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EU Sanctions a plausible upside risk to crude: Breamer

- **Crude price has eased amid the global economic slowdown but implementation of European sanctions poses an upside risk in our view**
- **We believe gasoil tightness and potentially lower European runs will extend support to refining margin**
- **Market outlook bullish for dirty tankers tankers as per Breamer; slowdown in crude supply a key risk**

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We attended a discussion on 'Cycles, Conflicts and Carbon' by Anoop Singh, Regional Head of Tanker Research at Breamer ACM Shipbroking (Breamer). Key takeaways:

Crude demand outlook stronger despite economic slowdown: Despite the global economic slowdown, IEA's forecast for oil demand growth remains strong at 2mbpd and 2.1mbpd for CY22 and CY23 respectively, supported by higher consumption during winter season (at 700kbpd). China appears to be turning a corner with improvement in retail consumption and infrastructure investment.

European sanctions a plausible upside risk to crude price: As key buyers such as China and India have little economic incentive to forego cheaper crude and Russia has better leverage from reduced crude flow and higher prices, the implementation of price caps looks difficult and raises the possibility of tougher EU sanctions from Dec'22. These will prohibit EU insurers from insuring vessels with Russian cargo and pose the risk of a shift in trade to the 'shadow' tanker market. Further, the proposed ban on seaborne imports of Russian crude could open up the risk of losing 1-1.5mbpd of supply, tightening the overall market.

Refining margin to receive support from gasoil tightness ahead: Refining margins have softened with a ramp-up of refining runs, ease of demand-pull during shoulder season and the possibility of a material increase in China's export quota in Q4CY22. However, the European diesel market remains tight with the refining system impacted by high natural gas prices and the loss of Russian feed. The tightness could be exacerbated by added sanctions on Russian crude and products as well as the end of US SPR release which reduces the availability of lighter crude.

Bullish outlook on tanker market: A long-term chasm between Europe and Russia will make trade inefficient and support the tanker market. After weakness seen over the past two years, dirty tanker utilisation has increased and may reach 2019 levels in 2024. The average haul length for Russian crude exports is likely to more than double once flows are fully redirected. Clean tanker market utilisation has been ramping up well since last year, benefitting LR2s. CII and environmental regulations are not near-term tailwinds in 2023-24 that will impact availability of tankers.

Crude price has eased but upside risks remain

Oil demand outlook remains strong despite economic slowdown

The International Energy Agency (IEA) expects oil demand to grow by 2mbpd and 2.1mbpd in CY22 and CY23 respectively despite the global economic slowdown. Breamer agrees with the assessment of strong demand over the winter months (Q4CY22 and Q1CY23), supported by the use of oil in power generation and gas to oil switching. However, it expects European demand decline of 0.1-0.2mbpd vs. the IEA's forecast of 0.1mbpd.

China turning a corner – positive for crude and product demand

While Chinese demand has been significantly affected by Covid-related lockdowns, Breamer believes China is finally turning a corner. It flagged recovery in retail consumption in August which grew at its fastest pace in the last six months. The research house also expects a response to stimulus in the infrastructure segment and highlighted that China has committed an additional CNY 1tn of stimulus in August. Breamer acknowledged that real estate construction remains a challenge.

European sanctions a plausible upside risk to crude price

Breamer believes that European sanctions on Russian crude (ban on seaborne imports and on EU insurers of Russian cargo to kick in from 5 December) remain quite plausible as the proposed price cap is unlikely to be agreed upon globally. We believe that this could pose a significant upside risk to crude prices.

- **Key buyers have no major incentive to agree to the price cap.** Two key buyers of Russian crude – China and India – would lose their 'significant' access to cheaper crude with the proposed price cap.
- **Lower crude supply raises Russia's bargaining power with the western world.** While Russia needs revenue to continue supporting its war against Ukraine and its economy, it has two options – (1) higher crude supply at the lower capped price, or (2) lower crude supply at a higher price. The latter will give Russia better leverage in its negotiations with the western world.
- **Sanctions on EU insurers could shift Russian trade to the shadow tanker market.** Under European sanctions, EU insurers will be prohibited from insuring vessels carrying Russian cargo from 5 Dec 2022. This could shift Russian trade flow to the shadow tanker market.
- **Price cap failure will cut Russian supply by 1-1.5mbpd by 2022-end.** Russian export has recovered over past two months, although it still remains 0.4mbpd in Aug'22 below the pre-war level. However, European sanctions scheduled from December could result in the loss of 90% of Russian crude by the year-end. Out of the 2.5mbpd that Russia exports to Europe, Breamer estimates that Russia can redirect only an estimated 1.5mbpd to the Asia Pacific including the 1mbpd already redirected, factoring in the processing ability of refineries and available logistics. This implies a significant risk that 1-1.5mbpd of Russian crude production will be permanently shut off.

