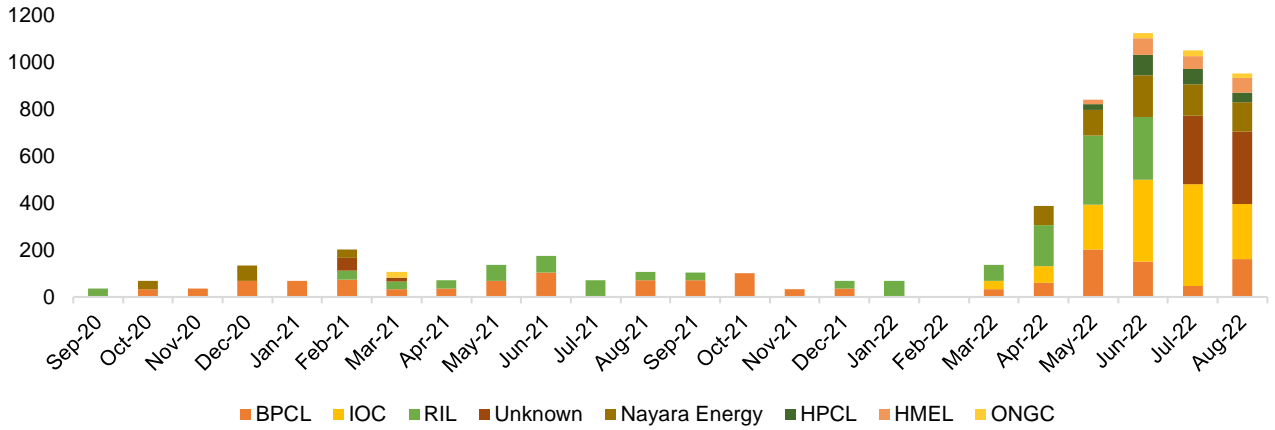
The key objective of the price cap is simple: reduce Russia’s oil revenues and avoid a price spike by allowing Russian crude to continue flowing, with the proviso that trades are made at or below a proposed price cap (still yet not determined). Given that the price cap would be set above the cost of marginal Russian production (even accounting for rouble-adjusted upstream cost inflation and non-uniform production costs across various brown and greenfields), incentive economics would suggest Russia would participate, so the argument goes. The key weapon in the G7 arsenal is the fact that around 95% of the global tanker fleet is covered by shipping insurers in G7 countries. Given this, Russia would be incentivised to join in order to keep its crude sales going and revenues flowing.

The neatness of the proposal does however defy some market realities. In particular, we see four key issues:

- **First, India and China are unlikely to opt in:** India has already been a key beneficiary of discounted Russian crude, with imports currently ranging between 800kbd to 1m b/d. India has extracted sweeteners from Russia (delivered pricing, heavy discounts, and optionality on laycan window preferences). Likewise, China has increased its intake of both Urals and ESPO. While Chinese independents have faced higher costs of late for Urals and ESPO (**Fig. 16**), it remains unclear how participating in a price cap would help lower costs. Without any guaranteed allocated volumes for Indian and Chinese players, the widening of the

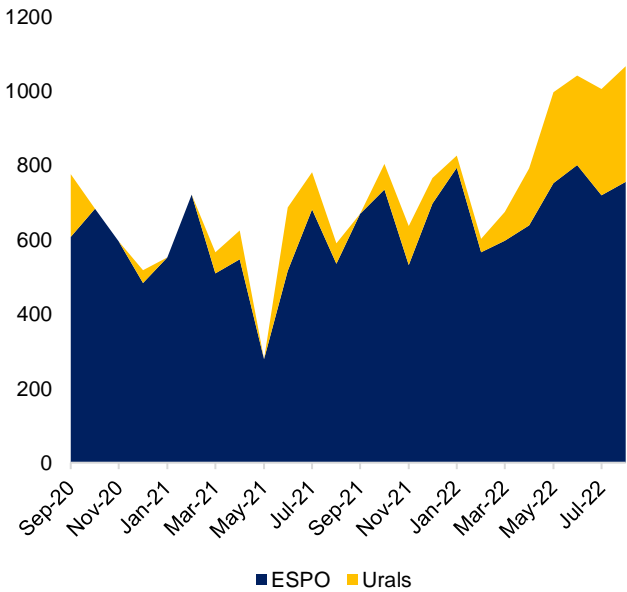
buyer/trading pool under the price cap would increase competition. With the price cap set to spur further demand for Russian crude, Russia will likely look at cash assessments in the physical market to price cargoes, rather than a G7-imposed outright price.

