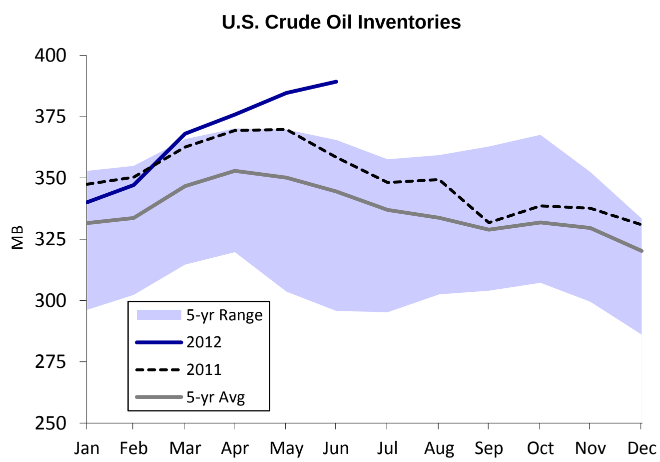
US Crude Stock Build Continues

Extended US crude stock build a rising threat to tanker demand

Six weeks ago, we observed that a surprise US crude inventory build was consistent with seasonal patterns, risk aversion ahead of Iran sanctions, trapped Cushing storage and Motiva stock building. We suggested that these rising inventories, driven by surging US shale oil production, poised a threat to crude tanker demand on any normalisation of inventory levels in a weakening demand environment. Since then, US crude stocks have continued to rise against historical seasonal patterns -- despite strong crude runs -- thus raising the stakes in the prospects for the tanker market

US crude stocks are 45 MB above the five-year average and 8% higher yoy



Source: EIA, Poten

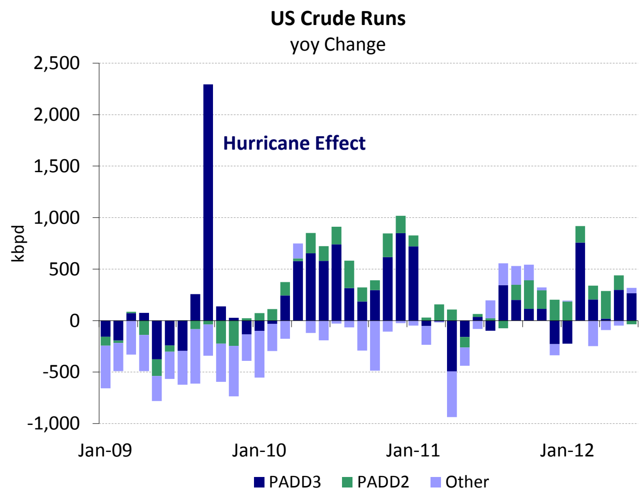
Crude inventories not following typical summer seasonal patterns

As shown in the above chart, US crude inventories have continued to rise in May and June versus normal seasonal patterns, in which crude stocks peak in early-May, before higher summer crude runs and stable imports allow inventories to decline at an average 200 kbpd rate (or 26 MB overall). This week, however, crude prices extended losses after the US Energy Information Agency (EIA) reported that commercial crude inventories rose by 2.9 MB, to 387.3 MB, versus market expectations for a 1.1 MB draw. The stock levels are at 22-year highs and 40 MB above the five-year average, exaggerated by the 1.0 MB (34 kbpd) rise in Cushing stocks during the past month, to 47.8 MB, despite the mid-May start-up of the 150 kbpd reversal of the Seaway pipeline.

US crude runs higher, despite lower US demand

Although US product demand year-to-date through May has been 337 kbpd lower year-over-year (yoy), US crude runs have actually risen, jumping by 312 kbpd yoy during the first five months of 2012. As shown in the chart on the following page, USG refiners in PADD3 have led this refining growth, showing a 210 kbpd yoy rise, partially on higher gasoil export demand. Midwest (PADD2) refiners, enjoying higher margins on depressed WTI prices, have also supported crude runs, by lifting their inputs by 178 kbpd yoy through May.

