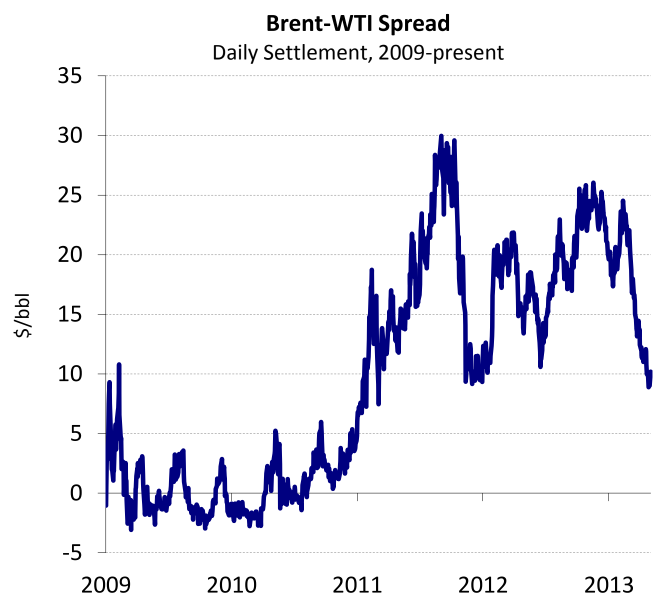
Frequently Cited Oil Spread Moderates on Evolution of Transportation Options

The Brent-WTI spread's blowout in late 2010 through 2011 made and lost many a small fortune. The spread was largely a result of unforeseen increased production running into transportation bottlenecks, creating an opportunity for everyone from railroad to barge owners as traders and refiners sought out lower cost inland crude (LLS, on the other hand, has continued to track Brent relatively closely). The response to these opportunities, along with record crude oil inventory builds in the United States, has led to a tightening of the spread thus far in 2013 (though it should be noted that 2012 saw a similar move to date).

Spread off highs of $30, down around $10

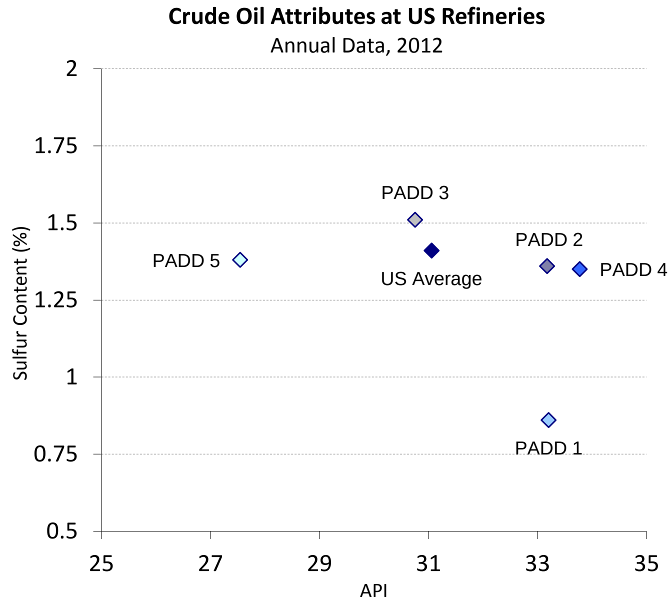


Source: Bloomberg

Abundance of lighter domestic crude a "new normal?"

Much of the increased production in the US has been of a lighter, sweeter variety, which is most compatible with refineries on the East Coast. This has created a notable intra-US supply-refinery configuration imbalance. Although forward curves indicate market expectations of a sub $10 spread through the end of 2016, a repeat widening on a further production glut or untenable storage levels could prompt domestic refiners to adjust processing grades. EIA noted in last week's *This Week in Petroleum* that, near-term, "refiners that switch from heavy to light crude may need to reduce their total volume of refinery runs given operating constraints that limit their ability to handle light fractions. Over time, these refineries may invest capital to increase the capability to run light crudes."

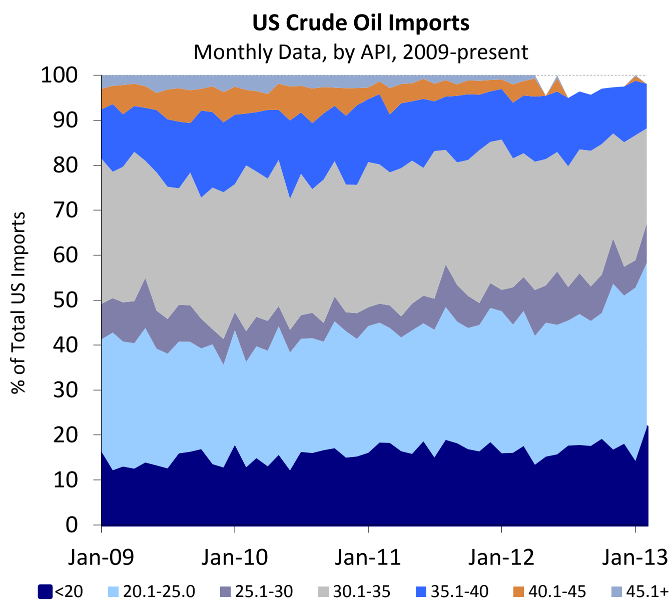
East coast refineries most compatible with lighter grades



Source: EIA

Indeed, lighter imported crudes are the ones being displaced, making up less of the US import mix as refiners have access to this cheaper domestic production.

