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EAST OF SUEZ OIL BENCHMARKS
Must Have vs. Nice to Have?

This Special Report reflects the insights and opinions of senior delegates from the regional and global oil market who actively participated in Gulf Intelligence's Energy Markets Workshop in early October in the UAE's Emirate of Fujairah. The event was held under the Chatham House Rule. Any further use of this material must cite this Special Report and Gulf Intelligence.

Benchmarks Provide Critical Stability!

Benchmarks provide a critical touchpoint of stability amid the waves of volatility that oil stakeholders face daily; a dynamic that is magnified in the current environment. Energy security is firmly at the top of the global priority list as governments grapple with the domino effect of the Russia-Ukraine war, rising inflation, and the global climate agenda. This makes preserving the integrity of existing benchmarks paramount, delegates stressed. Sustaining confidence in core benchmarks in the Middle East and beyond is critical to helping buoy liquidity, for one, even if market stakeholders believe structural elements can be enhanced. 'Nice to have' benchmarks currently refer to the next generation of benchmarks, such as early work on benchmarks for the burgeoning hydrogen market and voluntary carbon pricing systems. These are not critical to supporting and preserving energy security right now – a growing global concern – but they will be instrumental in supporting the Middle East's plan to continue diversifying its energy basket.

Another factor for oil markets to consider is that world trade is expected to lose momentum in the second half of 2022 and remain subdued in 2023 as multiple shocks weigh on the global economy, further impacting dynamics across oil markets. Global merchandise trade volumes will grow by 3.5% in 2022 and by 1% in 2023, which is down sharply from the previous estimate of 3.4% for next year.[1]

> Oil players are increasingly fatigued by today's degree of guesswork. They want less volatility, more predictability, greater liquidity, and to be able to hedge. But for now, the volatility is inescapable.

Valuable exploration

Conversations about how to elevate the quality and effectiveness of existing benchmarks in the Middle East and beyond is good practice; reviewing and updating these critical elements when necessary helps curate a healthy oil ecosystem, both East and West of Suez. That is not to say changes should be made regularly, however, for this feeds confusion and instability into an already unpredictable commodity market. Extremely careful consideration must underpin any change, but open discussions about what those could / will be is welcomed.

In this vein, benchmarks must support two cornerstones of the traded oil market: liquidity and risk management. These are instrumental to bolstering confidence, especially in relatively new benchmarks. In turn, these must be underpinned by strength in legal and compliance, especially as two large oil producing nations in the East-West vicinity, Russia and Iran, are now sanctioned. Overall, the strength of these four points must be reinforced in existing benchmarks before the market embarks on establishing new ones, with some delegates flagging the risk that new benchmarks in today's turbulent landscape could further reduce coveted liquidity.

Crisscrossing lanes

Russian crude oil is going to Asia and the Middle East, while refined fuel produced in these regions is flowing to West as global trade is disrupted by sanctions placed by the world's biggest economies on Russia, the world's third largest oil producer. Russian crude oil imports into the EU and UK fell to 1.7mn b/d in August from 2.6mn b/d in January[2] – a 35% decline so far – after Russia invaded Ukraine on February 24. More than 1mn b/d of US crude is expected to flow to Europe by year-end to help the continent plug its gap and shore up its energy security as some countries talk about power-saving schemes during the upcoming winter months.

In parallel, multiple factors are evolving in the Middle East's oil and gas industry, providing springboards for positive change, notably stronger transparency and liquidity. East of Suez oil and gas benchmarks have advanced in recent years, such as the IFAD Murban crude contract and the Platts JKM for liquified natural gas (LNG). Support for the Middle East to have its own independent oil products benchmark to better serve the East of Suez markets into Asia and Africa is building too. This would help facilitate the development of a healthy derivatives market and improve access to fuels from all over the world. Oil products stored and traded out of the UAE's Port of Fujairah, the world's third largest bunkering hub, are done via the Singapore swap – arguably a weak reflection of regional dynamics.

Sources: 1 World Trade Organization (WTO); 2 International Energy Agency (IEA)

TOP RECOMMENDATION:
The journey to exploring the relevance and value of regional benchmarks – such as a Fujairah oil products benchmark – is only possible if it is complimented by a continued commitment to further transparency, such as publishing the monthly Inter Tank Transfer data.

Looking ahead, how well can existing Middle Eastern oil benchmarks absorb all these market shocks and changes in flows? And importantly, what can be done to support the ecosystem of benchmarks for crude oil and products in this rapidly changing landscape? We explore the answers to these loaded questions in this Special Report, concluding with Top Takeaways from delegates for market stakeholders to digest and perhaps apply over the coming year, ever strengthening the region's oil ecosystem.

