The Heavy Hand In Oil Markets

When you teach, you learn something from your students, or at least you should. One of the early lessons I picked up was financial traders, those who spent their time in equity and equity option markets in particular, found the forward curves in commodity markets very difficult as they had no parallel in their world. However, as more and more investors moved into commodity-linked investments, they found out the hard way how powerful forward curves can be; check out the total returns on instruments such as the U.S. Oil or Natural Gas funds for example.

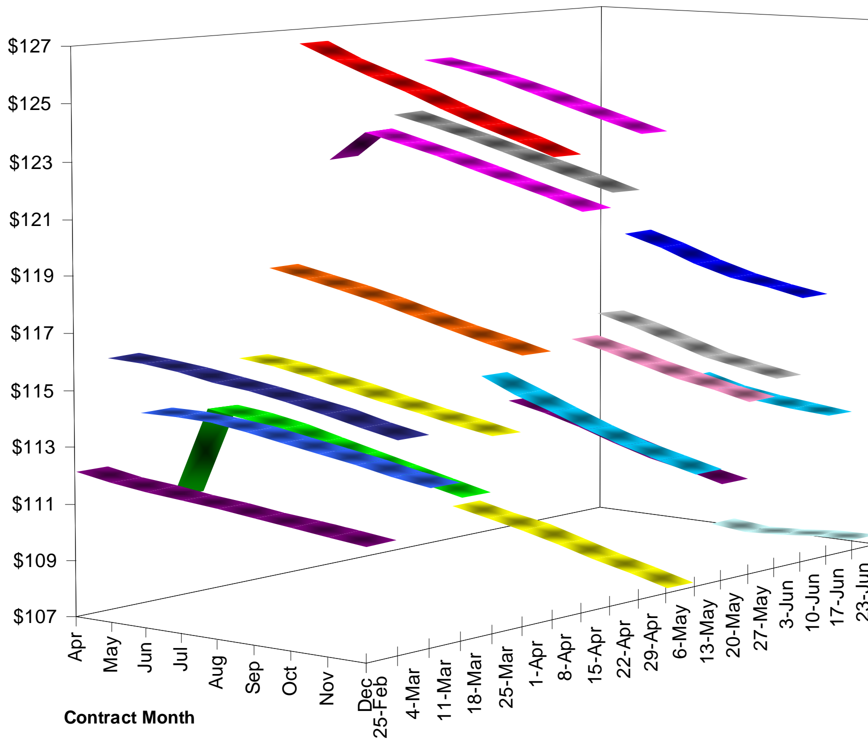
What, then, are we to do when two seemingly related markets such as West Texas Intermediate (WTI) and Brent Blend, the bases for the benchmark North American and North Sea crude oil futures, respectively, have two different forward curves? As I discussed back in March in the context of refining equities, the two markets can and have become disconnected from one another. The spread, which for years had seen WTI at a premium, had blown out last week to where Brent was at a $20+ premium to WTI…with no realistic arbitrage potential to get crude oil from Cushing, Oklahoma, out into Atlantic Basin markets.

Scatter

One answer for how this could happen during a period when inventories as Cushing were moving lower and U.S. refinery runs were at normal summer levels was a differential response in the two markets to the Libyan supply disruption. It is as if the police broke up the local craps game and half of the miscreants ran left and half ran right; this response might be considered small-scale diversification of risk.

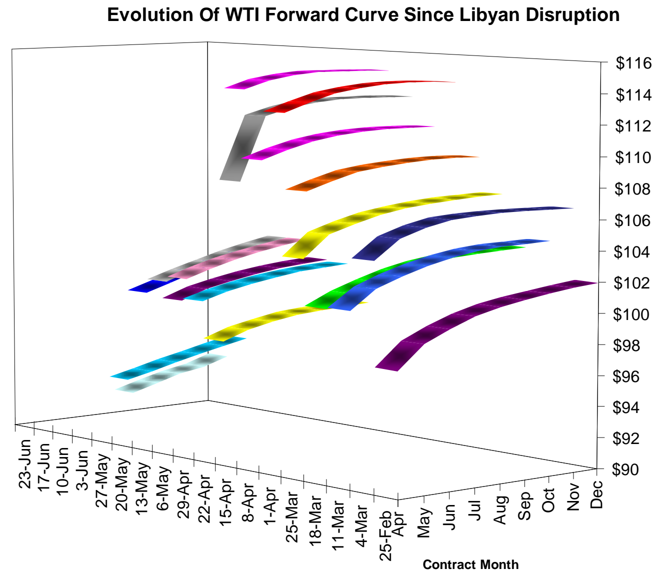
Here is how affairs proceeded from late February onwards. The loss of high-quality sweet crude exports from Libya and the lack of a direct inventory storage mechanism for the cash-settled Brent created a buying panic for front-month Brent-basis cargoes and pushed the forward curve into backwardation. This is a classic response in a supply-constrained physical market. Note how the successions of forward curves from February into June all have the front-month higher than the back-month prices.

Evolution Of Brent Forward Curve Since Libyan Disruption



Now if we repeat the exercise with WTI futures, we see something very different. Here the front-month contracts remain at a discount to the back-month contracts regardless of whether prices are rising or falling. This is because, unlike cash-settled Brent, the WTI contract is physically delivered to one place, Cushing, and convergence between the cash market and the futures market is assured. The availability of inventory and the tendency of back-month

prices to rise as long-only funds exhaust sellers' liquidity in the back months allow WTI to rise and fall in a carry structure.



The net result was crude oil was ample in the U.S. market while it was scarcer in the European, particularly the Mediterranean, markets. The release of strategic reserves last Thursday under the aegis of the International Energy Agency thus injected a supranational actor into the markets to act as a stabilizer not only of prices but implicitly of spreads as well.

This sets a very bad precedent, of course, as if we live in a world where further bad precedents are required. Petroleum markets can be tough enough without worrying about a potential bounding action by the IEA during a non-crisis situation.