Energy

February 14, 2011

Industry Brief

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Energy: Stat of the Week

WTI Is Dead, Long Live Brent! Oil Price Disconnect Is Here to Stay...For Awhile

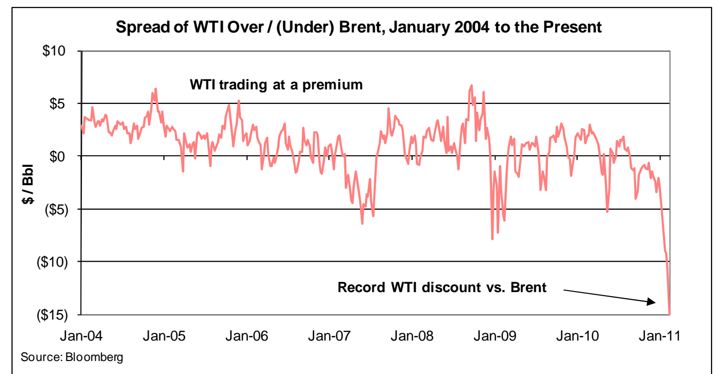
If oil prices ramped back up into the triple digits, you'd normally expect anguished press articles, CNN interviews at the gas pump, and even more demagoguery than normal about "energy independence" and "obscene oil company profits" from assorted Washington politicos. Time to wake up, America! **The world of $100+/Bbl oil has already returned, you just don't realize it yet.** What are we talking about? When you want to check the latest oil prices, your Bloomberg or Reuters screen will tell you that, as of Friday's close, it was $85.58/Bbl. While that's a factually correct answer for West Texas Intermediate (WTI) oil prices, the reality is that **most of the rest of the world is already paying over $100/Bbl!** As of Friday's close, Brent was trading at $100.60, Louisiana Light Sweet at $103.08, and Urals at $98.07. The purpose of this Stat is to review why this WTI oil price disconnect has happened and try to predict how long it will last.

Over the past half century, West Texas Intermediate (measured at the Cushing Hub in Oklahoma) has emerged as the most common price benchmark for global oil prices. Since oil is usually a relatively fungible commodity, WTI normally trades at a relatively stable spread with other types of global crude. In fact, WTI has historically traded at a slight premium to most other crudes because of its attractive intrinsic qualities – low sulfur content (how sweet it is) and high API gravity (how light it is). On occasion, however, the normal trading pattern of WTI vs. other crude grades gets disrupted. These are usually very brief periods, like the 2007 refinery fire in Sunray, Texas or the 2009 oil demand collapse in the U.S., that led to $4 to $5/Bbl WTI discounts that self-corrected within months. Recently, however, the spread between WTI and other types of crude has blown out to unprecedented levels, with Brent now trading at a huge $15.02/Bbl **premium** to WTI (as shown below).

Spread of WTI Cushing Versus Global Crude Prices

	Historical Spread* Premium/(Discount)	Current Spread (02/11/11)	Current Differential from Normal
Louisiana Light Sweet	($0.62)	($17.50)	$16.88
Brent	$1.23	($15.02)	$16.25
Bonny Light	$0.56	($17.44)	$18.00
Dubai Fateh	$3.42	($12.28)	$15.70
Urals	$3.00	($12.49)	$15.49

*1985-2010 where available
Source: Bloomberg



Unfortunately for U.S. oil producers, it appears that this disconnect is more **structural in nature** than prior disconnects. In fact, we think it is a chronic, infrastructure-caused glut at Cushing that is unlikely to get resolved anytime soon. Simply put, we think transportation bottlenecks in and around Cushing will force WTI to trade at a meaningful discount to other crudes though 2011 and into 2012. That means the oil price most of us see on our screen every day is going to be virtually irrelevant in 2011 for energy companies that are not located in the central part of North America. In other words, global and U.S. coastal oil (and oil product) prices are likely to be much higher that WTI for the next 18 months. With this in mind, today we are rolling out our **first-ever** official forecast for Brent – the new undisputed champion of global crude price benchmarks.

