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Sprinting to Chase Contango

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You can't open up the paper these days without news of declining oil prices and fears of uncertainty for the oil and gas industry. As part of Haynes and Boone's alert series on this topic, we continue our review, this time focusing on the contango spread and how market participants are responding. It seems like there is a sprint taking place to lock in the benefits of the current contango spread. Is your company running, walking or standing still? We are discussing with market participants a unique concept called "purchaser intermediation," which provides an innovative structure that has numerous advantages for companies involved in the upstream, midstream and finance sectors in this current contango environment. Regardless of the pace of your response to the current market, there may be valuable options you have not yet considered.

Record Supply Glut and $10 Contango Spread

The record supply glut is expected to carry through the first half of 2015. The result is a spread that has developed between the lower spot market price for the physical commodity and the higher futures contract price for delivery (further out on the forward curve) one year from now (referred to as a "contango"). This "contango" spread has developed only recently. Some analysts believe, however, that it could steepen significantly in February and March when refinery utilization in the United States and Europe will decline sharply due to refinery scheduled maintenance and turnaround. A sharp drop in refinery utilization is expected to reduce demand in the physical market by at least 2 million barrels per day at a time when, according to EIA, the number of barrels of crude and finished products in storage in the United States is already at its highest level in at least 80 years and global oil production is at an all-time high. As of last week, the "contango" spread between the lower spot market price for WTI and the higher price of a futures contract for delivery in 12 months reached as much as $10 per barrel.

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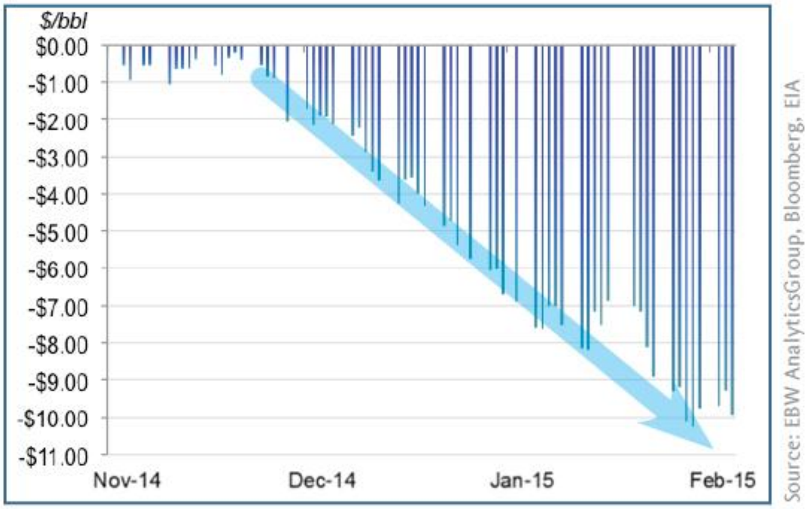
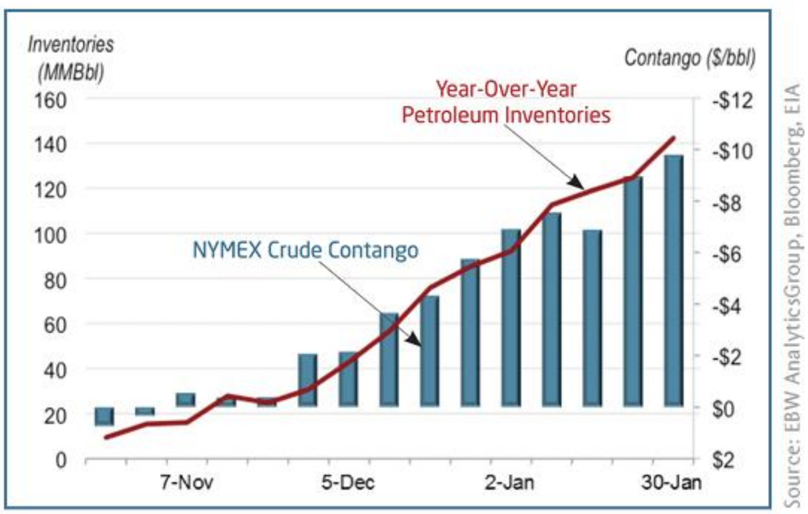
Contango Between NYMEX Front-Month Crude and Twelfth-Month Crude ($/bbl), since November 2014

