

A tale of two crude oil markets

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The vast majority of the world looks at two crude oils as the benchmarks for the majority of crude oils in the world. WTI is the signature U.S. crude for the CME Group while Brent serves that role for the IntercontinentalExchange. Both are high-quality crude oils with WTI U.S. based and Brent North Sea crude. From a quality perspective, WTI is a tad better than Brent and, all things being equal, WTI historically carries about \$1 to \$2 per barrel premium over Brent. The vast majority of crude oils sold in the world historically have been pegged to either WTI or Brent, depending on their proximity to the United States or Europe and/or their ultimate destination.

For years the spread was relatively predictable and somewhat straight forward to trade around a few key fundamental drivers. WTI is predominately a mid-west crude oil that mostly finds its way into what is referred to as the PADD 2 region of the United States with Cushing, Okla. (the delivery location for the Nymex WTI contract) a subset of PADD 2. Very simply crude oil inventories and the value of the Brent/WTI spread were correlated directly (and still somewhat are). When crude oil inventories in PADD 2 are building, WTI tends to depreciate in value vs. Brent, and when stocks are declining, the opposite relationship occurs. Over a long period of time inventories in PADD 2 have cycled through modestly long building periods followed by long destocking periods. Thus providing an excellent backdrop to trade this spread.

Since the financial meltdown, inventories in PADD 2 have moved toward the upper end of normal and for the most part have remained at relatively high levels for an extended period of time (although they have been destocking of late) resulting in the spread moving out of its normal historical trading range and into an atypical relationship of Brent trading at a significant premium to WTI. An issue with PADD 2 is there are many pipelines to move crude oil into the region, but none to move surplus crude oil out of the region. So once inventories approach above normal levels, the only way to get them down is to increase refinery runs in the region. Unfortunately, with oil demand growth in the United States still languishing, refinery utilization rates have been mostly below normal and as such crude oil inventory destocking has been a slow process.

On the other hand, oil inventories in the rest of the world slowly have been moving toward normal to even below normal levels in some regions. As such the market has looked to Brent as a more valid marker for crude that is representative of the global crude oil supply and demand balance. On top of this evolution the world of oil lost Libyan crude oil production because of the civil war at the same time as unrest heated up in Nigeria resulting in further losses of high quality crude oil. In addition, the normal maintenance season in the North Sea over the last several months has resulted in an underperfor-

mance of North Sea production. As a result, the premium in Brent has gone pretty much viral (see "Premium vs. regular).

As we entered September, the October Brent/WTI spread traded at an all time high of around \$27 premium of Brent over WTI. The spread has been in a relatively steep uptrend since late spring/early summer when Libya, Nigeria and North Sea issues started to work into the equation. Prior to that the spread was settling into a trading range of between \$8 to \$12 premium to Brent predominately driven by the growing surplus of crude oil in PADD 2. So the last \$15 or so is related

PREMIUM VS. REGULAR

Multiple factors have caused Brent crude oil to trade at a growing premium to WTI.



Source: eSignal

mostly to the non-WTI factors mentioned above. Interestingly, since early April crude oil inventories in PADD 2 have been in a destocking pattern and actually have declined by about 10 million barrels and are now back to about where they were toward the end of 2010 when the Brent/WTI spread was trading between \$4 to \$6 premium to Brent (before Libya).

So how do we trade this spread going forward? With extreme caution. The spread may look topy and trading at a very overvalued and unrealistic level, but it remains in an uptrend and as such one can only respect the trend until proven otherwise. There was a temptation to sell the spreads at the end of August when the Gaddafi regime was toppled, but as you can see there was no massive convergence in the spread as some had suspected. The fundamental factors to watch are: A return of a substantial amount of Libyan oil, stability in Nigeria and a return to normal production levels in the North Sea. Some combination of these will be the trigger to send the spread into a downward corrective move.

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