Why does Cushing have such a severe glut?

In a Stat from two years ago (February 17, 2009), we addressed another temporary blowout in the WTI vs. Brent price spread. At the time, we noted that the main reason for the roughly $5 WTI discount was that oil demand in the U.S. took a steeper hit than in just about any other major economy. This was not surprising, given that the U.S. was the epicenter of the global economic crisis. Recently, however, U.S. demand has rebounded faster than either Europe or Japan, while WTI/Brent spreads have completely blown out to well above $10/Bbl. That tells us the current glut at Cushing is not a function of cyclical or temporary supply/demand interruptions, but rather a longer-lasting infrastructure problem. Specifically, an increasing amount of inbound oil from emerging horizontal plays in Canada, the Bakken, and Permian Basin has outpaced the outbound pipeline capacity from Cushing, Oklahoma, as Cushing storage has substantially increased.

Please read domestic and foreign disclosure/risk information beginning on page 7 and Analyst Certification on page 7.

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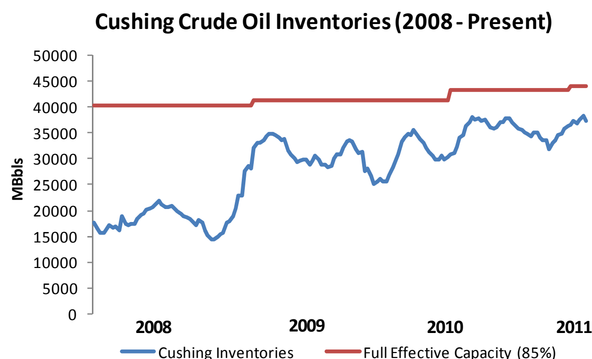
Cushing storage has a big influence over WTI pricing due to pipeline bottlenecks that can allow more oil to accumulate at the hub than can be shipped to the Gulf Coast. The chart on the right shows the huge buildup of inventories at Cushing since early 2008 – roughly a 2x increase. Earlier this month, in fact, Cushing inventories reached the highest level on record. We assume that full **effective** *(effective = 85% of max)* capacity is 44 MMBbls, since Cushing tanks can safely store between 80% and 90% of total capacity. Since there seems to be room to store more oil at Cushing, we think the primary culprit behind the divergence in WTI and Brent prices is a function of the limited outbound (takeaway) pipeline capacity to move *out* the increasing amount of horizontal drilling related oil flooding *into* Cushing.



Source: DOE

There are storage expansions in the works that should provide some modest incremental relief, but on the flip side, there is a brand-new source of incoming crude – a classic example of "one step forward, two steps back." Last week's completion of TransCanada's Keystone Cushing extension (from Steele City, Nebraska to Cushing shown on the map below) stands to compound the bottleneck problem at Cushing in 2011. This extension added about 155,000 bpd of additional inbound capacity to Cushing with **no incremental outbound capacity.** Additionally, operators in the Bakken and other developing horizontal shales are now trucking and rail shipping even more crude into Cushing. In other words, the bottlenecks at Cushing appear likely to get even **worse** in the coming months.

Will storage expansion help in 2011?
As detailed in the table on the right, several storage operators at Cushing have released plans to expand capacity in 2011 from 52 million barrels to over 66 million barrels. Plains All American, Enbridge, and Magellan Midstream Partners have all announced substantial additional capacity additions for this year. In total, we would expect Cushing capacity to increase 28% (or about 15 MMBbls) over the course of 2011. Since current Cushing inventories of 37.4 million barrels are well below current effective capacity of 44 MMBbls, it is safe to say this is not an inventory problem. At least not yet. Instead, the market seems to be looking ahead to the pipeline takeaway bottleneck that is likely to become an acute problem this year. For example, if oil supply into Cushing (from the Permian and Bakken) is growing at 200,000 bpd to 400,000 bpd in 2011 and outbound pipeline capacity does not grow at all, then Cushing inventory capacity would need to grow by 100 MMBbls (not 10 MMBbls). In other words, it looks like surging oil supply growth will fill the new storage capacity within months unless operators figure out a way to get the oil out of Cushing.

