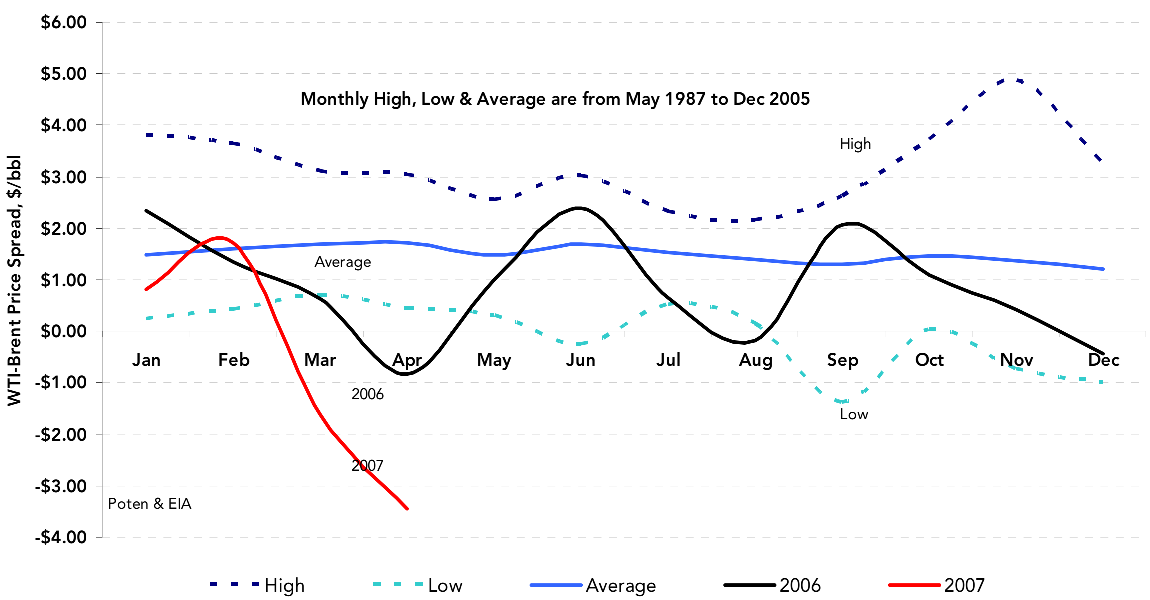
POTEN & PARTNERS

No Longer Crudely Related

April 20, 2007

Recent events – some transient and some not – appear to have compromised any sense of a "typical" price relationship between West Texas Intermediate (WTI) and Brent crude oils. These crude oils have similar sulfur contents, but as WTI is lighter, the market perceives it as more valuable. As both these crude oils have futures market, their price relationship is closely followed.

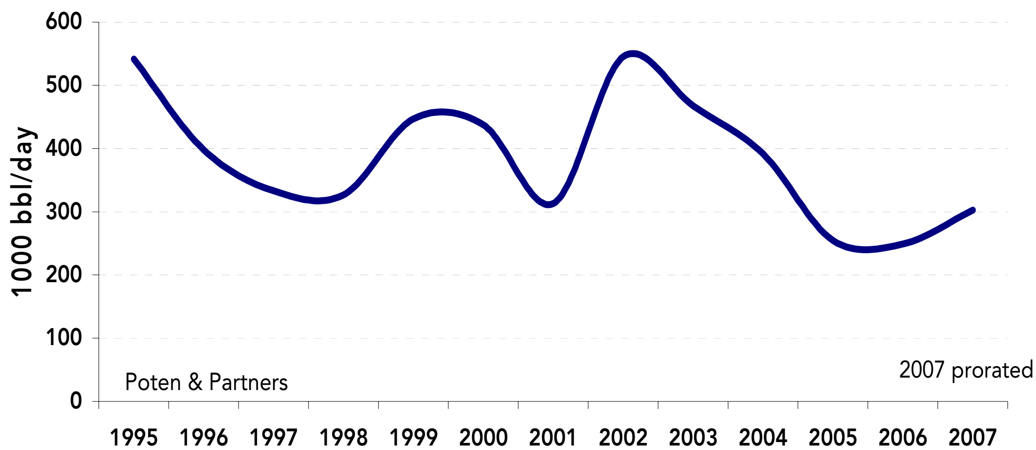
From early 1987 through 2005, WTI's price premium over Brent meandered around the value of about one and a half dollars per barrel. The chart below, however, illustrates that swings in a price relationship can be masked by averaging prices.



On the plot of highs, WTI's premium reached a monthly peak of almost $5 per barrel over Brent in November 2004. Market repercussions of Kuwait's invasion in August 1990 led to Brent's temporary rise over WTI and produced a premium low one month later. Although the band of highest monthly highs and lowest monthly lows is quite broad, the majority of the lows were still positive indicating that the price of WTI held mostly above Brent's.

UKC Crude Oil Imports Into the US Gulf Coast

Translating reported spot market fixture data into US Gulf Coast crude oil import volumes from the UK Continent indicates a generally declining trend over the past few years.



This trend is consistent with an overall decline in North Sea exports. What is surprising is that crude oil movements did not drop in 2007 as the cost of Brent became relatively pricey in the US market.

A Harbinger

Although WTI's premium stayed mostly positive in 2006, it only occasionally exceeded the premium's composite monthly average of the preceding 18 years. The start of 2007 saw WTI's premium return to near its historic monthly average – but for only a short time. Recently, the availability of too much crude oil at Cushing, OK (the WTI pricing location for the NYMEX) has prompted an unprecedented depression of WTI's value. The confluence of recent refinery outages – either planned or unexpected – and the continuing influx of Canadian crude oils into Cushing is attributed to WTI's sharply negative premium since this past March. While the transient refinery outages are already beginning to abate, the supply of Canadian crude oil is poised to increase with the Spearhead pipeline's expansion.

Nothing Is Perfect

Managing price risk using crude oil futures isn't a perfect game. With experience and history, market players have learned to accept all the warts, pimples and idiosyncrasies attached to futures. Unexpected supply or demand outages have been weathered by the futures market of both these crude oils. But when the intrinsic value of the futures' underlying crude oil is structurally eroded by introducing the long-term competition of new alternate crude oils, will players adapt or will they demand a change in the underlying crude oil? The answer to this question depends on how quickly a positive WTI-Brent price spread returns and how sensitive it is to Cushing's growing influx of Canadian crude oils. If change does eventually come to the WTI futures market, perhaps a wide market, waterborne crude oil rather than a constricted market, pipeline constrained one will represent the underlying contract.