Brent-WTI Crude Spread on a Path Toward Normalcy

BY DOMINICK A. CHIRICHELLA, ENERGY MANAGEMENT INSTITUTE

May 13, 2013

The spot Brent/West Texas Intermediate crude oil spread has narrowed for 12 out of the past 13 weeks, shrinking 71 cents a barrel, or 8.28%, just over the last week.

Over the last 13 weeks the spot spread has declined by $10.96/bbl or 58.4% (compared to where the spread ended last week). The spot spread traded in single-digits for the entire trading week and below the $8.25/bbl support level.

The spread remains in a trading range of $8.25/bbl (hit back in mid-December of 2011 basis the spot continuation chart) on the resistance side and around $5.30/bbl on the support side. WTI last had a premium to Brent in October 2010 (on May 13, Brent’s premium traded around $7.81/bbl).

The following chart shows the spot Brent-WTI spread, along with the EIA weekly crude oil inventory level at Cushing, Okla., the delivery location for the spot Nymex WTI contract.

As shown, inventories in Cushing moved into a mild destocking pattern earlier this year, contributing to the narrowing of the spot Brent-WTI spread over the same timeframe.

The Brent-WTI spread is the most widely-traded spread in the oil complex, and the change in the relationships between these two global markers for crude has implications to both oil and refined products on a global basis.

The spread is not only traded by the speculative community but very actively traded by those on the asset side or those purchasing the hundreds of different international physical crudes from around the world.

The spread has been trading in an atypical relationship, with Brent trading at a premium to the slightly better-quality WTI for the last several years. Over the last week or so, the spread has narrowed to a level that suggests the period of extreme widening moves may be over.
Since early January 2011, the spread has been in a volatile and strongly widening pattern which at times has seen Brent trading at over a $27/bbl premium to WTI and thus resetting all of the crude oil and refined product interrelationships.

With the spread now trading below $8/bbl, many of the crude and refined product relationships are slowing moving back to more normal historical relationships that existed back in 2010 and before.

**Why has the spread narrowed so strongly over the last three months and what is in store going forward?**

Certainly the main reason for the widening period that existed since early 2011 has been the phenomenal crude oil revolution taking place in the U.S. and Canada. Crude oil has been flowing into Cushing and the broader PADD 2 (Midwest) region from places like North Dakota, West Texas and Canada.

Over the last few years the only way to move the growing supply of oil entering this region was through the conversion to refined products. Crude supply far outstripped refined product production and the net result was crude inventories in the region surging to record high levels.

Over the last year or so, the second phase of the oil revolution in the U.S. emerged: The oil infrastructure revolution. Pipelines have been reversed and rail movements of crude oil are occurring from the region to all of the coastal areas of the U.S.

All of a sudden crude oil is not as landlocked as it was in the Midwest and crude oil inventories are finally starting to destock off record high levels. The net flow of crude oil out of Cushing has changed the market sentiment resulting in the almost 60% narrowing of the spread just this year alone.

Since there are two sides to the spread, further contributing to the strong narrowing trend has been the robust and relatively consistent production coming from the North Sea, along with minimal, if any, interruptions in other global crude oil. Oil is well supplied internationally while inventories in the Cushing area are finally starting to decline.

**Where does the spread go from here?**

I have been suggesting for months in my daily newsletter (available on CME Group’s Market Commentary & News/http://www.cmegroup.com/education/market-commentary/) that the spread has entered a path toward normalcy.

Normalcy, meaning back to WTI trading at a small premium over Brent, as it did for years. In the 1990s, WTI had an average premium of about $1.30/bbl above Brent. From 2000-09, WTI’s premium averaged $0.55/bbl.

The path to normalcy is a slow process, although the spread narrowing to single-digit levels certainly occurred faster than I expected. In addition, it is not going to be a continuous uninterrupted narrowing. Rather, it will be a bumpy path that will likely evolve into 2014.

The longer-term trend will be a narrowing as the crude oil net flow out of the Cushing area will continue as new pipelines are built while others into the region are reversed.
For example the new southern leg of the Keystone XL South pipeline should be operational by December with a capacity of 400,000 bpd. By early 2014 total new capacity of diverted pipelines away from Cushing as well as reversed and new outflow lines are estimated to exceed 1 million barrels per day or a level that will accelerated the path to normalcy.

The longer-term is clearly suggesting an ongoing evolution toward the spread trading at more normal historical relationships.

The short-term will certainly continue to be impacted by production levels in the North Sea and weekly crude oil inventory levels in Cushing and PADD 2, as well as any unforeseen global geopolitical events that could impact the supply of international crude oils.

Dominick Chirichella, a CME Group featured contributor and founding partner of Energy Management Institute, is an expert in all facets of energy and commodity trading, risk management, education, consulting and financial services. He has worked with, and consulted for, start-up operations, integrated major oil companies and international trading companies.

Energy Management Institute is a premier commodity education and analysis company, providing comprehensive training for energy professionals and, with CME Group, provides training to domestic and international exchange communities.

Dominick Chirichella can be reached at dchirichella@mailaec.com

This information was obtained from sources believed to be reliable, but we do not guarantee its accuracy. Neither the information nor any opinion expressed therein constitutes a solicitation of the purchase or sale of any futures or options contracts.