



Eurasia Energy Observer

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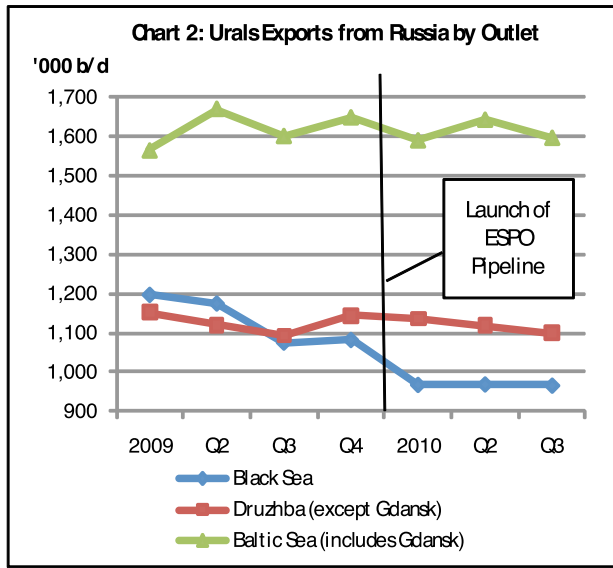
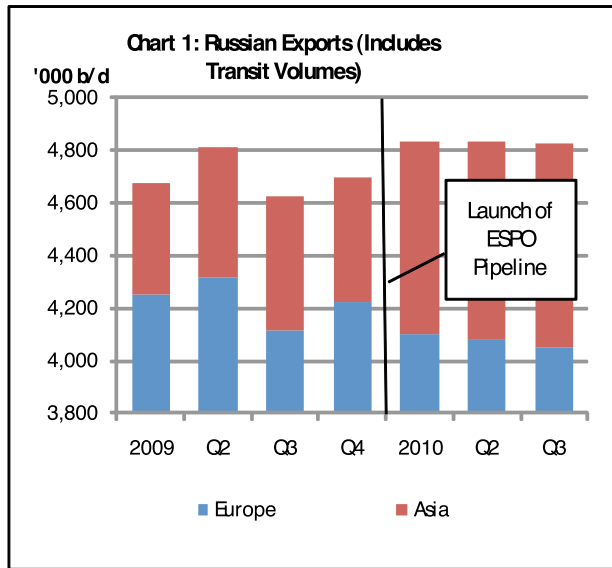
Growing Premium for Russian Crude

By Andrew Reed

As the market for ESPO Blend takes shape, prices of the new Russian crude blend are gradually improving. Meanwhile the re-distribution of Russian crude exports, particularly the decline of exports from the Black Sea, is supporting Urals values in Europe.

Demand for ESPO Blend is gradually picking up and should lead to a continued improvement in prices in the second half of 2010. A half year has passed since Russia launched exports of ESPO Blend from Kozmino Bay, increasing Russia's role as crude supplier to the Pacific Basin. With outflows now at just over 300,000 b/d, combined with seaborne exports from Sakhalin and overland rail deliveries to China, Russia now exports 775,000 b/d of crude directly to Pacific Basin markets (see Chart 1). Early on ESPO Blend has fetched a low price relative to the regional benchmark Dubai, which is of inferior quality. ESPO Blend generally traded at a \$0.50 per barrel or more discount to Dubai in the first quarter of 2010. ESPO Blend should eventually trade at a premium to Brent, like similar-quality Omani crude.

Increased purchases by China and Japan, which have been hesitant buyers early on, will strengthen ESPO Blend values. Japanese refiners have taken a wait-and-see approach. CNPC will buy all the 300,000 b/d of ESPO Blend to be delivered through the overland pipeline that will be completed in 2011. In the meantime though, China is taking very little of the seaborne exports from Kozmino Bay. This has even led to speculation that Sinopec is refraining from purchases in order to not drive up the price of ESPO Blend. Since the price CNPC will pay for overland deliveries is linked to the spot price at Kozmino Bay, aggressive purchases by Sinopec would push up the price paid by CNPC. Inconsistent quality may be causing hesitation in



China just as it is in Japan. ESAI expects Chinese and Japanese purchases to grow. South Korea is importing greater volumes.

More consistent quality and adjustment of the sales terms will also increase demand for ESPO Blend. Inconsistent quality and prompt sales have undermined demand for ESPO Blend in the period since exports began. For example, sulfur content has varied by shipment. The quality of the crude is expected to become more consistent in the near term. Initially spot volumes were sold on a short-term basis with as little as ten-days forward delivery, but sellers are adapting to the Asian market by increasing the forward length of sales to two months. There has already been a trend toward more narrow discounts to Dubai as sellers have increased the forward length of sales. ESAI expects ESPO Blend to trade at a consistent premium to Dubai after imports to China and Japan pick up.

Tightening Urals Outflows

The launch of ESPO pipeline led to a decline in Russian exports of Urals from the Black Sea, which will be bullish for Med sour crude fundamentals and the discount of

Urals to Brent. As Chart 2 illustrates, in the first quarter of 2010 the launch of ESPO pipeline contributed to the 180,000 b/d decrease in Urals exports to Europe. The decrease would have been bigger had a dispute with Belarus not caused Russia to reduce deliveries to that country’s refineries. The lion’s share of the decrease, 115,000 b/d, was in Urals outflows to the Black Sea. Since ESAI expects OPEC output to grow, reduced Urals supply to the Med will offset growing sour crude supply to that market from the Middle East. Thus in 2010 the impact of reduced Urals exports will be to prevent the Urals discount, which has been less than \$1 per barrel in June, from widening to much more than \$1.50 per barrel. ♦

Andrew Reed is director of Russia & Caspian at Energy Security Analysis, Inc. (ESAI). He analyzes developments in the Russian and Caspian oil markets and their impact on the global market in ESAI’s monthly publication CISWatch. For a complimentary table with detailed data about Russian crude export trends or other inquiries contact him at areed@esai.com.