

*Oil prices have remained in the doldrums so far this year, but the market took a surprising turn as it slipped into a contango at the end of 2008 that has so far remained in place. Pauline McCallion examines its causes and speaks to analysts about their revised outlook for 2009 oil prices*

# THE LAST CONTANGO

As recently as November, most oil analysts were forecasting an average 2009 oil price of over \$100 a barrel. Just four months later and these forecasts have all dropped by roughly 40–60%, with the overall average falling by 52% from \$107.80/bbl to \$51.83/bbl.

On March 31 the price of the front month light, sweet crude contract on Nymex – commonly referred to as WTI – was at \$49/bbl, up 50% from

this year's low of \$33.98/bbl, but 65% down from July's all-time high of \$147.27/bbl.

Subdued demand and ample supply is set to keep oil prices depressed for the foreseeable future and the market is pricing in a weak global economy for much of 2009. Supply cuts by the Organisation of Petroleum Exporting Countries (Opec) could help shore up the supply glut, but opinion is mixed on whether they will be sufficient to

help pull the market out of its current contango structure. This structure is incentivising storage and perpetuating the current weak market.

Michael Wittner, global head of oil research at Société Générale, describes the market as locked in “a classic battle between a weak economy with collapsing demand and Opec cutting supply”.

In December, Opec agreed to cut supply by 4.2 million barrels a day (b/d) from September 2008 production levels, beginning in January 2009. These cuts will need to feed through to the glut of oil currently in storage before outright prices and the forward curve are affected. Inventory levels at Cushing, the delivery point for Nymex crude, while still relatively high, have eased slightly, according to the latest figures from the US Energy Information Administration. But

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Addison Armstrong, Tradition Energy



they still stand at 33.9 million barrels, compared with 17.5 million a year ago.

“I think Opec has succeeded in putting a floor under crude prices,” says Wittner. “But the question is: when will these Opec cuts more than offset the weak demand and provide the market with some stock draw? That’s not happened yet, but we think that’s going to happen in the third quarter, which is why we were bullish on prices for the second half of this year. However, the second quarter looks like more of the same and we expect the price to be pretty steady around \$45/bbl.”

Although Opec decided not to implement further production cuts at its meeting in March, a statement released afterwards noted initial signs of a reversal in crude oil-stock trends, and a narrowing of the contango. It added that Opec member compliance with the 4.2 million b/d cut was running at 79%.

Opec discipline will be pivotal to prices going forward. “In the medium term, the extent to which Opec members maintain their quota discipline will be important,” says Addison Armstrong, director of market research at Tradition Energy. “If you’ve got a combination of good Opec discipline and the prospect for a mild turnaround, within a year you could see the back-end of the curve start to move, which would affect the contango.”

Lou Pellathy, vice-president, brokerage at Parity Energy, agrees that the discipline of Opec members will make a difference to future prices. He highlights the dangers of oversupply as producers attempt to keep up with their revenues since the price of oil fell from \$147/bbl in 2008.

On the other side of the equation is demand, determined by the global economy. “What will make us or anyone else right or wrong, is the economic situation,” Wittner adds. “We’re assuming a v-shaped recovery in the second half of this year – not that we’re expecting a return to previous levels of growth, but as the second half of 2009 progresses we will start to see some signs of improvement.”

WTI has been subject to several hits since the beginning of the year



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*Ehud Ronn, Center for Energy Finance, University of Texas*

as negative economic figures have fed through to the market. For example, WTI for April delivery fell \$1.77 to \$43.61 per barrel on March 5 after a slump in US stock markets and disappointing news from China on a stimulus package.

On the demand front, the picture continues to be bleak, with the International Energy Agency revising down its 2009 demand forecast for global oil in March to 84.4 million b/d from 85.6 million b/d – a drop of 1.5%.

### Managing expectations

But it remains to be seen how much of the negative news that is still to come on the economic front has already been priced into market expectations. Nicholas Brooks, head of research and investment strategy at ETF Securities, says: “I suspect that on a 12-month view, there is more upside surprise potential than downside surprise potential – just because I think so much bad news is being priced in right now.

“I think demand will be very weak and continually bad over the next six to 12 months, but it’s just a question of how much of that is already priced in; I suspect a large part of that is now priced in,” he says.

On the other hand, others believe the market may have further to fall on future economic news. Armstrong says: “The general feeling in the market is that if the Chinese economy is shown to have entered into recession in the first quarter when the official figures come out [on 18 April 2009], then the price of oil will once again test the \$32 level,” he says.

Pellathy adds that such market fundamentals have even more of

an impact now that there are fewer financial players in the market after the financial crisis. “The market is returning to basics: people are paying attention to the inventory levels; people are paying attention to who is shipping what from different parts of the world.

Fundamentals are back in vogue and money flow is not as important to where the market is going.”

Looking to the medium term, he says: “The factors I would point to are: the collapse of a lot of financial players; true oversupply for the producers to keep up with their revenues; and dropping demand across the board. It’s going to take at least six to eight months to flush the effects of these events out.”

The strength of the contango structure in WTI took many market participants by surprise. The market had been backwardated right the way along the curve since mid-2007. But by February, the front-month WTI spread was in contango by \$6/bbl. Much of this was due to the supply glut at Cushing.

