



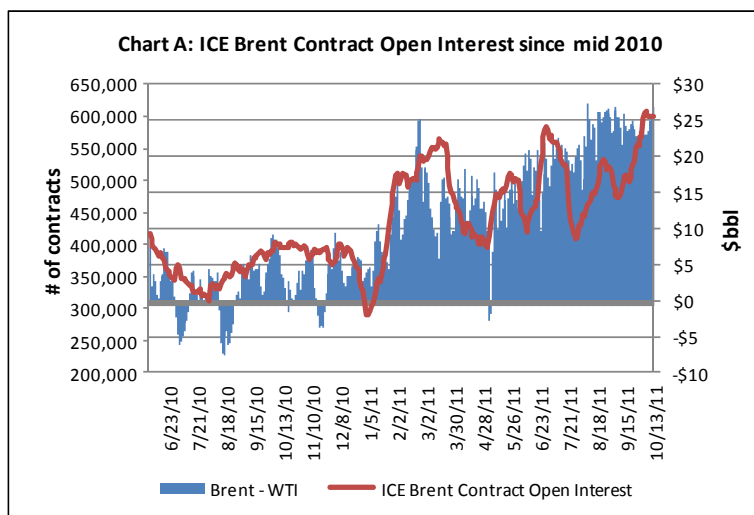
## Brent-WTI Spread Will Narrow

**The Brent-WTI spread has begun to narrow as WTI finds support from tighter PADD II fundamentals. Meanwhile, the Atlantic Basin light sweet crude balance is loosening, removing some of the fundamental support for Brent. In sum, the physical market will encourage a further narrowing of the spread even if the paper market dynamics encourage a strong Brent price.**

As we described last month, the crude oil fundamentals in the midcontinent of the United States are no longer weak enough to warrant a significant price discount, and we continue to believe that the wide spread between Brent and WTI is more a function of a Brent price premium than a WTI price discount. Indeed, much of the fuss over the landlocked nature of the midcontinent crude oil market is due to an overblown emphasis on pipeline capacity and delayed expansions, such as the now infamous Keystone XL, which is still awaiting final approval from the Obama Administration. Notwithstanding higher Canadian imports thanks to oil sands and higher PADD II oil production from the new shale basins, and the difficulty of sending crude from PADD II to PADD III via pipeline, southbound rail capacity is expanding and net receipts from PADD III to PADD II have fallen, easing the supply glut and tightening the PADD II market. Although new southbound pipeline capacity is still required to link the Cushing market to the US Gulf Coast, the far bigger story with regard to future oil prices is Brent.

### **Brent Premium Will Fall**

In contrast to the WTI discount, the Brent premium is still significant and, frankly, unsustainable. The factors that have supported Brent all year are well known. The biggest factors are the loss of Libyan exports and the decline in North Sea production of close to 500,000 b/d since early 2010. In addition, growth in Open Interest for the ICE Brent contract suggests the run up in price has coincided with greater index investment in the paper Brent market (see Chart A). Moreover, the reweighting of the major commodity indices such as the S&P GSCI and DJ UBS index towards Brent and away from WTI, by definition, will continue to encourage paper demand for Brent from index investment. These factors, among other smaller items, have kept Brent very strong, and Brent has pulled along all of the other internationally traded light sweet crudes, and even some of the internationally traded medium sour crudes. But the fundamentals are beginning to work against the Brent premium



### **Atlantic Basin Light Sweet Balance Signals Change Underway**

ESAI's Atlantic Basin light sweet crude oil balance, however, indicates that the fundamentals are changing in a manner that is likely to weaken Brent relative to WTI even before new pipeline capacity is built in the U.S. Chart B illustrates the regional balance which measures the supply of light sweet crude in Eastern Canada, the North Sea, North and West Africa and the demand for light sweet crude in PADD I, Europe and Africa. That balance typically yields a 1.0 to 1.5 million b/d surplus, most of which heads to the US Gulf Coast or Asia. In the second half of 2010, however, the balance surplus has fallen to an average closer to 1.0 million b/d, except in October when the Marseille port strike caused refiners



to cut runs significantly. Then in May 2011, the light sweet crude balance went into a deficit largely due to the loss of Libyan exports, which were replaced primarily by sour barrels from the Middle East, and some sweet crude and petroleum products from strategic reserves.

In essence, there has been a substantial physical squeeze on light sweet crude in the Atlantic Basin and the price of Brent has responded, remaining fairly high despite the economic weakness of the Euro zone and the threat of a Greek default. As the nearby chart illustrates, however, the return of Libya is already pushing the balance back into surplus. Additional supplies from Angola in West Africa will add to that surplus. Meanwhile, the immediate closure of the Philadelphia Trainer refinery and the likely closure of two Sunoco refineries also in Pennsylvania in mid-2012 will eliminate as much as 500,000 b/d of light sweet crude demand by 2013, adding to the Atlantic Basin light sweet surplus. As illustrated in Chart B below, the region's light sweet crude oil tightness is easing as the region's balance moves back into surplus, but the resulting surplus in 2012 and 2013 will still be smaller than the period prior to late 2010. That suggests the Brent premium will not disappear, but merely decline.

While ESAI does not envision the complete elimination of the Brent premium, the spread is likely to narrow as WTI finds some support from tighter PADD II fundamentals. The start up of the Keystone XL (or Wrangler) pipelines remain interesting developments because they would tie the Canadian barrels to the USGC with significant capacity, moving some of the midcontinent supply to the U.S. Gulf Coast. This would help narrow the LLS-WTI spread and pull WTI back towards Brent. More importantly, the Atlantic Basin light sweet crude balance described above is loosening, removing some of the fundamental support for Brent.

In sum, there are many factors that will change the Brent-WTI spread over the net two years, but the physical market trend will be towards narrowing the spread even if the paper market dynamics encourage a strong Brent price. ESAI expects the spread is likely to average close to \$12-\$13 in 2012 and \$6 in 2013 after averaging \$18 in 2011 and \$23.00 since the loss of Libya.

