

Middle distillates driving refinery margin strength

Refinery margins have surged recently due to a tightening in the refined products market. Uncertainty over Russian export supply has only added to fears. The tightness in the refined products market is dominated by middle distillates. And there is no quick fix to ease this



A refinery in Germany

Middle of the barrel is where the strength is

While the oil complex has strengthened this year on the back of the Russia-Ukraine war, it is middle distillates that have stood out. Over the first quarter of the year, ICE gasoil has rallied by 59%, compared to ICE Brent strengthening by almost 39%. ICE gasoil prices hit record highs of \$1,665/t at one stage in early March.

Whether we look to Europe, the US, or Asia, middle distillates stocks are low. In the ARA (Amsterdam-Rotterdam-Antwerp) region, gasoil inventories have fallen to their lowest levels since 2008 for this time of the year. It is a similar story in Singapore, where middle distillate stocks are also near a 14-year low, while in the US, distillate fuel oil stocks are at their lowest levels since 2014 for this stage of the year. Tight inventories coupled with plenty of uncertainty over supply has meant that middle distillate cracks have seen significant strength, along with volatility. Clearly, this is unlikely to change until we see a de-escalation in the war.

Why the market has tightened

There are several reasons for this tightness and strength in the middle distillate market:

Firstly, Russia is a key exporter of refined products. In fact, after the US, it is the second-largest net exporter of product. The International Energy Agency (IEA) estimates that prior to the war, Russia exported in the region of 1MMbbls/d of gasoil. Self-sanctioning would mean that a portion of this will be finding it more difficult to make its way to the world market. Russia is a key supplier of refined product to OECD Europe, supplying about 39% of total imports according to the IEA.

Secondly, the export of gasoil from China has continued to decline this year, which has helped to tighten up regional Asian markets. The decline in exports is a result of reduced releases of export quotas to state refiners, and this is a trend that is likely to continue. The first batch of refined product export quotas for 2022 was reduced by 56% year-on-year to 13mt. And this is after full-year quotas in 2021 declined by 36% year-on-year. The reason behind this reduction is due to the government's ambitions to tackle emissions and reduce inefficient refining capacity. There had been reports that the government asked state refiners not to export diesel or gasoline over April due to uncertainty about the Russia-Ukraine war. Although that was prior to the Covid-19 lockdowns that we are seeing across China.

The natural gas market has also provided support to middle distillates in two forms. Firstly, higher natural gas prices in Europe would have increased refining costs, particularly when it comes to desulphurisation. This is less of an issue now, given that refinery margins have strengthened to cover the increased cost of natural gas, whilst natural gas prices have also come off from their record highs. Secondly, higher natural gas prices would have also seen some gas-to-oil switching for power generation. This would be supportive for gasoil as well as fuel oil demand.

Let's not forget that we also saw a sizeable amount of refinery capacity shut following Covid-19, which will mean that it is more difficult for the refining industry to respond to tightness in product markets. IEA numbers show that global refining capacity closures exceeded new capacity in 2021 for the first time in 30 years. Global refining capacity is estimated to have fallen by around 730Mbbbls/d last year.

What could help ease the tightness in middle distillates?

There is no quick fix to the tightness we are seeing in the middle distillate market, which suggests that prices/cracks will likely continue to trade at elevated levels. The tightness and the current uncertainty also mean that the market will likely remain volatile. However, there are several factors that could help improve the supply picture.

Clearly, a swift end to the Russia-Ukraine war would likely see a significant reduction in the risk premium that is currently priced into the middle distillate market. However, it would probably be naïve to assume that if the war was brought to an end that we would see a quick end to self-sanctioning. Sanctions that have made trade more difficult would likely take a while to be lifted. In addition, the EU has made it clear that they plan to wean themselves off Russian fossil fuels. And it is unlikely that this trend will be reversed when the war comes to an end.

While China has been a supportive factor for refined products post-Covid, in the short term the latest Covid-related lockdowns that we are seeing across some cities could offer relief to regional markets. China had previously asked state refiners to avoid exporting diesel and gasoline over April. However, recent lockdowns are weighing on domestic demand, which would leave the government less concerned over domestic supply. And so there is potential for a short term pick-up in export flows.

Strong middle distillate cracks should mean that refiners look to maximize their middle distillate yields. During peak Covid-19 lockdowns we saw refiners decreasing jet fuel yields (due to a collapse in demand from the aviation sector), which led to an increase in gasoil yields. However, it is unlikely that we see a repeat of this now, with jet fuel demand recovering and the European jet fuel diff trading at multi-year highs. So refiners will have to look to adjust their yields from other parts of the barrel.

If refiners are unable to increase middle distillate yields significantly, strong margins should also see increased runs where possible. Although, obviously doing so would not only increase the middle distillate supply, but also the supply of other products, which are not as tight as the middle distillate market. Also, it is important to remember that whilst prompt refinery margins are very attractive, the market is in steep backwardation, which makes it less appealing for refiners.

Finally, demand destruction would also help. The IEA recently published a 10-point plan, which they believe if followed by advanced economies could reduce oil demand by as much as 2.7MMbbls/d within four months. A large part of this plan is reducing the usage of private vehicles. If this were achieved, it would help to ease the tightness in the middle distillate market. However, the action we have seen from several countries so far does not appear to be aligned with this plan. We have seen some governments cutting fuel taxes or even subsidising fuel prices, which is unlikely to lead to the demand destruction that the IEA is hoping for.

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