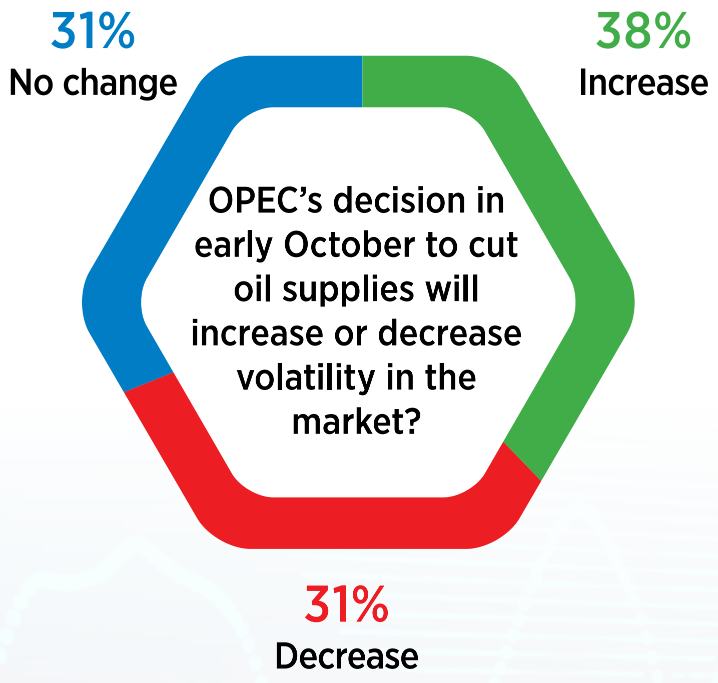
Stay the course

Benchmarks cannot react to the news cycle, which includes geopolitical events, even major influences like the Russia-Ukraine war. Regularly changing benchmarks risks eroding the very essence that makes them relevant, i.e., reliability and stability. While leaving benchmarks unchanged amid volatility may lead to some dislocations and surprises in the market, preserving the common denominator – the benchmark – must be the priority.

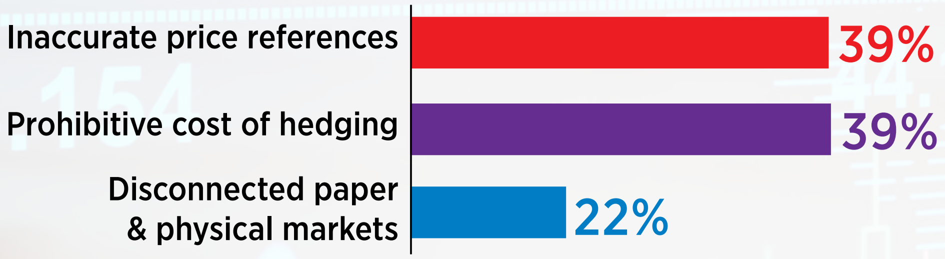
Moscow's domino effect

Arrivals of new oil from Russia in Asia and Africa are likely in the short to medium-term as volumes to Europe continue to slide. The market appears to have largely "turned its back" on Russian oil, but that is not to say trading activity is not still underway, as seen with Iranian oil over the years. The longer the Russia-Ukraine war continues, the changing flows we see today have a higher chance of being embedded as the new norm; every month of war equates to a few years of ingrained change, delegates said. For one, oil and broader energy infrastructure projects are being signed off and built in the West in a way that no longer factors in the support of Russian oil. Another delegate said that if the Russia-Ukraine war ended tomorrow, the flow of Russia's oil would not return to what it was pre-war; customers' trust is too damaged.
Meanwhile, China's reduced growth – from near double-digits to 3% – heralds a step change for what has long been a global engine of commodities. A knock-on effect is inevitable, but it is more likely to affect freight rates than benchmarks.

GIQ SURVEY



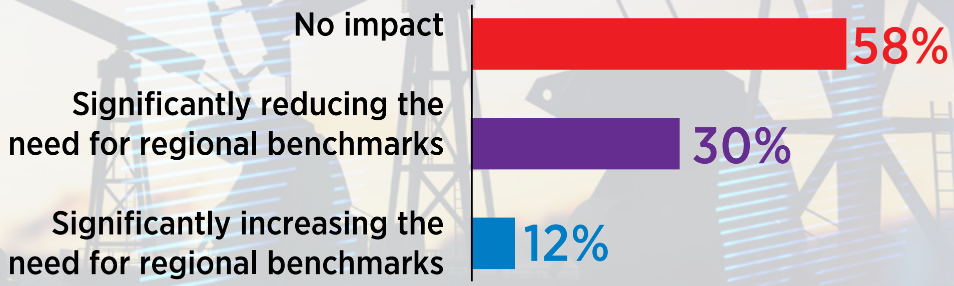
What will be the consequences of sustained thin liquidity in market trading?