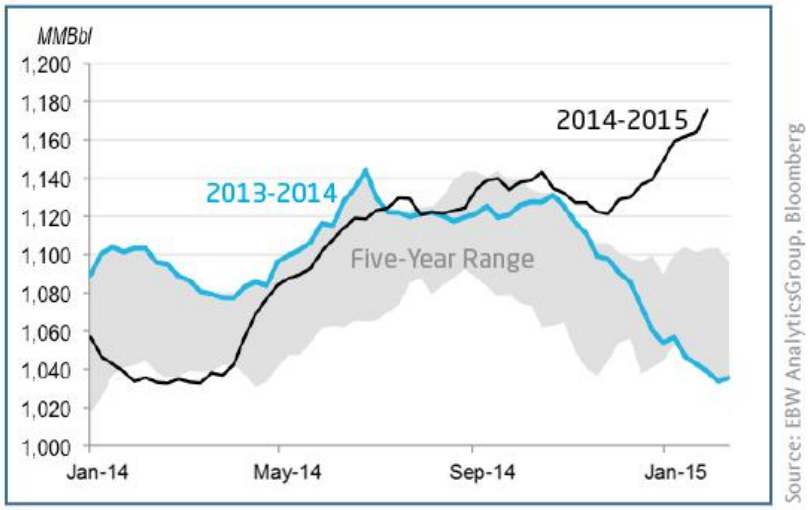


Surging Crude Oil Inventories Drive Widening Contango

Year-Over-Year U.S. Petroleum Inventories (MMbbl) vs NYMEX Crude Contango ($/bbl), Since October 31, 2014



Commercial U.S. Total Petroleum Inventories (MMbbl), 2014-2015 vs 2013-2014 and Five-Year Range



In the last three weeks there has been intense activity by some in the market to lock up what is called “floating” storage (storage on floating vessels), to presumably capitalize on the spread. It has been reported that companies such as Vitol, Koch, Shell and Trafigura have locked up as much as 50 million barrels of floating storage, which some estimates indicate is half of the available global capacity. While this is big news, the story of on-land storage opportunities is equally as exciting.

On-Land Storage Opportunities—Who Has the Cash?

Several industry sources report that most of the readily accessible on-land commercial storage available globally is located in the United States (Cushing, Oklahoma and the Gulf states)—with up to 80 million barrels of available storage capacity (this capacity equates to 20 percent of the total amount of crude oil currently in commercial storage in the United States). While China intends to expand its strategic reserves (potentially by as much as 125 million barrels), most of its existing storage capacity is full and storage tanks currently under construction may not be completed until mid-year. The estimated all-in cost of on-land storage in the United States is as little as 30 to 70 cents per barrel per month versus an estimated $1.05 to $1.90 per barrel per month for floating storage. Just like floating storage, the demand for on-land storage capacity is on the rise. There remain opportunities for market participants to take advantage of the contango spread. But with many in

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the upstream and midstream space bracing for hard times and limited availability of capital, is there any opportunity to participate in the current market spread? The answer is “yes” using a concept called “purchaser intermediation” either with on-land or virtual storage.

Thinking Outside the Storage Tank—Purchaser Intermediation

The word “intermediation” can mean many things to many different people. Used in a strict financial context, intermediation can mean the role of a financial intermediary to match funding with a borrower. But the concept of “purchaser intermediation” removes any lender and borrower relationship and instead involves a buyer (which could be a bank, private equity participant or other) and seller (which could be a producer, refiner or trading/marketing company). This deal structure involves a purchase and sale agreement, which may be accompanied by a form of master agreement detailing intermediation services to be provided by the buyer—called a Master Intermediation Agreement (the “MIA”). While the exact structure will differ depending upon whether the seller is an upstream (producer) or midstream (commodity trader/marketer/refiner) entity, in all cases the core structure stems from true sale characterization with respect to the underlying purchase. The benefits of the structure can be numerous: (1) ability to capture the contango spread value; (2) buyer is able to provide seller with an immediate injection of cash; and (3) with an MIA, deals can be structured as credit neutral for buyers, which gives greater flexibility to the pool of potential sellers.

Haynes and Boone is actively working with buyers and sellers alike to identify if a purchaser intermediation structure is appropriate for buyer and seller needs and meets all regulatory and commercial requirements. The current environment necessitates “out of the storage tank” thinking to adequately assess all available options.

For additional information, please contact one of the lawyers listed below.

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