Brent Spreads Hit 8-Month Low as Supply Recovers

By Rupert Rowling

March 15 (Bloomberg) -- The incentive for investors to buy and hold Brent crude has dwindled to its weakest level in eight months as supplies from the North Sea recover.

The premium for immediate supplies of Brent crude versus later deliveries shrank to 28 cents a barrel on March 13, the least since July, as production headed for the highest in 10 months. The narrowing spread is dimming the attraction of buying front-month futures and then transferring, or rolling, the position into the next contract at each monthly expiry. Brent traded as high as $110.53 a barrel in London today.

“The Brent structure has been weakening,” Olivier Jakob, managing director at consultant Petromatrix GmbH in Zug, Switzerland, said by phone on March 13. “And if Brent cannot sustain a high enough roll return, then investors will be more hesitant to hold it at these kinds of price levels.”

Futures have dropped 8 percent from this year’s peak of $119.17 as Europe’s debt crisis and the resumption of North Sea output prompted money managers to cut bullish bets by the most in 18 months. Returns are falling just as the price difference between Brent and West Texas Intermediate, the U.S. benchmark oil, shrinks to its narrowest since Jan. 18.

Roll Yield

Excluding gains or losses from changes in the price of the underlying security, an investor could have made almost $12,000 by buying and rolling a 1,000-barrel lot of Brent through 2012, according to data compiled by Bloomberg. The same strategy returned $17,000 per contract in 2011.

Buying WTI, for which immediate supplies are cheaper than later deliveries, and rolling it through 2012 would have lost $3,150 per contract.

The Brent curve is “slackening” amid the resumption of North Sea supplies, a seasonal lull in refiner demand while plants are in maintenance, and the prospect of a drop in Asian demand, said Harry Tchilinguirian, head of commodity-markets strategy at BNP Paribas SA in London.

Exports of the 12 main North Sea crude grades will rise by 8 percent in April to 2.04 million barrels a day, the highest level since June, according to loading programs obtained by Bloomberg News. Supplies have been boosted by the resumption of the Buzzard and Elgin-Franklin oilfields, and the restart of the Brent Pipeline system following a leak.

The 200,000 barrel-a-day Buzzard field, the biggest contributor to supplies of Forties, the North Sea’s most abundant crude stream, returned from a scheduled halt on March 4, Calgary-based operator Nexen Inc. said the following day.

Korean Buying

Total SA is working on restoring output from the Elgin- Franklin field to 70,000 barrels a day, or about half its total, after a gas leak almost a year ago, Europe's third-biggest energy company said on March 11. The Brent Pipeline System, which transports the grade to its export terminal in Scotland, resumed flows on March 7 after the leak on one of the platforms halted operations for five days.

Speculation that South Korean refiners may curtail purchases of North Sea crude if tax incentives are removed are "what has really moved the market," according to Petromatrix's Jakob. Purchases by Asia's fourth-largest economy, spurred by a Free Trade Agreement with the European Union, "kept the market very well supported for the last 18 months and introduced a notion that one could not be short the Brent spread," he said.

South Korean firms that import North Sea crude stand to receive smaller rebates on their exports of oil products under tax changes scheduled to start April 1, according to government and refinery officials, diminishing their incentive to buy the region's oil. The Asian country purchased 39.8 million barrels from Norway and the U.K. last year, or about 4.2 percent of total imports, according to data from Korea National Oil Corp.

Brent Contango

Global supply constraints and strengthening demand will still ensure Brent for earliest delivery remains more expensive, or in backwardation, relative to later supplies, according to Goldman Sachs Group Inc. and BNP Paribas, rather than become cheaper, or in contango, which offers investors no roll return.

"For a contango in Brent, you would need a situation in which the Atlantic basin develops a surplus of light, sweet crude," Tchilinguirian said. "You would need the U.S. to completely stop importing light oil."

While the Brent curve is unlikely to flip into contango, the backwardation has probably peaked and "if anything, is susceptible to slackening," Tchilinguirian said. Markets in contango are typically associated with price declines, while backwardated markets are more correlated with gains.

Hedge Funds

The slide in Brent returns may be leading speculators to trim their holdings. Hedge funds and other money managers cut bullish bets on Brent crude by 159,816 lots in the week ended Feb. 26, the biggest reduction since Aug. 9, 2011, according to data from ICE Futures Europe.

"Tightness in the Brent market is being alleviated," said Hakan Kocayusufpasaoglu, chief investment officer at Archbridge Capital AG, a Zug, Switzerland-based hedge fund. "For long-only,

commodity-index investors the narrowing of the backwardation is going to make Brent slightly less attractive.”

Brent’s premium to WTI shrank to as little as $15.27 a barrel yesterday, the smallest gap since Jan. 18. The spread widened to a record $28.08 in October 2011.

--With assistance from Nidaa Bakhsh in London. Editors: Raj Rajendran, Justin Carrigan