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Channoil Newsletter

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"Putting our experience to work for you"

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Channoil successfully launched its first training programme in Geneva in March. Over 20 delegates attended from several oil trading companies and feedback was very positive. The programme is set to run again next Spring. see page 8

We are moving offices! New contact details effective 15th October 2007:

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GOODBYE CONTANGO: WITH THE MARKETS SLIPPING INTO BACKWARDATION, IT SEEMS THE PARTY IS OVER. WHAT'S GOING ON?

BY *STEWART JAMES*.

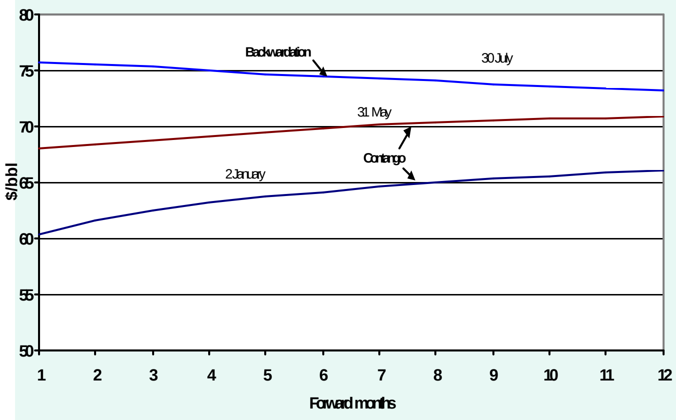
A prolonged period of contango has been a boon to traders and storage companies alike. Now (July 07) with the market slipping into backwardation, it seems that the party is over. What is going on?

The Forward Curve

The forward curve shows how prices for forward or future delivery relate to current delivery prices: are they higher or lower? Higher forward prices mean **contango** market structure. Lower forward prices mean **backwardation**

ICE Brent Crude Oil: Forward Curve at different dates in 2007

This chart of forward Brent/BFO prices shows that in January and May 2007 forward prices were higher than prompt prices **(contango)**.



But, on 30 July prices for later delivery were lower than prices for prompt delivery **(backwardation)**.

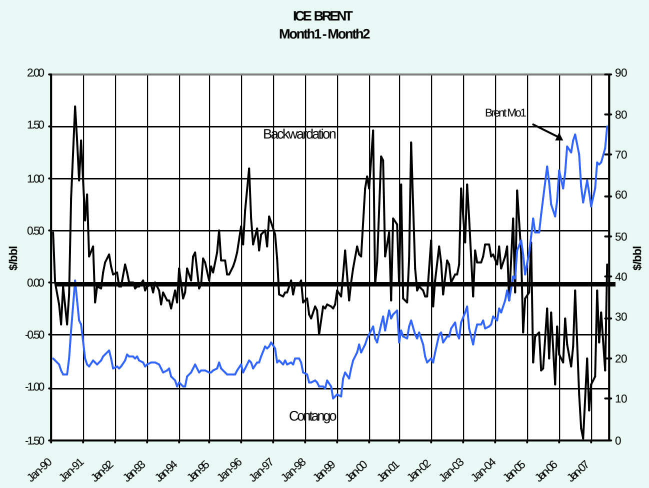
Why is the shape of the curve important?
The shape of the forward curve determines much of oil companies' trading and storage policies.

Contango markets offer particularly profitable trading opportunities, for example by buying cheaper prompt (spot) physical oil either for:
Sale to a distant market, since the long voyage time allows the contango premium (difference between futures and prompt prices) to be captured by the sale of futures at the time of physical purchase, or
Holding oil in storage, hedged by the sale of futures, as long as the contango premium exceeds storage and finance costs.

In contrast, backwardation:
Penalises long haul sales and holding oil in storage, but,
Offers profit if oil can be bought on a forward floating price basis and sold at the current higher price level.

So are oil markets normally in contango?

Not at all. This chart below shows the Month 1/Month2 premium for ICE Brent from 1990 to date.



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GOODBYE CONTANGO, CONTD...

A contango market (Month 1 below Month 2) only appeared at the end of 2004. Before that the market was predominantly in backwardation. In the early period, a good correlation existed between oil price direction (the absolute Brent price is indicated on the right-hand axis) and the forward curve: rising prices are identified with increasing backwardation. That relation collapsed at the end of 2004.