Crude Oil Storage Capacity at Cushing, OK

Operator	2010 Capacity	2011E Capacity
Enbridge Energy Partners	14.80	16.80
Plains All American Pipeline	14.20	18.50
Magellan Midstream Partners	7.80	12.05
BlueKnight Energy Partners	6.71	6.71
The Gavilon Group, LLC	0.00	4.00
SemGroup Corp	4.20	4.20
Enterprise Products Partners	3.10	3.10
ConocoPhillips	0.80	0.80
Sunoco Logistics Partners	0.30	0.30
Total	**51.91**	**66.46**

In millions of barrels (MMBbls)
Source: Thomson Reuters, company filings

Is there a short-term solution? Look for rail and trucks to bridge the gap.
Ahead of the long-term pipeline solutions (discussed below), the possible interim measures to alleviate the Cushing glut is for oil producers to bypass it by shipping crude **(1) via rail directly to Gulf Coast refining centers, which typically costs $4 to $6/Bbl**; or (2) **by truck down to the Gulf Coast ($8 to $10/Bbl)**. Since the spot price of Louisiana Light Sweet (LLS) crude is currently $17/Bbl above WTI, it actually makes financial sense to use these alternative methods. Producers can pay the additional transportation charge and still capture incremental margin. After digging through this topic with our railroad analyst (with some quick calls over to Union Pacific), it appears that rail capacity directly to the end users may be somewhat limited through much of 2011, particularly in terms of terminals (beginning or end of the line). While truck capacity can be limited during winter storms, it represents the clearest short-term solution to the lucrative "arb" provided by the Cushing glut.

The long-term solution: adding new outbound pipeline projects at Cushing.
The ultimate, lowest-cost solution to the current WTI imbalance is to build more oil pipeline takeaway capacity to the Gulf Coast. While there are a couple of projects in the works, it appears that it may be awhile before the pipeline bottleneck is alleviated. For example, the adjacent map shows that TransCanada has recently completed the Keystone pipeline extension to Cushing (yellow line) but has yet to receive approval to build the Keystone XL pipeline that will run to the USGC (dotted line). A more detailed discussion of the Cushing pipeline options is included below.

Source: TransCanada Corp.

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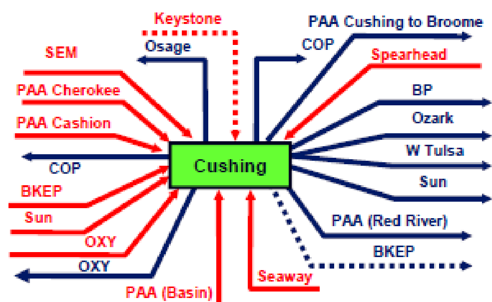
TransCanada's Keystone XL Project. TransCanada has proposed the Keystone XL Pipeline from Canada, through the Bakken, through Cushing, to the Gulf Coast (North America's #1 refining center) as shown by the dotted line on the previous page. If built, this pipeline would bring roughly 500,000 bpd of oil from Canada and the central U.S. to the Gulf Coast. Unfortunately for U.S. oil producers, the outlook for Keystone XL is somewhat uncertain right now. The issue is that Keystone XL requires approval from the State Department, since the northern portion of the pipeline will cross the Canadian border. President Obama and the State Department have stated that project approval is not a guarantee at this point due to environmental concerns and resistance from the EPA. Obviously, if Keystone XL is not built, then there is no Cushing-to-USGC link. **Even if Keystone XL is built, it is possible that the estimated completion date in early 2013 will be pushed out**.

Enbridge's Monarch Pipeline. Enbridge has also responded to the takeaway capacity constraints at Cushing by proposing a 150,000 bpd pipeline (expandable to 350,000 bpd) that would ship crude south from Cushing to the Gulf Coast. **The Monarch pipeline could be operational by late 2012**. Enbridge hopes to have enough shipper support by July 2011 to begin securing regulatory approvals for Monarch.

