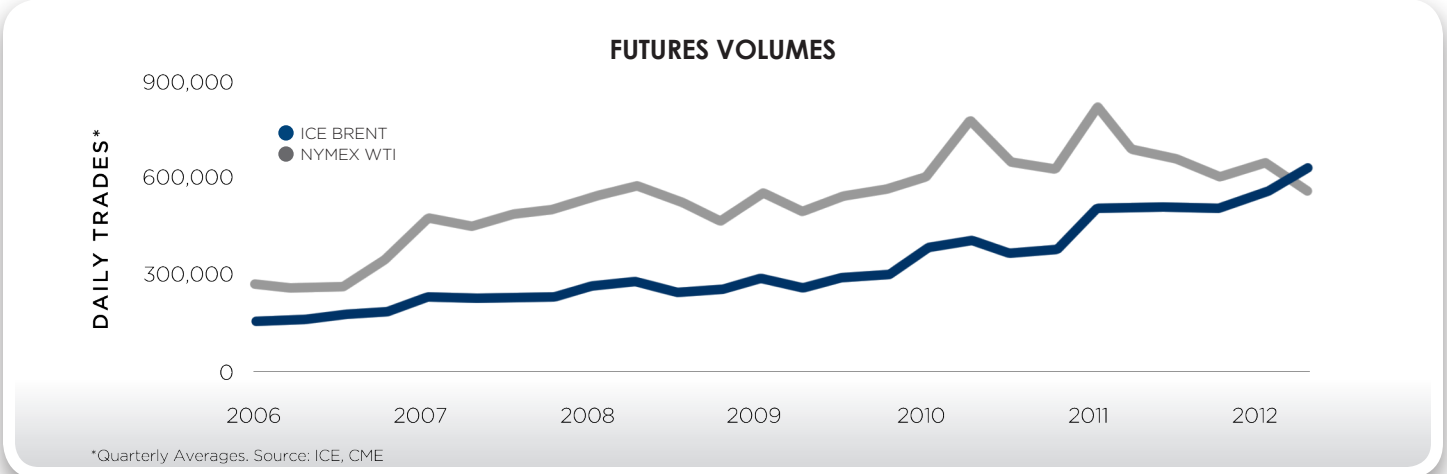
In Battle of Exchanges, ICE Brent Gets Upper Hand in Volumes

Energy Intelligence Briefing

Matt Piotrowski, Washington - **20 July 2012**

- Brent Volumes surpass Nymex WTI
- Backwardation steepens in Brent; WTI entrenched in contango
- Despite Seaway pipeline reversal, differential still wide

Volumes in the ICE Brent market have now overtaken those for US benchmark Nymex West Texas Intermediate (WTI) in what appears to be a structural shift that has been several years in the making. During the second quarter, ICE Brent's volumes exceeded Nymex WTI's for the first time, largely the result of growing investor appetite for the European benchmark and WTI being land-locked and cut off from international markets (EIB Apr.17'12). Although Nymex WTI still has the upper hand with open interest and the options markets, it is clear ICE Brent has healthier volumes, passing 700,000 lots per day in July for the full Brent curve versus about 590,000 for its US rival. So far this year, volumes for ICE Brent are slightly under 603,000 lots per day compared to about 583,000 for Nymex WTI, down about 100,000 versus 2011 averages.



At the beginning of 2012, the two leading commodity indexes — the DJ-UBS and the S&P GSCI — increased their exposure to Brent after it outperformed WTI last year and showed a persistent backwardation, versus contango for WTI — which hurts investors on the monthly roll. This has led to an influx of money in Brent while taking away some of WTI's market share. In addition, heavy fluctuations in the Brent premium have made WTI less suitable as a physical hedge for US refiners, so they have switched, starting this year, to Brent futures for their seaborne imports.

The volatile spread between the benchmarks is the result of regional disparities. With Nymex WTI being a land-locked crude, it has taken a major hit versus waterborne crudes amid growing US domestic production in the Midwest and Canada and rising inventories in the region. As global prices rallied to close to the $130 level, this year and last, WTI was held back by this emerging regional glut.