So why does the shape of the forward curve change?

Changes are driven by:

- Physical stock pressures – short term over or undersupply.
- Short supply can force stock drawdown, pull up prompt prices and create backwardation.
- Surplus supply can depress prompt prices and create contango.
- Financial/speculative considerations - how much money is invested, and at what point, along the curve.

What next?

So after two years of contango, are we now set for another long period of backwardation?

The 2005 switch to contango was unusual. The trigger was local over supply at Cushing, Texas depressing the prompt price for NYMEX Light Sweet Crude. Contango was created as future oil prices continued to rise driven by a range of geo-political concerns, followed by the arrival of a wave of speculative money.

In contrast, the recent 2007 reversion to backwardation may seem like a return to a more normal market structure, except that with the market still adjusting to higher priced oil we cannot yet talk about normal behaviour.

The curve demonstrates the balance between the physical oil markets and the financial markets. While we have some measure of physical oil stocks, we do not have much information on financial investment in paper oil. While the statistics from oil exchanges provide a window on the increasing level of transactions, the volume of off-exchange business is unknown. This factor introduces an unavoidable level of uncertainty into any market analysis.

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PRICELESS BRENT—WHY THERE IS NO PRICE ASSESSMENT FOR BRENT BLEND CRUDE OIL, BY *BEN HOLT*.

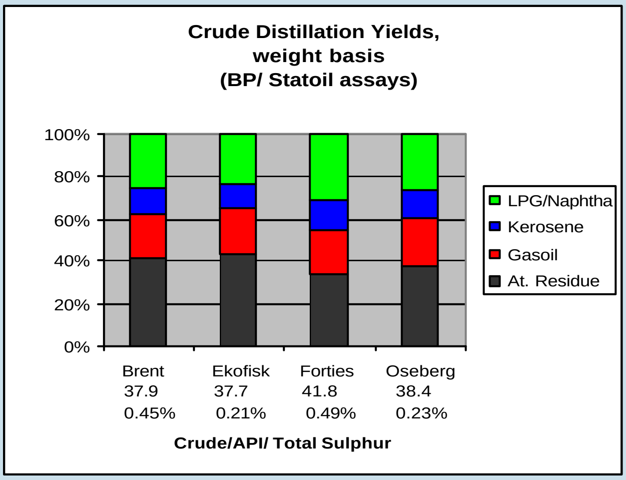
Several initiatives led by Platts over the past five years to maintain price discovery in the North Sea traded crude oil market in the face of generally falling output have led to a situation where there is now no Platts price assessment for Brent Blend crude oil most of the time.

Platts now bases its "Brent (Dtd)" assessment on the price for the cheapest grade among Brent, Forties, Oseberg and Ekofisk (BFOE). Forties Blend became more sulphurous and heavier at the start of 2007 with the entry of Buzzard field oil. Since then Forties has usually been the cheapest of the four grades. Platts' recent addition of an adjustment for Forties cargo prices when quality falls below a threshold level is unlikely to have much sustained effect as the grade should only rarely breach this threshold.

Platts does publish separate price assessments for physical Forties, Oseberg and Ekofisk but they do not have such an assessment for physical Brent itself, which is therefore usually "priceless". Indeed there are indications that traders are now more reluctant to discuss prices for Brent crude with Platts: such information no longer has leverage.

Presumably Platts is reluctant to change the name of its Brent (Dtd) assessment, given the amount of the world's oil whose price is based on it. Petroleum Argus's Methodology is similar in some some respects, but it now refers to its benchmark as 'North Sea Dated' and it has a separate assessment for Brent itself. However, many industry players refer mainly to Platts quotes.

The four BFOE crude oils differ in yields and qualities, as the figure below shows. Uncertainty over the new quality of Fortes has led to it being discounted recently. Some methods may indicate that it should be valued above Brent, based on its high API gravity and yield of light products, but the grade now produces atmospheric residue with around 1.3% sulphur and this is a constraint for some refiners.



The output of Forties blend now exceeds that of the other grades in the basket: of around 1.5 million bd of the four crudes scheduled for lifting in September 2007, 42% is Forties, 27% Ekofisk, 16%Brent and 15% Oseberg.

