The Crude Oil Contango Storage Trade Worked Well

Commodities In Hedged Storage Are A Call Option

There are certain things you do in life whose economic value far exceeds their accounting value; no one understands this less than my accountant friends, most of whom still believe your employer pays half of your Social Security ding every year because, hey, that is who writes the check. Economists understand you, the employee, pay 100% of the whole affair because it comes out of the compensation pool.

I mention this not because economists are a superior life-form to accountants but because I had to fight (and win, I might add) the good fight two decades ago with some bean-counters over crude oil storage. I argued if I could place crude oil in storage in Cushing and sell the next-month future at a price in excess of the storage costs that the firm's potential economic gain exceeded the cash-and-carry accounting gain.

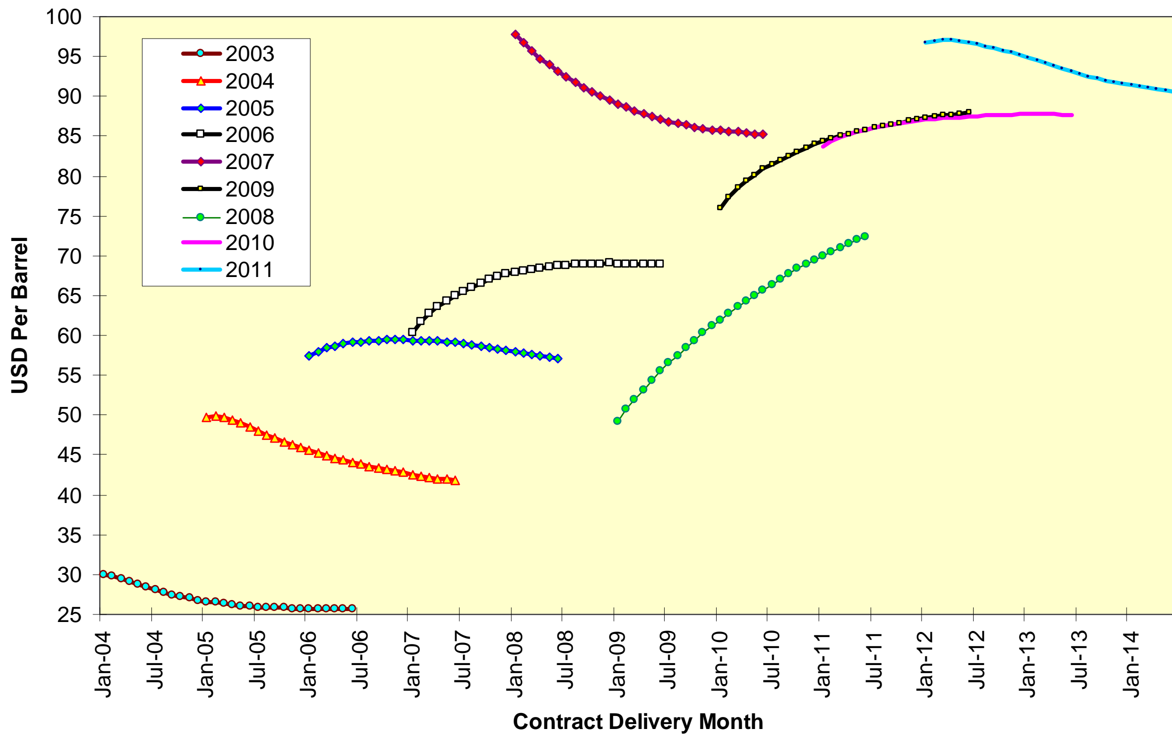
How so, you ask? Let's say for the sake of over-simplified argument it would cost me $0.90/barrel/month to store crude oil and I could sell the second-month future, now February for $1.00/barrel over the cash market price. That is a locked-in accounting gain of $0.10/barrel. Now let's say sometime during the pipeline scheduling window another firm finds it is short of barrels and comes a-knocking on my door:

Them: Knock-knock.
Me: Who's there?
Them: What will you sell me prompt barrels for?
Me: Twenty cents under February.
Them: Okay, you [inaudible].

I now realized a gain of $0.80 when I initially expected a gain of $0.10. The potential gain is open-ended and the lower bound of $0.10 is fixed. If that does not sound like a call option, nothing does.

This trade was going on in the proverbial real world, the one filled with real goods and populated by real people; that is so unlike the electronic fantasy land where I spend my waking hours. However, as I discussed in February's S&P 1500 Refiners Group Outperforming Market, but Spread Normalization Looms, the wide refining margins available in the mid-continent region would lead to an inventory drawdown and a shift into backwardation in a self-reinforcing cycle.

The chart below depicts the first thirty months of the crude oil forward curve at the Monday following Thanksgiving for each year since 2003. The curve had been in contango at this time in 2008 and 2009, but has shifted into backwardation today. As inventories are drawn down further, the level of backwardation, or discount of successive futures to the cash price, will increase and penalize refiners such as Valero (VLO), Tesoro (TSO), Sunoco (SUN), Marathon (MPC) and integrated majors such as Chevron (CVX), ExxonMobil (XOM) and ConocoPhillips (COP).



Finally, please note how small the shift into backwardation that prompted this inventory drawdown was. The spread between the first two crude oil futures contracts is still relatively flat, but that has been accompanied by a significant drawdown of inventories. This will set the U.S. market up for short-term price spikes in crude oil next spring.