While these proposed projects will boost outbound capacity, their anticipated completion dates are more than 18 months away. While the use of rail terminals and trucks to bypass Cushing and deliver barrels directly to premium Gulf Coast markets may provide some temporary relief, the infrastructure constraints at Cushing are here to stay for the foreseeable future. To get a better feel for the pipelines in and out of Cushing and a list of the larger players, we have included the graph and table below.



Source: Plains All American Pipeline

Midstream Operators at Cushing, OK		
Inbound Pipelines	**Storage/Terminals**	**Outbound Pipelines**
Blueknight Energy Partners (BKEP)	Blueknight Energy Partners (BKEP)	BP p.l.c. (BP)
BP p.l.c. (BP)	ConocoPhillips (COP)	ConocoPhillips (COP)
Enbridge Energy Partners (EEP)	Enbridge Energy Partners (EEP)	Enbridge Energy Partners (EEP)
Enterprise Products Partners (EPD)	Enterprise Products Partners (EPD)	Magellan Midstream Partners (MMP)
Plains All American Pipeline (PAA)	Magellan Midstream Partners (MMP)	Osage Pipeline Company
Seaway Crude Pipeline Company	Plains All American Pipeline (PAA)	Ozark Pipeline
SemGroup Corporation	SemGroup Corporation	Plains All American Pipeline (PAA)
Sunoco Logistics Partners (SXL)	Sunoco Logistics Partners (SXL)	Sunoco Logistics Partners (SXL)

Source: BlueKnight Energy Partners

Could something else be driving Brent higher?

While we think the Cushing issues described above explain the vast majority of the current disconnect between WTI and Brent, there appears to be another structural market dynamic at work as well – on the other side of the Atlantic. In the first half of the past decade, WTI consistently traded at about a $2 premium over Brent ($2.10/Bbl during 2002-2005). By comparison, the average from 2006 to the present has been essentially parity, a premium of only $0.14/Bbl. Given that WTI has been trading close to Brent (or even at a discount) above and beyond the Sunray refinery fire in 2007, the cyclical demand fall-off in 2009 and the current Cushing glut, this suggests that part of the explanation relates to the North Sea.

Remember: Brent is not as light and not as sweet as WTI, so intrinsically it should always be cheaper than WTI. So why has it been trading above WTI so much more frequently? Here's one theory that provides a plausible explanation. North Sea oil production has been steadily declining in recent years, particularly in the U.K. sector, where the Brent benchmark is based. The U.K. sector's oil output fell 9-10% in 2004, 2005 and 2006 – despite progressively higher oil prices in each of those years. After flatlining in 2007, it quickly resumed declines – down 6% for each of the past three years (and we project 4-5% declines in both 2011-2012). Because the U.K. is part of the Northwest European refining hub, it may be that there is now a shortage of locally produced crude in the region. It was only in 2004 that the U.K. became a net oil importer, and it has steadily become more imports-dependent since then. Because of this, it seems reasonable that local oil (i.e., Brent) might merit a transportation-related premium.

Until the situation at Cushing normalizes, keep your eyes peeled to other benchmarks, especially Brent.

RJ&A Oil Price Estimates (as of February 2011)						
	2009	**Q1 09A**	**Q2 09A**	**Q3 09A**	**Q4 09A**	**2009A**
WTI		**$37.20**	**$52.40**	**$68.05**	**$75.80**	**$58.36**
Brent		**$44.63**	**$50.82**	**$69.06**	**$72.45**	**$59.24**
	2010	**Q1 10A**	**Q2 10A**	**Q3 10A**	**Q4 10A**	**2010A**
WTI		**$76.65**	**$77.55**	**$76.25**	**$78.95**	**$77.35**
Brent		**$74.81**	**$81.12**	**$75.75**	**$83.38**	**$78.77**
	2011	**Q1 11E**	**Q2 11E**	**Q3 11E**	**Q4 11E**	**2011E**
WTI	Bloomberg	$87.00	$88.00	$90.00	$94.65	$89.91
NYMEX	Futures	$88.20	$92.75	$96.76	$98.18	$93.97
WTI	**Current RJ Oil**	**$85.00**	**$90.00**	**$90.00**	**$95.00**	**$90.00**
Brent	**Current RJ Oil**	**$95.00**	**$98.00**	**$96.00**	**$101.00**	**$97.50**
	2012	**Q1 12E**	**Q2 12E**	**Q3 12E**	**Q4 12E**	**2012E**
WTI	Bloomberg					$98.00
NYMEX	Futures	$99.04	$99.38	$99.48	$99.63	$99.38
WTI	**Current RJ Oil**	**$95.00**	**$100.00**	**$100.00**	**$105.00**	**$100.00**
Brent	**Current RJ Oil**	**$100.00**	**$105.00**	**$104.00**	**$109.00**	**$104.50**

