

3 March 2022

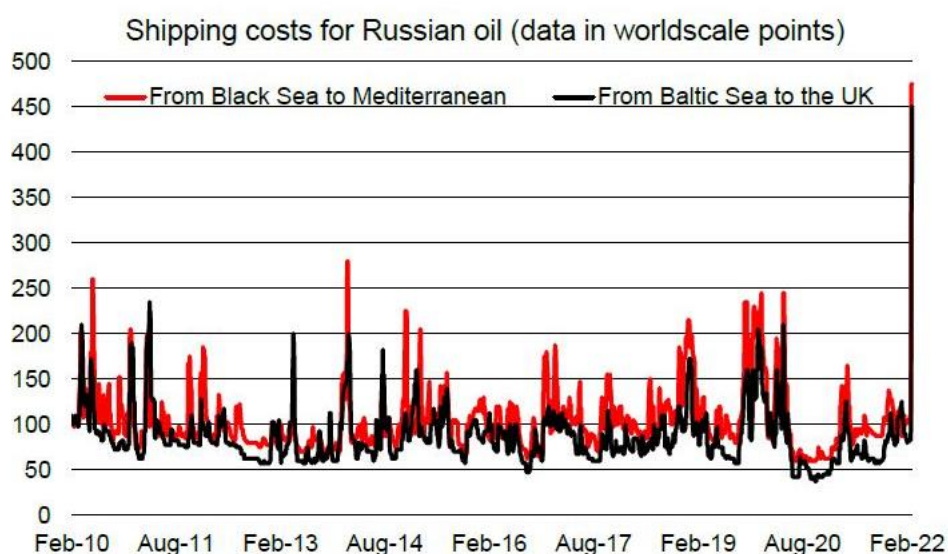
Geopolitical Risks Trigger Oil Shipping Costs Increase

Abstract from *Oil update*

UniCredit Research

This rising geopolitical risk premium not only reflects the risk of damage to oil facilities during the military conflict or potential Western sanctions on natural gas/oil but it also incorporates soaring insurance costs to ship Russian oil. This is shown in Chart 1, which shows shipping prices for oil coming from the Baltic Sea and the Black Sea (freight rates are usually expressed in so called worldscales points). Freight rates for both routes have more than tripled in a couple of days, as crude-oil buyers struggle to find shippers willing to send their vessels into Russian ports. This is part of a broader phenomenon of “self-sanctioning”. **Market participants are simply refusing to deal in Russian oil, even if Western governments allow it within the sanctions they have imposed on Russia in response to its invasion of Ukraine.** According to Bloomberg reports, this is due to confusion about what is legally permitted, fears about reputational damage or moral objections.

CHART 1: COSTLY RUSSIAN OIL



Source: Bloomberg, UniCredit Research

What if Russia cuts its oil supply?

Russia exports around 5mn b/d of oil worldwide. Europe and China are the major buyers. In a risk scenario in which energy supplies are affected to some extent for a short period of time, we expect the price of Brent to peak at around USD 130/bbl before gradually returning towards USD 95/bbl at the end of our forecasting horizon. In such a scenario, there would be few mitigating factors. This forecast does not incorporate spillover effects from the curtailing of natural-gas supply – which would likely push Brent prices even higher.

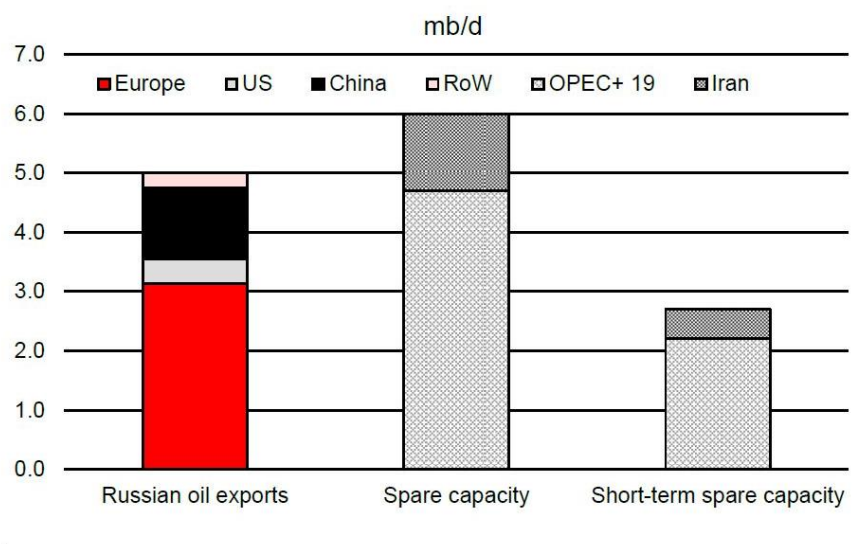
OPEC+’s spare capacity (production that can be activated in less than 90 days) amounts to 6mn b/d, including also sanctioned oil from Iran. However, short-term spare capacity (that can be activated in less than 30 days) amounts to just 2.5mn b/d. Therefore, **if Moscow decided to cut its oil exports to zero or if the West decided to sanction them, then there would be an output shortfall of about 2.5mn b/d, and this would likely send Brent prices towards USD 150/bbl (in our risk scenario, we assume that oil supplies will only be partially curtailed).** In addition, current figures pertaining to OPEC+’s spare capacity (see chart 2) should be taken with a pinch of salt. In January, its production was 910,000 b/d below target because other countries, such as Nigeria and Angola, have struggled to meet their production quotas.

In general, as it was confirmed by yesterday’s review meeting, **OPEC+ has no appetite to revise its tapering strategy, even when prices are substantially higher than what it thinks it is optimal for a stable market.** Equally, an Iranian nuclear agreement seems within reach, and we think that Washington is aware of a need to reach an agreement quickly. Nevertheless, it will take a few weeks for Teheran to bring its barrels of oil onto the market once a deal has been signed (no more than 500k b/d initially).

In the very short term, US shale oil cannot be counted on to make up for supply shortfalls either. Shale-oil suppliers are likely to take advantage of shorter lead times between drilling and production relative to traditional oil production

in reaction to favorable market conditions. However, such producers are emerging from two years of under-investment, which has weighed on their ability to ramp up production quickly in the short-term. The data which shows shale-oil rig counts and the number of drilled but uncompleted wells (DUCs), indicate that the recovery in production in recent months was facilitated by the drawdown of existing wells and not by the discovery of new ones. When drilling activity grows faster than completion and production, then the number of DUCs increases – creating spare capacity that can be activated in case of need. Given that the average life of non-conventional oil wells is around 18 months, with their productivity declining rapidly over this time horizon, DUCs represent an important cushion to adapt to sudden changes in demand. At the moment, the number of DUCs is low, and to boost their numbers in a significant way (and thereby increase oil production) might take around 12 months of intense investment activity. Thus, this would take too long to facilitate a reaction to a sudden drop in Russian supply.

CHART 2: DON'T COUNT ON OPEC+ TO MAKE UP FOR SUPPLY SHORTFALLS



Source: International Energy Agency, UniCredit Research