PADD3 crude runs leading rise on diesel export demand



Source: EIA, Poten

Onshore Texas crude output actually leading US production gains

Still, crude stocks continue to rise, despite virtually no annual increase in crude imports. The culprit, of course, is the dramatic rise in US crude production, with surging shale oil output contributing to a 642 kbpd yoy jump in total production during 1q12. North Dakota production was 210 kbpd higher yoy during the first quarter, driven by rising Bakken output, but onshore Texas production leapt by 418 kbpd yoy during the period, from the Eagle Ford shale and other fields. With rising active oil rig counts, the market anticipates additional gains from shale oil, while offshore Gulf of Mexico output continues to recover from the 234 kbpd yoy declines of 2011 and should no longer serve as a drag on US output. With US production poised to rise from today's 6.3 mbpd level to 6.5 mbpd by year end, inventories would continue to grow without some corrective action to crude imports.

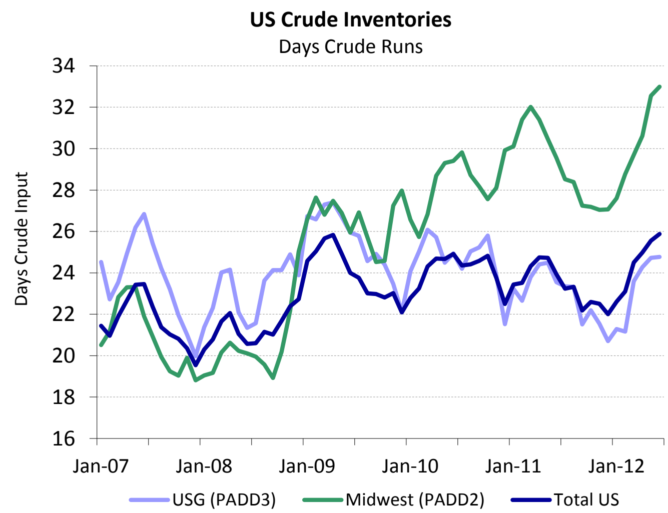
Motiva Port Arthur story has contributed to inventory rise

Some of this action is coming from an unexpected source, as Saudi Arabia has halted shipments of crude to Motiva's Port Arthur, Texas refinery, which has shut down its recent 325 kbpd expansion for several months due to corrosion problems. Motiva would have built up at least 25 days worth of crude inventories before the start-up of the expansion, or 8 MB. Indeed, the 112 kbpd yoy jump in Saudi Arabian imports to Port Arthur during 1q12 and the larger-than-seasonal jump in overall PADD3 crude stocks were consistent with this. Following the start-up issues and fire at the new unit during early-June, PADD3 crude inventories could be carrying as much as 5 MB of unexpected crude that Motiva should have processed.

PADD3 crude stocks not that high relative to crude runs

Although the 190 MB of PADD3 crude inventories are at a three-year high and are 7% above five-year averages, they are not excessive relative to increased crude runs. As illustrated in the chart below, PADD3 crude inventories, at 24.7 days of forward crude runs, are not outside historical patterns, even when Motiva's expansion is excluded from forward demand. As suspected, the sharp rise in Cushing stocks within PADD2 are distorting US crude inventories, when expressed as days crude runs.

The primary stock build culprit is trapped Cushing crude



Source: EIA, Poten

Year-end inventory management could slash US import demand

Ultimately, refiners will resolve this inventory rise by moving trapped PADD2 barrels to PADD3 for processing, but elevated Cushing stocks will continue until Seaway and other outlets develop. In the near-term, however, the US refiners' annual practice of cutting year-end stocks for tax and accounting purposes could influence import demand. During the past three years, year-end crude stocks have closed near 22 days of forward crude runs. If year-end PADD2 stocks remain at an elevated 30 days and total US crude inventories finish 2012 at a higher level of 23 days, then crude imports would have to drop dramatically under the current crude production and crude run regime. In fact, crude runs would need to drop to 8.5-8.6 mbpd during 2h12, or 300 kbpd lower yoy, but would still leave crude stocks at 354 MB, or 7% higher yoy, by year end. This drop in US imports would drive an 8% yoy plunge in US crude tonne-mile demand during 2h12.

Demand brought forward ultimately repaid

After all, excess oil inventories cannot continue forever and will achieve some sort of mean reversion. Tanker market participants have been anticipating a negative tonne-mile impact from rising US shale oil production, but have been sheltered from its effects through inventory building. That will not continue.

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