Source: Bloomberg, Thomson Reuters, RJ est.

Historically, our oil price forecasts comprised only WTI, since it (1) was the main benchmark for U.S. producers; and (2) had a close correlation to international benchmarks, not just Brent in Europe but also Tapis (Southeast Asia), Urals (Russia), etc. In the future, we will also forecast Brent, which – at least for now – provides a much better proxy than WTI for the true "global" oil price. In addition to the North Sea, crudes from Africa and the Mid-East, and sometimes even further afield, tend to be tied to Brent.

To be clear, WTI's recent record-setting discount vs. Brent ($15/Bbl) strikes us as unsustainable. For one thing, there is an element of speculative trading (Egypt?) that seems to have led to an abrupt widening in recent weeks. Thus, the discount will probably diminish over the next few months. That said, we do not expect Cushing bottlenecks to be resolved in the next 18 months.

So, what is the right discount for WTI?

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A decade ago, the Rocky mountain gas prices experienced what seemed to be a perpetual pipeline bottleneck driven price discount. During that period, Rocky Mountain gas prices often traded at a 30% to 50% discount to more active gas hubs. Even though the pipeline bottleneck problem in Cushing is similar, there are more, non-pipeline options to move the oil out of the Central U.S. Since operators can truck an unlimited amount of oil from Cushing to the Gulf coast for $8 to $10/bbl and/or rail a limited (for the time being) amount of oil for roughly half that cost ($4 to $6/bbl), we think the WTI discount will settle out in the $5 to $8/bbl range over the next year. More specifically (as shown in the previous table on page 3), we are forecasting a $7.50 average discount this year falling to a $4.50 average discount next year. In the very long run (3+ years), a return to a WTI premium is likely once the bottlenecks are alleviated. Unfortunately, the timing of these projects is uncertain at best. For now, we are assuming that pipelines are brought on-line and the bottleneck eliminated by 2013. (As a technical point: our quarterly averages for Brent are based on the same "bid week" approach that we have always used for WTI, i.e., the average of the three futures contract roll-off prices.)

Who wins from WTI's current disconnect?

From the standpoint of oil producers, the simple answer is: "anyone outside of the U.S." Unfortunately, the reality is never that simple as many oil-producing countries set oil pricing formulas that are linked to the WTI benchmark; this is certainly the case throughout much of Latin America. Setting that fact aside, on a relative basis, the discount of WTI vs. other global crude markers certainly favors the more internationally focused integrated majors and large-cap E&P companies. The companies with the greatest amount of international (ex-Canada) oil exposure as a percentage of estimated 2011 companywide production include: Hess Corp. (52%), Chevron Corp. (51%) and BP plc (49%) among the majors; and Occidental Petroleum (34%), Apache Corp. (28%) and Anadarko Petroleum (15%) among the large-cap E&Ps. Within the small-cap E&P space, few companies venture outside North America, but Peruvian operator BPZ Resources stands out. Among Canadian companies, Bankers Petroleum is 100% oil-linked to Brent prices, while Nexen and Vermilion Energy are both roughly 60% Brent-linked.