In June 2022, seven years after export restrictions from the US were lifted, Platts, part of S&P Global Commodity Insights, announced the inclusion of the US crude WTI Midland into its suite of assessments in the Brent complex. The revised Brent benchmark will decrease or increase the role of existing East of Suez crude oil benchmarks?

The Arabian Gulf is expected to add 1.3mn b/d of new refining capacity in 2022/23, including Kuwait's Al Zour (615,000 b/d) and Saudi Arabia's Jizan (300,000 b/d). This will accelerate urgency for the region to have its own products benchmark and move away from Mean of Platts Arab Gulf (MOPAG).

What's most at stake the longer the oil markets remain in extreme uncertainty?



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CRUDE OIL

How will changes in global crude oil flows impact East of Suez Benchmarks and how should assessments adapt to remain fit for purpose?

A cacophony of geopolitical and environmental factors is redrawing the landscape of crude oil, but benchmarks are one point that delegates believe should not change – for now. Shifting structural flows have never been more evident than in the past six months, primarily triggered by sanctions on Russian crude oil amid Moscow's invasion of Ukraine. Increased volumes of Russian crude oil have been flowing to Asia, at varying discounts, as it seeks to replace its sales into Europe and the US. Russian crude oil is going to go further to find different markets. Therefore, it will likely have to trade at a discount, which Moscow may be willing to / have to absorb until the geopolitical outlook calms.

Meanwhile, more US crude oil has flowed to Asia (seen as an important hedge against volatility in the Middle East) and to help plug the gap in Europe, especially as energy security concerns in parts of the continent escalate. Other factors include more oil releases from the Strategic Petroleum Reserve (SPR) and the rising cost of freight insurance. The trade dislocation and the complexity of the supply chain is inevitable and delegates called for more work to understand the changing economics of trading. This includes pinning down pricing patterns, which would be more beneficial to the whole market in the short-term than establishing new benchmarks.

India is another one to watch. Indian refiners were getting ready to "cash in" with discounted crude oil from Russia, said delegates, before their advantage suddenly weakened as Europe increased its purchasing activity. Delegates questioned how much of a discount India will get now / when Europe' buying appetite falls even further and how the upcoming price caps will affect India's desire to soak up more Russian crude oil. Meanwhile, China's shrinking demand and increased unpredictability will affect crude oil over the coming year, though marginal demand will continue to come from Asia.

Europe's juggling act, especially on the precipice of its winter season, means Germany has essentially stopped its production of petrochemicals amid soaring gas prices (spiked by the Russia-Ukraine war). Instead, its appetite for imports from the Middle East has risen. Again, the ripple effect of this changing supply-demand balance feeds into the broader dynamic of crude oil – the full effects of which will only become clearer in the first half of 2023, delegates said.

Environmental factors are also playing into crude oil's matrix more than ever, as delegates discussed how to ensure the current instability does not impact growing efforts to build credibility in Environment, Social, and Governance (ESG). Plus, new benchmarks are more likely to evolve in emerging markets, like carbon and ammonia, rather than crude oil, which is relatively well catered to for now. Amid long-running discussions for a new marker for East of Suez crude, Platts Dubai and Oman DME contracts have been established as benchmarks. And in March 2021, ICE Futures Abu Dhabi (IFAD) launched the first futures contract based on Abu Dhabi's Murban crude, which accounts for about 50% of ADNOC's production. Given this swathe of disruption, the existing East of Suez crude contracts are still fit for purpose. But stakeholders must be ready to move proactively if needed.

> Relationships between the major hydrocarbon producers are moving at the speed of light. The degree of change is immense.

OIL PRODUCTS

How will changes in oil product flows impact East of Suez Product Benchmarks and how should assessments adapt to remain fit for purpose?

Buffeted by global influences far more than usual, stakeholders in oil products are finding their feet – and benchmarks are welcomed stable ground. Standardization, transparency, and liquidity form the core of successful oil product flows. This foundation in the Middle East and beyond remains robust with existing benchmarks and, considering the high level of global volatility, it is best to avoid any significant changes in the near-term. However, that does not mean that oil products' evolution will not need the support, or be affected by, changing and new benchmarks going forward.

