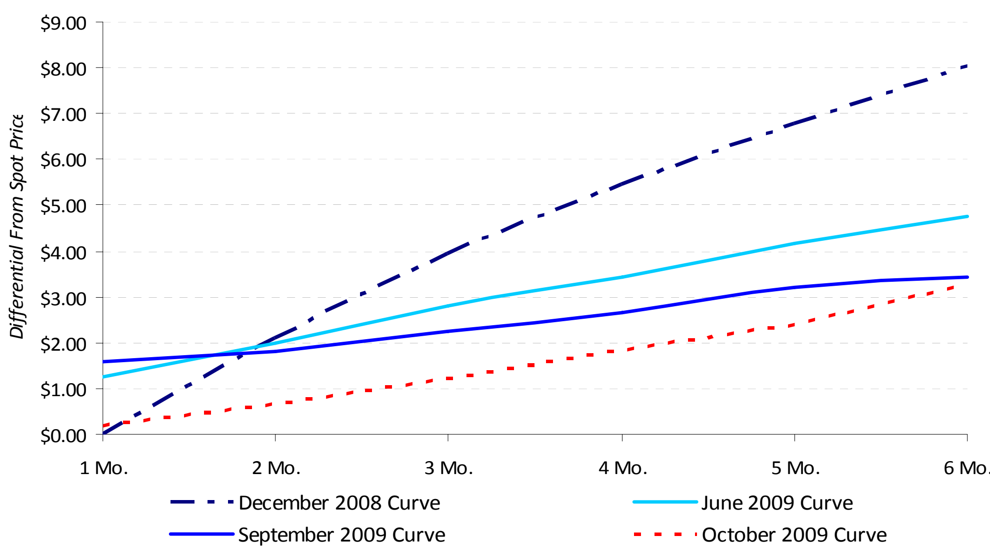
A Farewell Contango?

The storage of crude oil and petroleum products at sea has been an important factor in the tanker market throughout 2009. It can be argued that the use of tankers as floating storage by refiners, oil majors, and traders has helped support freight rates by providing term employment for ships in a challenging rate environment. The contango structure in crude oil markets which inspired the uptick in storage fixtures has narrowed since the first quarter of this year and there are indications that the dynamics of floating storage are in flux. Some players who have been storing crude oil on tankers appear to have changed their strategy, as the amount of oil in floating storage has fallen in recent weeks. It is unclear whether these market players continue to dance with the contango or are merely finding another home for excess barrels.

Contango refers to a price structure where prices on the spot market offer a discount over futures contracts, leaving profit to be reaped by buying and storing a product, in this case oil. At times of weak freight rates and low oil prices, storing oil on tankers becomes a popular option after onshore storage has been filled, especially if its futures price promises a bonanza. As shown in the chart below, the slope of the curve shows profit potential. The economics supporting crude oil storage on tankers, however, have weakened in recent months as the difference between contracts to buy West Texas Intermediate for prompt and forward delivery has narrowed.

Crude Oil (WTI) Spot vs. Future Prices



Source: *Barchart/NYMEX*

Tanker storage fixtures are typically short-term time charters ranging from 30 to 90 days, often with the option to be extended longer. Additionally, vessels continue to be fixed on the spot market with storage options attached. Charterers park the brimming ships off the shores of trading hubs such as Rotterdam and Singapore. In some markets, tankers have been reportedly used to blend fuel oil into bunkers, as available onshore storage has become scarce.

The understandable penchant for secrecy among those involved in the storage play make the particulars of this trade very difficult to follow, and outside estimates vary widely on the current level of floating storage. Based on reported activity, the number of tankers chartered for dirty storage fell from a high of roughly 35 vessels in May to current levels of just over 20 vessels.

Unwinding Contango

A number of factors conspired to make storage beneficial for both charterers and owners this year. In December of 2008, with oil prices low in the aftermath of economic collapse, storage fixtures started to have a noticeable impact on the market. A flurry of such fixtures in last December and January took ships out of major markets and helped create some additional support for freight rates. Storage fixtures were welcomed by owners as opportunities to keep vessels employed and maintain their oil company approvals, which typically lapse after about six months without carrying oil. While contango has remained in the picture since the March's high, the narrowing spread has left little room for error for traders looking to churn out profit.

There have been a number of signals that traders are reacting to in starting to take the oil stored on tankers ashore. One of the most immediate indicators likely influencing crude storage decisions is on-shore stocking levels having started to ease back from highs reached earlier in the year. Organization for Economic Cooperation and Development (OECD) stocks of on-shore commercial crude oil have fallen by 30 million barrels since March. Storage levels at the Cushing, Oklahoma NYMEX delivery site fell by more than 20 percent between July and September this year. Whether these draw-downs reflect actual changes in demand or just the perception of changes is not yet clear, but they have been seen as influencing traders.

Many market players invest in oil futures in tandem with currency investment strategies and the declining value of the US dollar is thought to have also been a major force helping narrow the crude oil contango. Production cuts from the Organization for Petroleum Exporting Countries (OPEC) have also played a role, limiting supply and driving up prices for certain crude oils on the spot market.

If contango is in fact winding down, the reasons behind this change could spell mixed news for the tanker market. A reduction in crude oil in floating storage in the immediate future threatens to reduce import needs of long-haul crude oil by disgorging volumes of nearby oil to waiting refiners while simultaneously reintroducing ships to the market, undoubtedly depressing rates. If the narrowing contango is an indication of a recovery in short-run demand, however, it can be viewed as a positive for the international economy upon which the entire trade relies.

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