Whereas U.S. oil producers can lose out on the premium pricing of overseas crudes, U.S. refiners gain a competitive advantage relative to their international counterparts, obviously stemming from the fact that crude is their main input cost. That said, you can't simply paint every domestic refiner with the same brush – particularly given the fact that less than half of U.S. refining capacity actually runs WTI benchmarked (or "WTI-like") crudes. Mid-Continent refiners (Frontier Oil and Holly Corp.) are the best positioned to benefit from the WTI disconnect, given their proximity to Cushing and sourcing of local crudes.

Conclusion

We have all been accustomed to using WTI as the proxy for global oil prices. However, we now think the current supply glut at Cushing is a structural issue that is unlikely to be fully resolved anytime soon. That means WTI will become much less relevant than it has been historically. This is true for U.S. oil producers that don't transport their oil to Cushing, and even more so for companies with international operations. It appears that the long-term solution to the glut – more outbound pipeline capacity at Cushing – will take at least 18 months to materialize. With this in mind, we have initiated our first-ever forecast for Brent, which we believe will be the principal benchmark for global oil prices for the foreseeable future. We are projecting a full-year 2011 Brent average of $97.50/Bbl (vs. $90.00/Bbl for WTI), followed by $104.50/Bbl in 2012 (vs. $100.00/Bbl for WTI). While the current record-setting WTI discount vs. Brent should narrow over time, we doubt that WTI will revert back to its traditional premium until 2013 at the earliest.

Company Citations

Company Name	Ticker	Exchange	Currency	Closing Price	RJ Rating	RJ Entity
Anadarko Petroleum Corp.	APC	NYSE	$	78.49	3	RJ & Associates
Apache Corporation	APA	NYSE	$	119.73	2	RJ & Associates
Bankers Petroleum	BNK	TSX	C$	8.68	1	RJ LTD.
BP plc	BP	NYSE	$	45.80	2	RJ & Associates
BPZ Resources Inc.	BPZ	NYSE	$	5.93	1	RJ & Associates
Chevron Corp.	CVX	NYSE	$	96.45	2	RJ & Associates
ConocoPhillips	COP	NYSE	$	71.58	4	RJ & Associates
Enterprise Products Partners L.P.	EPD	NYSE	$	42.66	1	RJ & Associates
Frontier Oil Corp.	FTO	NYSE	$	24.63	2	RJ & Associates
Hess Corp.	HES	NYSE	$	80.60	1	RJ & Associates
Holly Corp.	HOC	NYSE	$	56.80	3	RJ & Associates
Magellan Midstream Partners L.P.	MMP	NYSE	$	57.03	2	RJ & Associates
Nexen Inc.	NXY	TSX	C$	22.22	2	RJ LTD.
Occidental Petroleum Corp.	OXY	NYSE	$	99.74	2	RJ & Associates
Plains All American Pipeline L.P.	PAA	NYSE	$	63.46	2	RJ & Associates
Vermilion Energy Inc.	VET	TSX	C$	46.24	2	RJ LTD.

Notes: Prices are as of the most recent close on the indicated exchange and may not be in US$. See Disclosure section for rating definitions. Stocks that do not trade on a U.S. national exchange may not be approved for sale in all U.S. states. NC=not covered.