Influencers include an additional 1.3mn b/d of new refining capacity in 2022/23 in the Arabian Gulf, including Kuwait's Al Zour (615,000 b/d) and Saudi Arabia's Jizan (300,000 b/d). This will likely affect existing product flows, but also more than one third of delegates (38%) believe it will accelerate urgency for the region to have its own products benchmark and move away from Mean of Platts Arab Gulf (MOPAG). Geopolitical twists and turns are also tracing new routes for oil products worldwide. For one, Saudi Arabia has been shipping 1mn b/d of crude oil to the US because of its political relationship (profitability is likely higher in Asian markets). This echoes the geopolitical power of the US' ties with China, as the energy giant continued shipping LNG eastwards at the height of the two behemoths' ongoing trade war.

Delegates pointed to China as the "elephant in the room." Growth in the world's second largest economy has slowed, relatively speaking, to 3%, which inevitably impacts oil prices. But the real impact of China is likely still to be felt. "In April 2020, China came in and hoovered up the whole market and then suddenly that demand disappeared," one delegate explained. Beijing's strategy is inherently volatile, so expect this approach to impact oil

In this rapid evolution, everyone in the world of oil products must be much more on their toes economically.

products going forward, although *how* this will play out is not clear.

Plus, intensifying momentum behind the global energy transition and the call for 'fuels of the future' will influence today's oil product market, especially as nations, including the UAE, strive to hit Net Zero targets by mid-century. For one, the Middle East's large aviation market and associated fuel trades will increasingly need to keep pace with the climate agenda. This includes greater support of sustainable aviation fuels (SAF), which are expected to have a global value of $15bn in 2030, climbing from $220mn in 2021.[1] The Middle East's impressively efficient adaption to the International Maritime Organization's (IMO) ruling on low sulfur fuel oil (LSFO) from January 2020 – arguably one of the biggest shifts in shipping fuels in nearly a century – led to greater visibility and new benchmarks. Delegates expect aviation to have a similar journey, though establishing new benchmarks will be a medium to long-term endeavor only.

Sources: 1 Future Market Insights

TOP 10 TAKEAWAYS

1. The journey to exploring the relevance and value of regional benchmarks – such as a Fujairah oil products benchmark – is only possible if it is complimented by a continued commitment to further transparency, such as publishing the monthly Inter Tank Transfer data.

2. Patience is a Virtue! Applying broader benchmarks with global scope to specific regions may not fully reflect the context or nuances of national or regional oil product trading, especially considering the plethora of macro influences underway. Equally, the widespread volatility and lack of liquidity are why this should be an exploration and review only, with no intention of launching or forcing a regional oil products benchmark in the market in the short-term.

3. Expect new arrivals of Russian oil in Asia and Africa in the short-term, as Moscow finds new homes for its product as the reduced flows to Europe and changing oil dynamics are magnified by price caps by some of the world's biggest economies on Russian oil by year-end.

4. The potential reintroduction of Iranian oil could help strengthen liquidity, reach, and competition and as such, the momentum behind exploring and establishing new regional benchmarks in the medium to longer-term. Equally, this move has been long anticipated, which oil stakeholders must consider if / when baking it into their forecasts.

5. Thinning liquidity is a challenge, exacerbated by the high degree of uncertainty worldwide. A liquid derivatives market is critical to managing price exposure, so stakeholders' activities may start to stagnate if they are not confident they can hedge effectively, in turn thinning liquidity further.

6. Review existing benchmarks to enable them to accurately reflect the current level of high volatility in the market, especially as continuing geopolitical instability – notably the impact of price caps on Russian oil in coming months – are yet to be fully felt. This must not translate into dramatically editing benchmarks, for stable goalposts are key, but simply reviewing their suitability means key stakeholders know what action, if any, can be taken in the medium to long-term.

7. Use data on Inter-Terminal (ITT) movements to support the growing transparency across the ecosystem of regional benchmarks. These accurate and daily figures on oil products handled by ports would help reduce ambiguity – a move welcomed by oil stakeholders.

8. The link between benchmarks and the global climate agenda was explored for the first time at this annual workshop, which is especially timely as COP27 opens its doors in Egypt this month. Oil stakeholders must start looking at benchmarks through an "environmental lens", i.e., considering the measurement, reporting, and applicability of carbon intensity ratios and carbon offsets. Connectivity between benchmarks and ESG was also discussed, signaling the oil market's appetite to keep pace with fast-evolving environmental metrics.

9. Greater support and incentives from regional governments for existing benchmarks, and the exploration of new benchmarks, would deepen transparency, encourage more market participants, and buoy liquidity. Government-supported progress would arguably create a more holistic outlook considering the strong influence of state-owned entities in the Middle East's energy sector. This could be especially useful in data transparency, availability, and fungibility.

10. More efforts are needed to enhance the oil market's understanding of price patterns and forecasts. While this could be a stepping stone to more clarity on where a new benchmark could / will fit in, the short-term benefit of bolstering transparency in today's unstable environment is considered more helpful.

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