Tighter times ahead for oil

Oil prices have seen a fair amount of weakness as we approach the end of 2022. Demand concerns are weighing heavily on sentiment. However, the market is expected to tighten during 2023 as the EU ban on Russian crude and products is implemented, along with OPEC+ supply cuts. We see higher prices next year

Russian supply set to fall

The key supply uncertainty for the oil market this year has been how well Russian supply would hold up following a number of countries banning Russian oil, along with an increased amount of self-sanctioning. Russian supply has held up better than many were expecting, with India, China and a handful of other smaller buyers increasing their purchases of Russian crude oil, given the steep discounts available as other buyers have pulled back. As a result, exports in October were 7.7MMbbls/d, down just 100Mbbls/d year-on-year.

However, the biggest disruption to the crude oil market still lies ahead of us. The EU ban on Russian seaborne crude oil comes into effect on 5 December, which will be followed by a refined products ban on 5 February. The key question is whether India and China can buy even larger volumes of Russian oil. Their ability to do so is likely limited. Russia has already become India's largest supplier, making up around 20% of total supply, and since the war, Russian barrels make up a little more than 18% of total Chinese imports, making Russia a marginally larger supplier of crude to China than Saudi Arabia. We expect that Russian supply will have to fall once the ban comes into full force and are assuming that supply in the first quarter of 2023 declines in the region of 1.6-1.8MMbbls/d YoY. The other uncertainty around Russian supply is the full impact of the G7 price cap. While the aim of the cap is to ensure Russian oil flows continue but Russian oil revenues are limited, it is still yet to be seen if Russia responds by lowering output. On several occasions, Russia has threatened to cut the supply of crude oil or refined products to any country that follows the G7 price cap.

How the Russia/Ukraine war evolves will be important for oil markets in 2023. While a de-escalation might not lead to the return of pre-war oil trade flows, it would remove a lot of supply risk from the market.

OPEC+ sticks to its guns

OPEC+ has clearly not read the book *How to win friends and influence people*. The group has largely ignored calls from the US and other key consumers to increase oil supply more aggressively this year amid higher prices and supply concerns. And the group's decision to reduce output targets by 2MMbbls/d from November 2022 until the end of 2023 has been criticised, particularly by the US. Although, to be fair, with hindsight the decision by OPEC+ appears to be the right one, at least in the near term with it offering stability to the market. Given that the bulk of members are producing well below their production targets, OPEC+ supply cuts work out to an effective cut of around 1.1MMbbls/d. In aggregate, OPEC+ production was 3.22MMbbls/d below target levels in October 2022.

However, the cuts may prove to be more destabilising in the medium term, given the expectation of a tighter market through 2023. In addition, we should not rule out the potential for OPEC+ to change policy over the coming months. Intensifying demand concerns could push the group to cut supply further, while significant Russian losses could see a relaxation in cuts. However, to see an easing in cuts, the group would want full clarity on the impact of the ban on Russian oil.

Could Iran and Venezuela make a comeback?

US sanctions have prevented Iran and Venezuela from fully benefitting from the higher price environment this year. Iranian nuclear talks have failed multiple times over the last year, and it is looking increasingly unlikely that we will see US sanctions lifted anytime soon, particularly given Iranian developments both internally and externally. If sanctions were lifted, Iran could increase supply by around 1.3MMbbls/d over time. However, we are assuming that the Iranian supply remains at current levels through 2023.

The potential additional supply from Venezuela is more limited (relative to Iran) if the US were to lift sanctions. However, the likelihood of an easing in these sanctions is probably higher at the moment. We have recently seen some softening in these sanctions already. An easing in sanctions would mean that US Gulf refiners would be able to process the heavy crude that Venezuela produces and replace a large amount of Russian residual fuel that was processed prior to the US-Russian oil ban. The potential for higher Venezuelan supply does not change the global balance significantly.

US not there to fill the gap

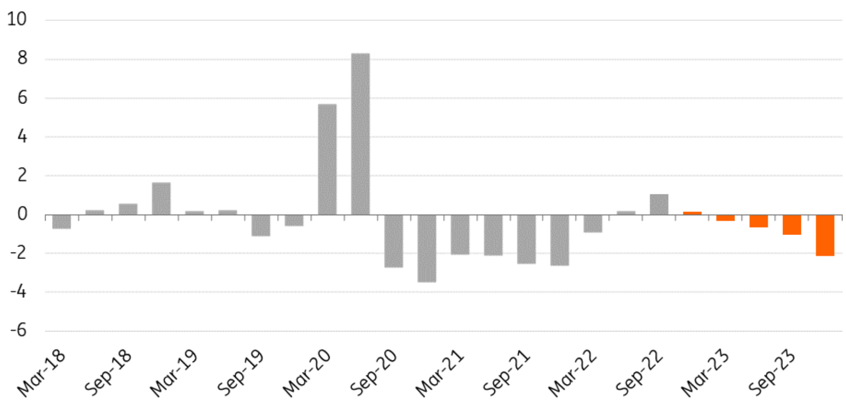
The response from US producers to the higher price environment this year has been anything but impressive. And this appears to have also given OPEC+ confidence to cut supply without the risk of losing market share. US crude oil supply is forecast to grow by less than 600Mbbls/d to average around 11.8MMbbls/d in 2022. While for 2023 supply is forecast to grow by less than 500Mbbls/d to around 12.3MMbbls/d. This growth is much more modest than the supply growth seen in previous upcycles. For example, in 2018 US crude oil output grew by around 1.6MMbbls/d YoY, after WTI traded from US$42/bbl in June 2017 to as high as US$76/bbl in October 2018. This year, WTI has averaged a little over US$95/bbl, whilst the forward curve has been trading above US$70/bbl all the way through to the end of 2024 for much of the year.

The mentality of US producers has changed significantly from producing as much as possible to focusing on shareholder returns, and as a result continuing to show discipline when it comes to capital spending. In addition to showing more restraint with capital spending, supply chain issues, labour shortages and rising costs have also played a role in the more modest supply growth expected over the next year.

Demand weaker than expected

A key drag on the oil market more recently has been the demand picture. High energy prices, a gloomier macro outlook and China's zero-Covid policy have all weighed on oil demand this year. At the beginning of 2022, global oil demand was expected to grow by more than 3MMbbls/d YoY and hit pre-Covid levels. However, demand is estimated to grow at a more modest 2MMbbls/d this year, leaving it below pre-Covid levels. While for 2023, demand is expected to grow in the region of 1.7MMbbls/d. Almost 50% of this growth is expected to come from China with the expectation of an economic recovery. Clearly, this is a risk if China's zero-Covid policy proves to be as disruptive as it has been this year.

Global oil balance (MMbbls/d)



Source: IEA, EIA, OPEC, ING Research

Tighter market in 2023

A combination of lower Russian oil supply and OPEC+ supply cuts means that the global oil market is expected to tighten over 2023. We expect a growing deficit over the course of the year, which suggests that oil prices should trade higher from current levels. We currently forecast ICE Brent to average US$104/bbl over 2023. Clearly, demand is a risk to this view, while if we were to see a de-escalation in the Russia-Ukraine war, a large supply risk would disappear even though we are unlikely to see a return to pre-war oil trade flows. Meanwhile, the potential for the US to refill its strategic petroleum reserves should WTI fall towards US$70/bbl is likely to provide a strong floor to the market.

ING oil price forecasts

	1Q23	2Q23	3Q23	4Q23	FY23
ICE Brent (US$/bbl)	100	100	105	110	104
NYMEX WTI (US$/bbl)	96	97	102	107	101

Source: ING research

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