Generally, the oil market is in backwardation 65–75% of the time. It makes sense that this is the market’s natural state, according to Ehud Ronn, professor of finance and director of the Center for Energy Finance, McCombs School of Business at the University of Texas at Austin. He argues that backwardation encourages producers to produce now rather than later. “A backwardated curve, with spot prices being larger than prices down the road, provides an incentive. The curve is saying to producers: if you produce now, I promise you a higher price. If you produce in the future, you may get a higher price but I’m not promising it.”



**Morgan Downey, head of commodities, Americas at Standard Chartered Bank**



**Lou Pellathy, vice-president, brokerage at Parity Energy**

Alternatively, a contango curve provides a powerful incentive to store oil for future sale, since prices – according to the futures curve – are expected to be higher. “It produces an arbitrage profit,” Ronn continues. “You buy now, store, sell forward, and profit from the spread. As a result, storage is likely to build up during these time periods because people have this incentive to store.”



**Michael Wittner,**  
Société Générale

### Reading the signs

Moving out of contango back into backwardation will be an important signal that prices are heading up again, but this won't happen until stocks tighten. Soc Gen's Wittner believes a return to backwardation could occur in the fourth quarter of 2009. Morgan Downey, head of commodities, Americas at Standard Chartered Bank, sees a strong chance that the curve could flatten out, if not return to backwardation, by the end of this year.

Others disagree. “Backwardation is not on the cards this year,” says Tradition Energy's Armstrong. “But I would imagine that while the contango may not get back up to \$6, it is going to be maintained somewhat. The front-end of the curve is going to be impacted by what's going on with demand and there certainly doesn't seem to be any likely turnaround for that.”

While popular explanations for the steep WTI front-month contango, such as speculators or the United States Oil fund (USO – see box) do cause some noise, according to Downey, the basics of supply and demand will go a lot further in providing an explanation.

“In my mind, contango is storage. People say it's being driven by index rolls and so on – those things make a little bit of noise around the edges – but the main driver of the contango in every commodity market is the storage, it is the price to store a barrel of oil for one month,” Downey says.

“Storage is very easy to build and so a contango curve doesn't last since more storage is then built and the contango is arbitrated out of the market. It can take a few years to get rid of a contango, but eventually you can get rid of it.” ■

### Oil price forecasts

Current analyst forecasts (US\$/bbl)	2009		2010	
	WTI	Brent crude	WTI	Brent crude
Barclays Capital	57 (115.50)	60 (114.20)	85	84
BNP Paribas	45 (115.80)	45 (114.80)	63	63
CIBC World Markets	65 (130)	–	100	–
Citi	46.80 (90)	48 (90)	55 (90)	55 (90)
Deutsche Bank	43 (92.50)	– (92.50)	55 (100)	– (100)
Goldman Sachs	65* (124**)	63.50* (122.50**)	–	–
JP Morgan	43.25 (100.54)	43.75 (–)	55	55
Merrill Lynch	52 (90)	52 (90)	62	62
Société Générale	49.40 (114.17)	– (113.67)	51.30	–

Figures in brackets are 2009 predictions made in November 2008

\* 12-month forecast from March 10, 2009

\*\* 12-month forecast from October 7, 2008

### USO – skewing the market?

The United States Oil (USO) fund is an exchange-traded security that invests in WTI futures contracts, among other types of petroleum-based fuels. Once a month, the fund needs to roll into the next forward contract before the current contracts it is holding expire.

However, the more money invested in the fund, the more contracts the fund must buy, pushing up prices and causing concern about the part the fund has played in the recent contango in WTI prices.

The monthly roll period encourages front-running since traders know when it will occur each month. In addition, in a recent note on the subject, energy economist Philip Verleger argued that the USO Fund has become too large for the market it seeks to follow, especially when combined with the purchasing power of the S&P Goldman Sachs Commodity Index (GSCI) and the Dow-Jones AIG Commodity Index.

In a Schork report issue on February 25, energy analyst Stephen Schork writes: “These funds are artificially skewing the front of the Nymex curve; putting downward pressure on it as they sell a massive percentage of open interest in the spot over the course of a few sessions.”

However, not all commentators believe these funds have such a sizeable impact on market trends in terms of their overall effect or the duration. Addison Armstrong, director of market research at Tradition Energy, points out that there have always been index rolls in the market – by the S&P GSCI and Dow Jones-AIG indices, for instance.

Armstrong does acknowledge that the one-day roll period of the USO fund (which has now been changed to a four-day roll period) was probably affecting the market in conjunction with other time-specific factors (such as the global economic crisis) but he believes the effects were short-lived.

“If it did have an impact, it was a week-long impact and not sustainable – as we've seen, the [first to second month] spread has since moved from \$6 to \$1,” says Armstrong.

At the time of writing, the spread between the current front month and the five-year forward crude contract on the light, sweet crude futures contract at the New York Mercantile Exchange – commonly known as West Texas Intermediate (WTI) – was at \$23.62, as the market faces a huge inventory build-up at Cushing, Oklahoma, the delivery point for WTI futures.