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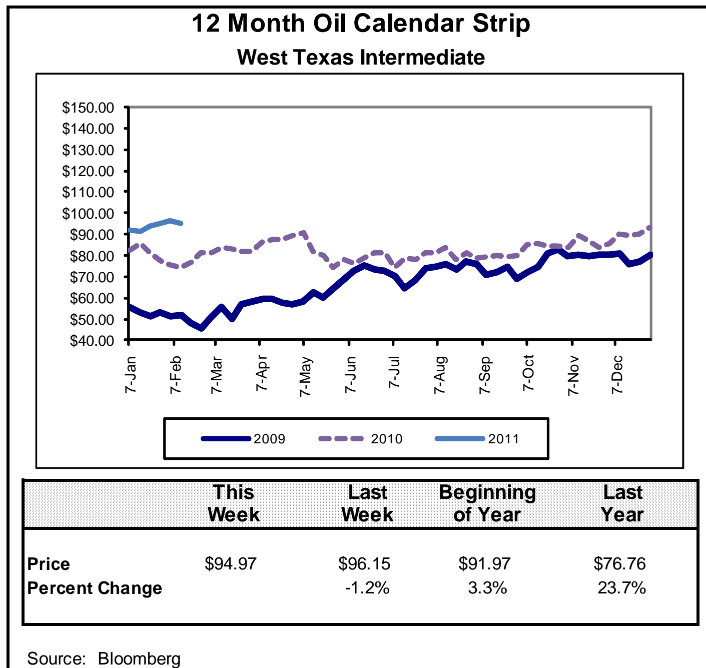
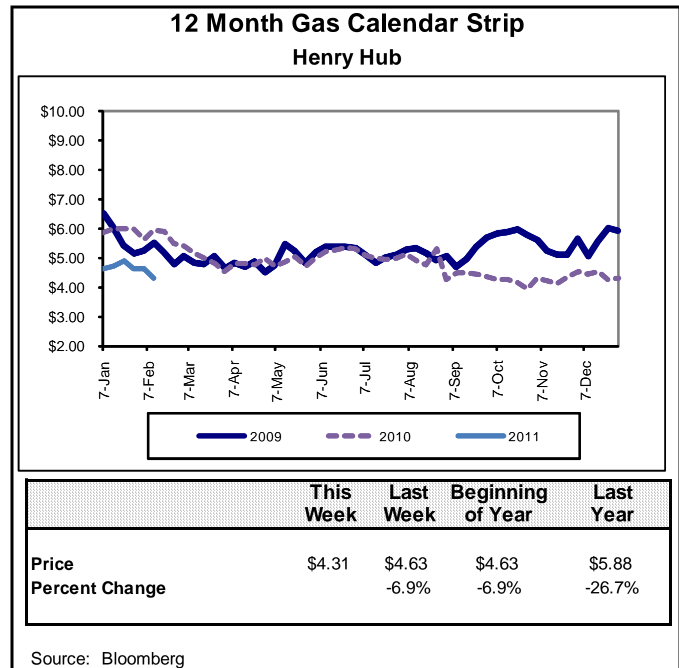
Raymond James Weekly Oilfield Review

For Week Ending: 2/11/2011



	This Week	Last Week	Beginning of Year	Last Year
Price	$94.97	$96.15	$91.97	$76.76
Percent Change		-1.2%	3.3%	23.7%

Source: Bloomberg



	This Week	Last Week	Beginning of Year	Last Year
Price	$4.31	$4.63	$4.63	$5.88
Percent Change		-6.9%	-6.9%	-26.7%

Source: Bloomberg

	11-Feb-11 This Week	5-Feb-11 Last Week	12-Feb-10 Last Year	Change From: Last Week	Change From: Last Year
1. U.S.Rig Activity					
U.S. Oil	805	818	443	-1.6%	81.7%
U.S. Gas	906	911	891	-0.5%	1.7%
U.S. Miscellaneous	10	10	12		
U.S. Total	**1,721**	**1,739**	**1,346**	**-1.0%**	**27.9%**
U.S. Horizontal	980	981	663	-0.1%	47.8%
U.S. Directional	225	229	232	-1.7%	-3.0%
U.S. Offshore	26	27	45	-3.7%	-42.2%
U.S. Offshore Gulf of Mexico					
Fleet Size	129	131	118	-1.5%	9.3%
# Contracted	60	62	73	-3.2%	-17.8%
Utilization	46.5%	47.3%	61.9%	-1.7%	-24.9%
U.S. Weekly Rig Permits *	1,114	1,418	1,298	-21.4%	-14.2%
3. Stock Prices (2/11/11)					
OSX	269.7	267.9	195.9	0.7%	37.7%
S&P 500	1,329.2	1,310.9	1,075.5	1.4%	23.6%
DJIA	12,273.3	12,092.2	10,099.1	1.5%	21.5%
S&P 1500 E&P Index	636.8	641.2	519.6	-0.7%	22.6%
Alerian MLP Index	369.8	371.9	283.3	-0.6%	30.5%
4. Inventories					
U.S. Gas Storage (Bcf)	2,144	2,353	2,215	-8.9%	-3.2%
Canadian Gas Storage (Bcf)	330	381	348	-13.4%	-5.3%
Total Petroleum Inventories ('000 bbls)	914,906	908,442	881,224	0.7%	3.8%
5. Spot Prices (US$)					
Oil (W.T.I. Cushing)	$85.58	$89.03	$74.13	-3.9%	15.4%
Oil (Hardisty Med.)	$61.85	$65.13	$67.52	-5.0%	-8.4%
Gas (Henry Hub)	$3.96	$4.48	$5.48	-11.6%	-27.8%
Residual Fuel Oil (New York)	$14.06	$13.70	$10.84	2.6%	29.7%
Gas (AECO)	$3.41	$3.86	$5.09	-11.7%	-33.0%
UK Gas (ICE)	$8.91	$9.16	$5.68	-2.7%	56.8%

