

Refiners Get A Gift

Return Of The Mid-Continent Discount Boosts Returns

You know when you are getting old when your phone has a landline, your camera has film and you think there is a single, integrated crude oil market operating between the Atlantic Basin and the U.S. mid-continent. I have had to discuss changes in spreads between Brent-basis crude oil, Louisiana Light Sweet at the U.S. Gulf Coast, West Texas Intermediate at Cushing, Oklahoma, the respective forward curves of Brent and WTI futures and refining margins several times over the past two years, most recently in October 2011's [Oil Refining Spreads Never Returned To Normal](#), and I suspect I will have to keep revisiting the subject.

Differential Forward Curves

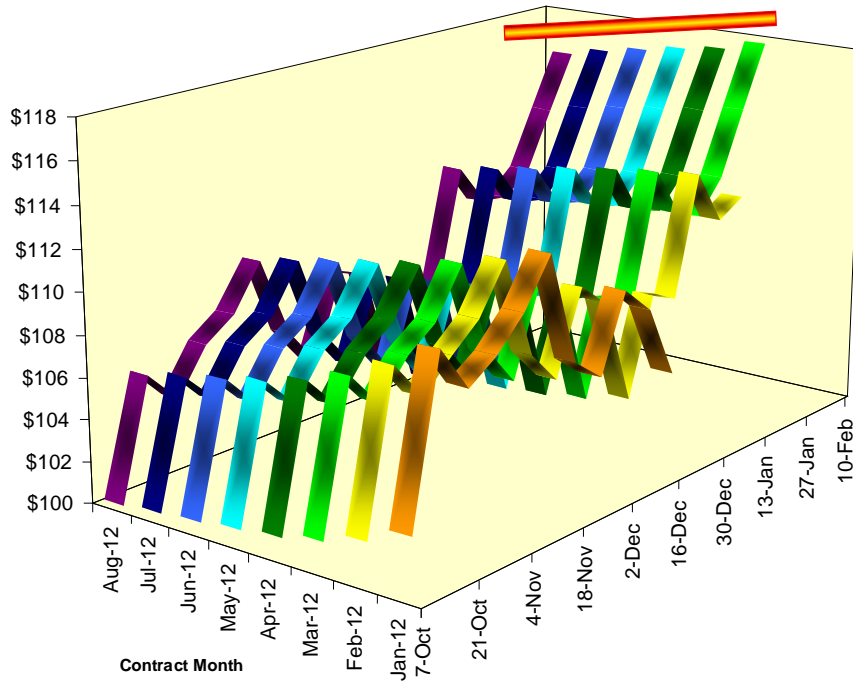
The S&P 1500 refining group higher, which includes Valero (VLO), Sunoco (SUN) and Tesoro (TSO) along with Marathon (MPC), HollyFrontier (HFC) and World Fuel Services (INT) has been on a tear since December 27, 2011; it has returned 25.39%, as opposed to 7.36% for the S&P 1500 Supercomposite itself. For purposes of comparison, the Integrated Oil & Gas group, comprised of Chevron (CVX), ConocoPhillips (COP), ExxonMobil (XOM), Hess (HES), Murphy (MUR) and Occidental (OXY), all of which have refining arms by definition, has returned a mere 0.63%. We sniff.

The key has been a huge expansion of the 2/1/1 crack spread in the mid-continent region, also known as PADD II. This spread, which measures the return on turning two barrels of crude oil into one each of heating oil and gasoline, has expanded from \$13 to \$29 per barrel; a comparable spread for Brent crude oil at refining centers in Northwest Europe has moved from \$5.90 to \$9.70 per barrel.

How has this differential expansion occurred? The answer comes right out of the Keystone Kops, not to be confused with the administration's task force on the Keystone XL pipeline: The forward curves for Brent and WTI futures have moved off in different directions during the period of heightened political tension with Iran.

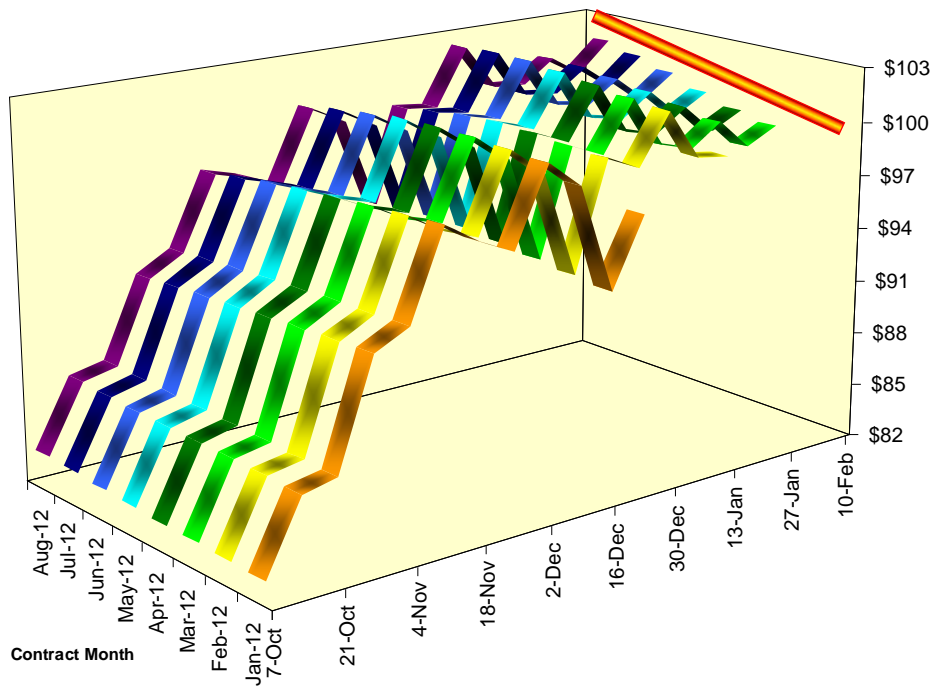
The reason for this divergence is very straightforward: Brent is cash-settled and has no direct inventory storage market associated with it; WTI is physically delivered and has a very active inventory storage market associated with it. In the Brent case, as is the classic case for all extractive commodities, the cheapest place to store it is in the ground; that makes the front month futures rise more rapidly than the back months and pushes the curve into backwardation. I highlighted this shift over time with a rectangle in the chart below.

Brent Forward Curve Rising In Backwardation



In the WTI case, the presence of long-only commodity funds means market-makers who sell front-month futures often buy the back months as a hedge. As these months have no immediate physical delivery, they rise faster than the front months and push the forward curve into a deeper carry. I highlighted this, too.

WTI Forward Curve Rising In A Carry



The wider spread between Brent and WTI is reflected in a wider Gulf Coast-Cushing spread and in wider refining margins. Refiners with access to Cushing storage really have received a gift from Iran.