ICE Brent, in the meantime, is closely linked not only to local fundamentals in the North Sea — which include declining production and periodic maintenance and technical outages — but also to the wider global market, making the Brent contract the lightning rod for political insecurity. In the past year and a half, prolonged outages in Libya (now resolved), Yemen, Syria and the Sudans have all impacted the global oil market, giving Brent a major lift. What's more, Iranian sanctions and the EU import embargo underpin Brent, as European customers of Iran have to look elsewhere for crude. At the same time, Brent is used more as a pricing benchmark in Asia, and more North Sea Forties being shipped to Asia reinforce that link. Iran's Asian customers cutting back has also affected Brent more so than WTI.
Geopolitical issues make Brent a more enticing investment vehicle, as it has more risk to the upside. But not only that, local issues have also

given North Sea crudes a boost. Besides declining production in the North Sea, labor disputes such as the one that recently occurred in Norway, problems at the Buzzard field, and typical summer field maintenance are in stark contrast to US output growth in the Midcontinent, where the increases over the past two years or so have caught just about everyone off-guard.

On the flip side, though, the Atlantic basin has seen lots more sweet crude floating around as a result of Libyan crude returning faster to market than expected and the US backing out large volumes of Nigerian sweet crude. This glut is not so much affecting the flat price of Brent but did push the contract on contango recently. Brent is now back in backwardation, but the available volumes of sweet oil should erode that front premium in due course.

The upside potential matters, but the shapes of the curves do too. Passive investors want to put their money in a market that is backwardated — with prompt prices higher than future contracts. This means that investors do not lose money when they roll their positions from the prompt month to the second. In the S&P GSCI, returns for Brent are up 2.3% year-to-date, versus negative 8.4% for WTI.

Brent flipped into contango for a short while recently, but has returned to backwardation and spreads have steepened to levels not seen since May, giving investors even more incentive to migrate toward Brent. Meanwhile, Nymex WTI is entrenched in contango because of the glut of supply in the US Midcontinent. The flat oil price would have to rise more than investors lose on the roll to make passive long investments in WTI worthwhile. If the structural trends regarding the two curves hold, which can be expected to last for the foreseeable future, investors will be even more confident in their migration to the European marker.

SEAWAY REVERSAL IMPACT SO FAR MARGINAL

Last fall, when Enterprise and Enbridge announced they would reverse the Seaway pipeline to carry crude from Cushing, Oklahoma to the Gulf Coast, analysts scrambled to revise their estimates for the Brent-WTI spreads. After blowing out to a massive $28/bbl last year, the spread would likely fall to more modest levels, perhaps as low as $5, some analysts estimated, as the overhang in the Midcontinent, and in particular Cushing, would go away.But this has not happened. The Brent-WTI spread is currently around $15, dipping below $10 on a few occasions

this year, but also rising to above $21, as it did at times in March and April. Since the reversal was completed in May, stocks at key pricing point Cushing have remained steady at around 46 million bbl, while the total in the Midwest (or Padd II) is at a near-record 110.5 million bbl, according to the latest data from the US Energy Information Administration (EIA). Shipping the surplus crude out of the region has a price. And that average price sets the Brent-WTI differential. The marginal barrels ship out by rail — hence the $15 discount.

There appears to be no immediate end in sight to the wide spread, or the glut of crude in the US Midwest. The Seaway pipeline carries only 150,000 b/d, not enough to significantly reduce the volumes at Cushing. "The impacts of Seaway have been canceled out by increasing volumes of crude production in the region," said Matt Smith of Summit Energy. With crude production ramping up on a monthly basis at the Bakken and other new fields, the US needs more infrastructure to move the crude to refineries on the Gulf Coast or East Coast. The expansion of the Seaway pipeline has been accelerated from the second quarter of 2013 to the end of this year, but, again, this may not be enough. The fate of the Keystone pipeline, to take more crude from Canada and the US Midwest to the Gulf Coast, will be settled after the 2012 presidential election in November — likely in its favor no matter which candidate wins — but its construction would bring the full line in operation only around 2015.

Although Nymex WTI is losing out on volumes to ICE Brent, it still has the upper hand when it comes to open interest — the total number of positions still open. In 2012, open interest for crude futures on the Nymex have averaged 1.487 million lots, roughly equal to 2011 levels and about 360,000 higher than ICE Brent. But Brent is clearly gaining — since 2010, open interest in Nymex WTI futures has held steady for the most part, but Brent's open interest has risen from just under 800,000 lots in 2010 to 1.126 million so far this year.

"Open interest is the key measure of liquidity and on this basis CME WTI is still ahead, although Brent is closing in rapidly," said David Hufton of brokerage PVM. "The switch has been well-signaled and comes as no surprise with the speed of the change assisted by a Brent market in backwardation compared to a WTI market in contango."

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