As the main benchmark for international crude oil trade over the past twenty years, Brent's price has many effects.

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PRICELESS BRENT—WHY THERE IS NO PRICE ASSESSMENT FOR BRENT BLEND CRUDE OIL, BY *BEN HOLT.*

Given the fall in quality of the price benchmark, differentials for crudes priced off Brent, including Russian Urals and African grades, have been unusually strong recently, suggesting that there may now be more basis risk in using ‘Brent’ as a marker. Traders of ‘Crack Spreads’ and refining margins have had to deal with this factor too.

Many industry entities, including companies in their annual and other management reports, publish “benchmark” refinery margins calculated for ‘Brent’. They may now actually be comparing the refined product value of Brent Blend with the market price of (usually) Forties, introducing a significant inaccuracy. The lack of a real price for Brent crude oil is also creating problems in oil valuation and quality bank systems that compare prices and refining values for a range of crude oils in order to assess the relative values of untraded crudes, for example those blended together in crude oil pipelines. Such systems may now need to be revised.

It would seem that Brent crude oil itself is effectively being abandoned as a price reference. There will need to be a clearer recognition that Forties is the grade predominantly used for price discovery and that it has a quite distinct quality.

TERMINAL VALUE– PRICES ARE REACHING UNKNOWN LEVELS IN THE OIL STORAGE AND TERMINAL SECTOR. *BEN HOLT* EXAMINES REASONS FOR THIS TREND.

The oil storage and terminal sector has been the object of unprecedented interest over the past year or so. New players are buying existing capacity and building more. Prices are reaching previously unknown levels.

Many of the traditional reasons for using oil tank terminals have strengthened recently. Regional imbalances in crude and products have increased, necessitating more arbitrage movements, often by trading companies. These often entail blending to meet the specification in the destination market. Oil terminals are now hosting and operating more niche processes, such as bio-fuel production, on their sites on behalf of other owners. Government strategic storage requirements are increasing, with demand growth, the accession of more states to the EU and with more Asian states building strategic oil stocks. Finally, oil price contango has predominated over the past few years, providing a financial incentive to hold oil stocks.

The increased demand for oil storage and throughput capacity has led a number of major trading companies, such as Vitol, Mercuria, Morgan Stanley, Horizon/IPG and Hin Leong to purchase terminals, often for their own use, or take long leases (Trafigura has signed up for 30 years at Tanjung Langsat). Control of such assets gives preferential access to many trading opportunities.

At the same time, several classes of non-industry investors have emerged, attracted by this business area, linked to the energy industry but with apparently less risk than the upstream and refining sectors. In addition to traditional bank financiers, venture capital funds and, increasingly, private investment funds are taking stakes in the oil storage and terminals business. Diversified storage portfolios can be significantly less risky than the average equity market, similar to a typical utility, especially when the terminals involved have a range of multi-year contracts to underpin revenue. Such contracts are now frequently used as a basis for financing new tank construction.

The attractions of oil tankage have resulted in deals being done at historically high levels. The table below shows some recent examples of these transactions, with prices sometimes in excess of $300 per cubic metre of capacity. In addition to deals there has been a spate of capacity expansion. But land in the best locations is scarce and the cost of construction has doubled in some cases recently. With the underlying driver, oil arbitrage, likely to grow in coming years, the sector may well stay strong for some time.

Subject	Location	Seller	Buyer
Eurodek	Tallinn, Estonia	Private	Mercuria
Silport	Sillamae, Estonia	Private	Alexela
Fujairah Refinery	UAE	Govt of Fujairah	Vitol
Flushing	Netherlands	Petroplus	Mercuria
LBC	Europe	JP Morgan	Challenger
Ventspils Nafta	Ventspils, LV	State	Vitol
Oiltanking	Amsterdam, Malta, Singapore (45%)	Oiltanking	3i

Table: Recent example transactions

TAKING CONTROL — RUSSIA HAS ACHIEVED A LARGE MEASURE OF SUCCESS IN ITS STRATEGY TO DEVELOP OIL EXPORT ROUTES INDEPENDENT OF THIRD COUNTRIES. IT NOW HAS AN INCREASING DEGREE OF FLEXIBILITY IN EXPORTS, BETWEEN CRUDE AND PRODUCTS AND BETWEEN EXPORT ROUTES. IT WILL BE INTERESTING TO SEE HOW THIS FLEXIBILITY WILL BE USED, SAYS *STEWART JAMES.*