Sources: Baker Hughes, ODS-Petrodata, API, EIA, Oil Week, Bloomberg
** Note: Weekly rig permits reflect a 1 week lag*

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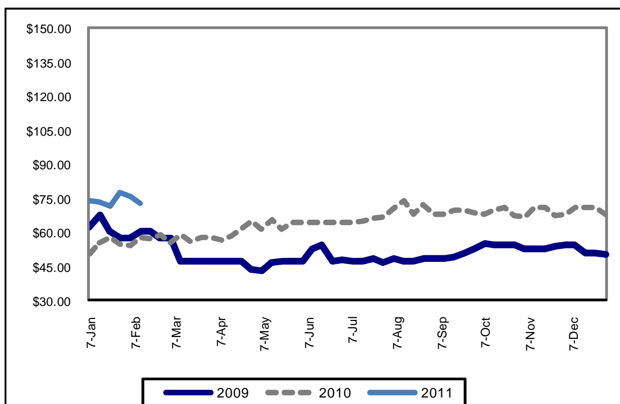
Raymond James Weekly Coal Review

For Week Ending: 2/11/2011

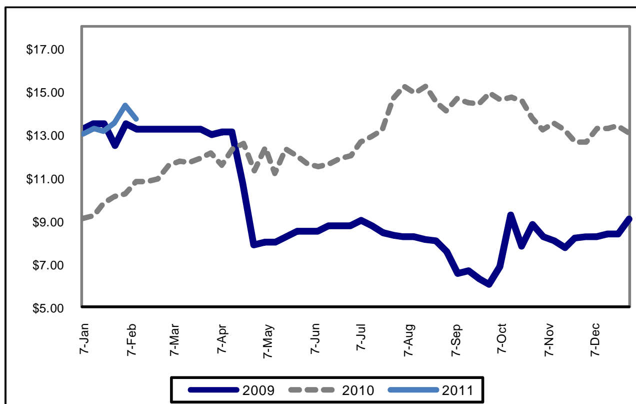
12 Month Big Sandy Barge Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	$72.75	$75.50	$74.10	$57.95
Percent Change		-3.6%	-1.8%	25.5%

Source: Bloomberg

12 Month Powder River Basin 8800 Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	$13.75	$14.35	$13.00	$10.85
Percent Change		-4.2%	5.8%	26.7%

Source: Bloomberg

	11-Feb-11 This Week	4-Feb-11 Last Week	12-Feb-10 Last Year	Change From: Last Week	Change From: Last Year
1. Coal Prices					
Eastern U.S.					
CSX 1%	$72.75	$75.50	$57.95	-3.6%	25.5%
Western U.S.					
Powder River 8800	$13.75	$14.35	$10.85	-4.2%	26.7%
2. Production	**4-Feb-11**	**28-Jan-11**	**5-Feb-10**		
Eastern U.S.	9,089	9,176	8,714	-0.9%	4.3%
Western U.S.	11,366	12,295	11,955	-7.6%	-4.9%
Total	20,455	21,471	20,669	-4.7%	-1.0%

Source: Bloomberg

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