In recent months, the market has touted Saudi Arabia's success in capturing a larger share of China's crude imports, surpassing Russia as the top supplier and even reaching record high export levels this summer. This development is in part the result of recent, strategic downstream investments by Saudi Arabia in China, but equally as much a mark of economic pragmatism and shifting winds in global crude markets. The kingdom will continue to face stiff competition in supplying the Chinese market, particularly from Russia, and has further work to do to secure its longer-term competitive advantage compared to other key suppliers.

## Saudi Arabia's strategic investments in China have enhanced demand for its crude

The kingdom has continued to slash crude exports to the US Gulf Coast (USGC) in favor of capturing a larger share of demand growth in Asia, and particularly in China where Saudi exports jumped from just over 1m barrels per day (bpd) in 2018 to over 1.7m bpd in recent months. Although Saudi Arabia retains interest in USGC refining through Motiva Enterprises, and USGC refinery configurations still look to Saudi heavy crude, the kingdom has been drawn to Asian demand growth prospects and has sought to secure its market share through strategic downstream investments.

These deals, which include a February 2019 agreement for a 35% stake in a refining and petrochemical complex in the Liaoning Province, and a September 5 memorandum of understanding for a 9% stake in the Zhejiang integrated refinery and petrochemical complex, contain long-term crude supply agreements and provisions for the use of crude storage plus access to fuel retail business. Strategic investments in China are likely to remain a cornerstone of Saudi Arabia's Asia-focused oil export strategy.

## Global politics and policy changes further strengthen Chinese demand for Saudi crude

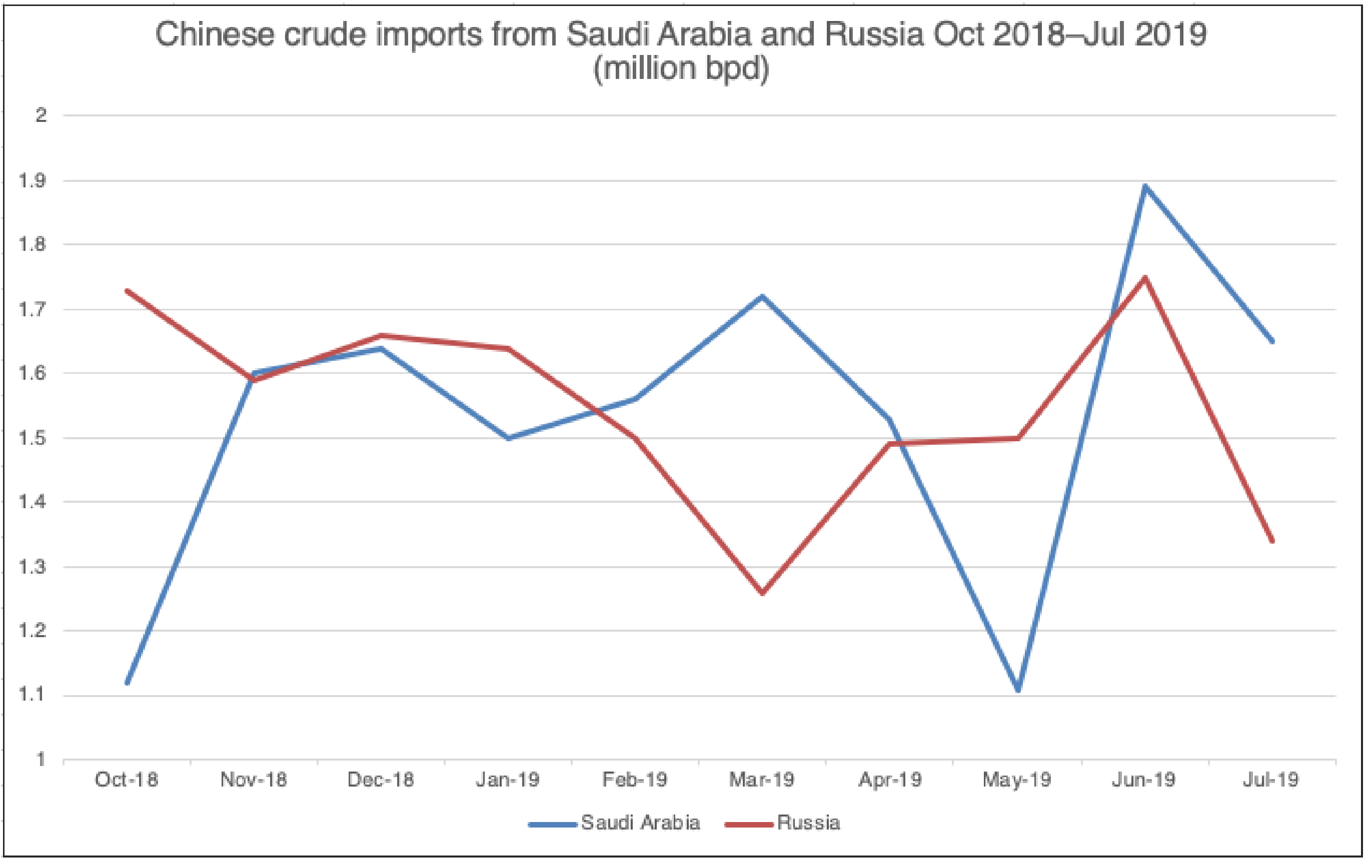
Arguably, geopolitics and policy shifts have had equally as much to do with creating supply gaps and opportunities for Saudi Arabia to capture a larger share of China's crude market. One such factor was the May 2 expiration of the US sanctions waiver program for Iranian oil purchases. Prior to this, China purchased around 790,000 bpd of Iranian crude in April. With the ability to offer a lookalike to Iranian crude, Saudi Arabia was able to move in quickly and pick up some of this extra volume.