After the break up of the Soviet Union in 1991, Russia found itself with a severely reduced coastline. All the major oil export terminals, except for Novorossisk and Tuapse on the Black Sea, were now on the territories of other, independent states. Ventspils in Latvia was the principal Baltic Sea terminal for crude oil and gasoil. Other Baltic and Black Sea states also provided transit for Russian oil to export markets. The key Druzhba crude oil pipeline, delivering Russian crude oil to Central and Western Europe now crossed independent Belarus and Ukraine.

When President Putin came to power in 2000, the Russian Energy Ministry stated that Russia was paying about $600 million per year in transit fees to third countries for crude oil alone. Paying these revenues for the use of pipeline and terminal assets constructed under the previous Soviet regime was a considerable source of Russian discontent.

Since then, Russia has pursued a vigorous policy to take control of export flows and has sought to reduce and even eliminate transit of Russian oil through third countries.

In 2002, Russia opened the Baltic Pipeline System to the newly developed port of Primorsk. St Petersburg and Vysotsk were also developed, for products. Russia also plans to construct a crude oil bypass line from the Druzhba to Primorsk, (BPS II) which could cut heavily into Belarus transit volumes.

The same policy of regaining control is evident in the Black Sea, although the impact is less, since the main crude oil port, Novorossisk remained on Russian territory. Russian involvement in Black Sea oil business is evidenced by Russian acquisition of regional refineries, supply/ transit issues in Ukraine and pressure to maintain southward (export) flow of the Odessa-Brody crude pipeline. Russian state-owned companies will have a majority share in the recently announced Bosporus (BAP) crude oil bypass pipeline.

Russia is constructing a diesel product pipeline to Primorsk in the Russian Baltic, which will allow diversion of products from Baltic States ports. Russian sources have suggested that Black Sea product exports should increase in future too, with volumes diverted from the Baltic. In the longer term, the Siberia-Pacific crude pipeline (ESPO) will largely export new oil production to the growing Asian markets.

Russia has achieved a large measure of success in its strategy to develop oil export routes independent of third countries. It now has an increasing degree of flexibility in exports, between crude and products and between export routes. It will be interesting to see how this flexibility will be used.

Training & Development— Embark on a new course!

Channoil successfully launched its first training programme in Geneva in March 2007, entitled 'Essentials of Crude Oil and Product Quality, Value, Trading and Price Risk Management'. Over 20 delegates from several oil trading companies attended and feedback was very positive. It is planned to run the programme again in Spring 2008.

Our courses on Fuel Oil and Bunker Fuel Markets and Trading, also organised for Vostock Capital, proved very popular. We ran editions of this in Riga, Latvia, and also in Singapore.

Given the recent great interest in the oil terminal business, we also presented a two-day programme on Oil Terminal Management, including Logistics for Traders, for Vostock Capital in Amsterdam, in May this year. Attendees from across Europe, the FSU and the Middle East appreciated the course, which included a tour of Oiltanking's flagship Amsterdam oil terminal.

Our long-standing course in Moscow, organised by the Energy Institute, on Crude Oil and Product Trading and Price Risk Management will be run again this autumn, from 30th October to 1st November.

MOSCOW April 2007

Some of the delegates at a recent Channoil-run Energy Institute programme in Moscow.

Staff Changes

Channoil is very pleased to have augmented its wealth of experience in international oil markets with the addition of Gerard Klijnsmit to its executive staff. Gerard has an Economics MBA and, after working in refinery economics with Shell in the Netherlands, he traded both crude oil and products for Texaco in Rotterdam, London and New York. For six years he then managed CIS crude trading and business development for Texaco before becoming Director of Crude and Product Trading with Petrokazakhstan in Almaty. After it was acquired by CNPC he has provided consultancy services on Caspian regional oil trade and other related matters.

Meanwhile Phil Nutman, former Director at Channoil, has left the company. We wish him well in his new role.

Channoil is moving

Channoil Consulting Ltd will be moving to new offices on 12th October.
Please note our new contact details:
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