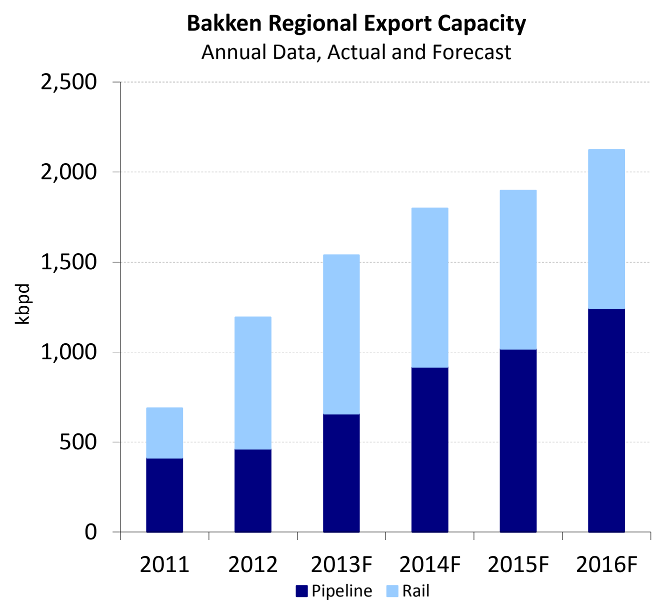
Lighter crudes not surprisingly losing import share



Source: EIA

In response to lower prices for domestically produced crude (benchmarks such as Bakken generally trade near WTI) and the resulting increase in domestic demand, rail owners are scrambling to produce additional transportation capacity. Although rail is generally more expensive than pipelines, it has shown an ability to scale more quickly. Take the Bakken region for instance:

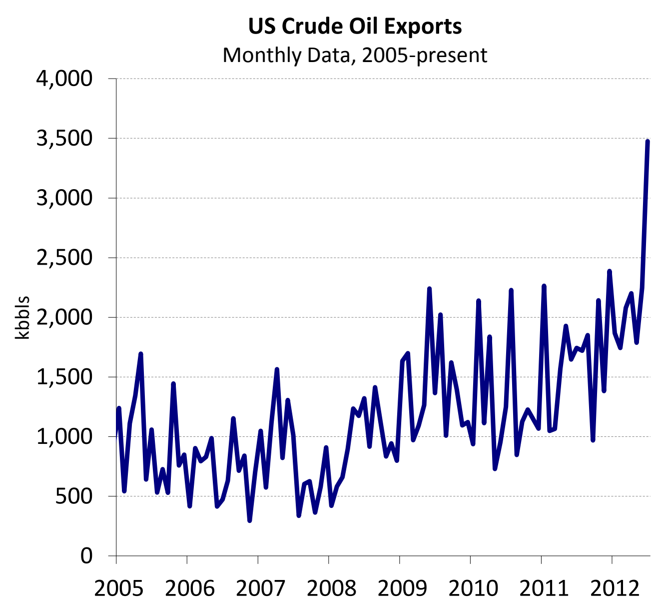
Ex-Bakken rail capacity ramping up quickly with pipeline expansions planned



Source: Citi Research

The plethora of cheaper light sweet crude has also caused some traders to take advantage and export a limited amount of crude oil to Canada, a move for which export permits can be actually be obtained. This trend has taken off significantly in the first two months of 2013, the only months for which EIA has provided data thus far.

US crude exports reaching levels not seen since late 1990s/early 2000s



Source: EIA

Narrowing spread not likely indicative of a notable increase in US crude oil imports

Both the transportation and export developments have helped to narrow the spread between Brent and WTI from peaks that had approached $30/bbl. On paper, this may suggest that foreign grades such as Bonny Light could become more competitive in the US again. Practically, though, this is not likely to happen. Some traders and refiners have already put forward contracts in place for US-produced crude oil, taking advantage of lower prices and limiting their need for spot cargoes. Furthermore, many forecasts suggest that North America's production growth is set to continue (USGS stated last week that Bakken and Three Forks have more oil than previously estimated, for instance), and transportation bottlenecks still remain. From a shipping perspective, while North American production growth has been fortuitous for owners of US-flagged tonnage, it is unlikely that the recent narrowing of the Brent-WTI spread is a precursor to an increase in demand for those crude oil imports into the US that have been displaced in the past few years. A sustained move towards parity between Brent and WTI should, however, improve European refinery margins selling into the US, creating increased demand for TC2 and similar moves (cargo counts for such a move have in fact been stronger of late).

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