Refining margin softens but diesel tightness ahead

Refining margins have moderated over August with the ramp-up of refining runs and concerns over an increase in exports from China in Q4CY22 given an anticipated rise in export quota. While product demand-supply has eased during shoulder season (Aug-Nov), tightness in the diesel market is likely to reemerge during winter. We believe this could support refining margins during winter.

Key data points highlighted by Breamer:

- While US refining has returned to pre-Covid utilisation levels of above 90%, the European refining system is struggling at 80% utilisation amid high natural gas prices and loss of Russian feedstock.
- The European refining system could face another shock when it stops importing Russian crude and US strategic petroleum reserve (SPR) releases come to a halt. A significant proportion of the 1.3mbpd SPR release was consumed by the European refining system. Europe could partially replace Russian crude with 600kbpd of light crude from Brazil, but faces challenges for utilising other crude sources as its refineries have not been technically geared to adopt alternative crude.
- Additional diesel trade flow of 0.6mbpd will need to rebalance as and when European sanctions on Russian diesel kick in from 15 Feb 2023. Breamer currently assumes that Europe will back out 75% of Russian gasoil by early 2023 and source most of the replacement from the US. While replacement demand could be lower owing to a potential recession in Europe (say ~0.2mbpd lower), it may also need a smaller proportion (0.1mbpd) from the Middle East and Asia. Although Russia may redirect diesel exports to Latin America, there is a possibility that Russian gasoil exports may fall by a third next year cumulative due to run cuts and demand loss.
- Refining tightness is likely to ease over the medium term with ramp-up of new capacities.

Fig 1 – New refinery projects

Region	Location	Refinery	Capacity (kbpd)	Start-up
Middle East	Saudi Arabia	Jazan	400	CY22
Middle East	Kuwait	Al Zour	620	CY23
Middle East	Oman	Duqm	300	CY23
Latin America	Mexico	Dos Bocas	300	CY23
Africa	Nigeria	Dangote	620	CY24

Source: Breamer ACM Shipbroking, BOBCAPS Research

Bullish outlook on tanker market

According to Breamer, a long-term chasm between Europe and Russia will make trade inefficient and support the tanker market.

Dirty tanker market

The dirty tanker market is optimistic about demand after weakness seen over the past two years.

- In dirty or uncoated segments, mid-size tankers have benefitted at the expense of very large crude carriers (VLCC), with redirections caused by Russian crude flows.
- Easing backwardation of crude oil price has helped recovery in VLCC freight rates. However, this was accompanied by an oil price crash as demand concerns increased.
- Dirty tanker demand in terms of tonne-km has ramped up with an increase in voyage distances for diverting Russian supply to Asia despite lower volumes. Given the additional need for diversion owing to potential European sanctions on crude, dirty tanker utilisation may ramp up back to 2019 levels in 2024. The average haul length for Russian crude exports is likely to more than double once flows are fully redirected.
- Enabling more product export out of China in Q4 through increased quotas could raise crude demand from China.
- With Middle East crude exports hitting a plateau, long-haul flows are likely to increase as new Indian expansions may have to access other sources. The Middle East plans to increase domestic consumption by 1mbpd with ramp-up of refinery projects, which will cause crude exports to plateau.
- Longer-run improvement in utilisation will be driven more by shrinking supply than by rapid demand improvement.

Clean tanker market

Clean tanker market utilisation for product movement has been ramping up well since last year.

- In clean segments, Long Range II, or LR2, tankers have benefitted from increased European imports from the Middle East and the West.
- Gasoil flows are likely to lengthen and move on to dedicated fleets, with additional European sanctions effective from 15 Feb 2023.
- Commissioning of Nigerian refining in 2024 could help bridge the supply gap for Europe from a shorter distance, thereby impacting some longer-haul flow.

Tanker supply

- Tanker yards are full with non-tanker orders. The current average age of the dirty tanker fleet is currently under 15 years. With a current low order book for tankers and an ageing fleet, several old fleets (20 years plus) will have to remain in use over the medium term. However, as a tanker ages beyond 15 years, the distance it can travel in a year falls sharply – by the age of 20 it can travel just 2bn tonne-miles a year from 6bn tonne-miles.

- So far, only a minor correction has been seen in pricing power. Breamer expects a shift in ordering from container ships to small ships, but believes this is unlikely to affect the market before 2025.

- CII and environmental regulations are not near-term tailwinds in 2023-24 that will impact availability of tankers. CII is an operational metric influenced by consumption rates and trading patterns. Over 2023-24, younger tankers (class A & B) could offset speed caps imposed on older tankers (class D & E). Breamer expects class D and E ships to account for 28% and 15% respectively of the VLCC fleet in CY26. Longer-term, speed caps could impact the effective availability of tankers, and the preference of time charters will move to a younger fleet.

Risks to bullish outlook

- Slower growth of crude oil supply due to (a) reduction in Russian crude export, (b) slower growth in US shale production, (c) thin spare capacity restricting crude growth, and (d) OPEC's apparent protection of a price floor of US$ 90/bbl

- Economic slowdown

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