A second, very recent factor has been China's September 1 imposition of a 5% tariff on US crude imports as part of the ongoing US-China trade war. Although the US had exported more than 300,000 bpd to China for much of 2018, shipments have tapered off or been redirected to India, South Korea and other markets in 2019 as Chinese buyers have been wary of possible tariffs and moved to decrease their exposure. In general, state refiners like Petrochina and Sinopec favor Saudi Arabian grades for feedstock, and the complexity of their refineries allows them to accept a diverse slate of these crudes. In addition, the kingdom has been building more robust ties to China's smaller, independent "teapot" refiners, which account for around 20% of imports. The combination of these factors has allowed for stronger growth of Saudi crude exports to China, and the kingdom's tendency to lower prices in the Asian market when expedient can serve as a useful tool to defend market share.

Finally, Saudi Arabia is well positioned to gain additional market share in the run-up to the introduction of the International Maritime Organization's (IMO) 2020 regulations in January, which will impose a 0.5% maximum sulphur content for bunker fuel. The regulations will drive increased appetite among Chinese refiners for light sweet crudes, in particular among the independent refiners, which have previously accepted larger volumes of higher sulphur fuel oil to balance higher oil prices and stricter tax enforcement. Both Saudi Arabia and Russia are preferred suppliers to China of lighter, sweeter crudes that meet necessary IMO 2020 specifications. With this in mind, it is important to note that Russian crudes, such as the East Siberia Pacific Ocean (ESPO) and Sakhalin blends, will remain worthy competitors to Saudi crudes in China as the regulations are introduced.

## The kingdom must find competitive edge to defend its market share amid steep competition

Despite these impressive gains, Saudi Arabia's longer-term growth in market share is not a foregone conclusion and will depend on a range of factors, including US-China trade negotiations, the price of Saudi crude grades and Saudi Arabia's ability to find its competitive edge in the Chinese market vis-à-vis other critical suppliers, most notably Russia.




Although the kingdom surpassed Russia as the top supplier to China for much of 2019 to date, its lead position is tenuous and requires foresight and playing into Saudi Arabia's comparative strengths. Russia's ESPO blend crude is expected to reach record high export levels to China this fall to match a recovery in run rates among China's state-owned refiners, and continued expansions on the ESPO pipeline (both the trunk line and the direct spur to China) will boost available export capacity for Russia. Russia's direct pipeline links are attractive for China to the extent that they remove some of the risk associated with seaborne supplies from Saudi Arabia and other Middle Eastern and African suppliers.

The kingdom's advantage lies in several key factors: diversity of crude exports, pricing strategy and investment. Unlike Russian producers, which are somewhat hamstrung by sanctions and limited in their ability to make strategic investments into China's downstream, Saudi Arabia can continue to accumulate stakes in downstream assets to support long-term contracts and build diverse relationships with Chinese refiners. This coupled with a more flexible supply of crude grades, and an ability to undercut prices of other key suppliers to China, gives the kingdom considerable leeway to manage its China presence and secure its long-term crude supply share, despite global market volatility.

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