Fig. 14: India imports of Russian crude by refiner (kb/d)



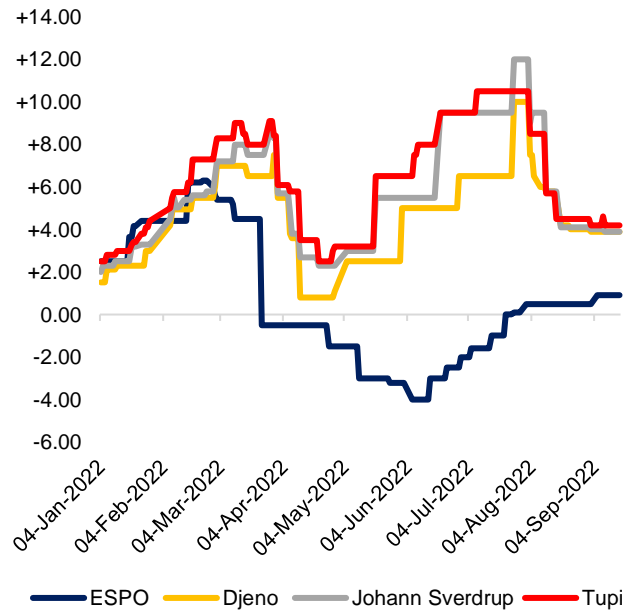
Source: REA, KPLER

Fig. 15: China imports of seaborne Russia crude (kb/d)



Source: REA, Argus, KPLER

Fig. 16: ESPO (DES) Shandong and competing spot grades v ICE Brent (US\$/b)



- **The price cap does not address the issue of bidding wars taking place:** having a fixed outright price cap does not address the fact that a bidding war could take place for discounted Russian crude (particularly given it would be free of sanctions). A liquid secondary market would also likely appear for Urals and ESPO under a proposed price cap as a potential new breed of trading firms would emerge, willing to retrade cargoes for a profit – spurring further demand.

- **Enforcement and policing the price cap:** already since Russia's invasion, pricing bids and offers for Russian cargoes have been less transparent. The exit of trading houses has led players like Rosneft to directly issue their own tenders. Tracking trades has become trickier and this is unlikely to ebb under a price cap. Insurers have already said they will not be able track physical deals, making it difficult to ascertain how a price cap would be policed. Banks would not want to carry the liability either.
- **We also note that the price cap does not discriminate between FOB or CIF pricing,** which could complicate the implementation of the mechanism, as the latter would need to take into account shipping and insurance costs.

Overall, a price cap would largely benefit trading houses who are unlikely to pass on any margin captured to refinery end-users. While we expect the price cap to be largely ignored by Russia, there is the potential for some volumes to be allocated to trading houses (helping soften the prospect of shut-ins).

Apart from this however, Russia is expected to operate largely outside the price cap window. Despite Sovcomflot's limited tanker availability, shipowners have now had months to prepare for the EU embargo. Russian enquiries have surged in recent weeks for older Suezmaxes and VLCCs; likewise, enquires have grown for ice-class Suez and Afras able to handle trading of Russian crude and products during the ice season. In short, at current shipping rates, it is not unreasonable to expect a market open up for handling Russian cargoes.

While there have been suggestions that Russia could retaliate by shutting-in production, this appears unlikely in our view.

Nevertheless, it is clear that Russia's costs will most certainly rise going forward. We see this happening in the following ways:

- Indian refiners which have their own tankers could use the price cap as a negotiating tool for steeper discounts. Further leverage could also be applied given the role played by India's Register of Shipping providing Sovcomflot with safety certifications.
- The cost of insurance will increase for Russia. We think there are non-G7 insurance mechanisms in place to continue flows, albeit at higher costs.

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

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