ENERGY

MARKETS

The New World of energy

BY DANIEL P. COLLINS

Perhaps the most over-hyped and misused phrase in the trading world is "paradigm shift," yet the proliferation of U.S. energy production has created just that. And it will take the world's energy producers and consumers a while to get used to it.

When writing about energy fundamentals, a key component over the last few decades has been geopolitical risk. But while in the past geopolitical risk meant one thing — fear of a disruption in the Middle East, or another of the world's hotspots that also produces crude oil, because of a threat of war — today it represents two-way risk. It is not only war that poses a threat to the supply/demand status quo, but peace.

Reversing the flow
OPEC infighting
U.S. production

Yes, there is still a threat that Israel will attack Iran over its nuclear enrichment program, and Iran will retaliate by mucking up oil transport through the Straits of Hormuz. But that threat has been reduced, and there is the hope of peace as the tentative agreement between the United States and Iran over its nuclear program eventually could lead to more Iranian oil on the global market.

"There always will be geopolitical risk. Iran seems to be cooperating with the U.S. and the world is pleased. I don't think the Saudis and Israel are pleased," says Todd Kramer, general partner at Blueshift Capital Group. "Can crude oil crash? Don't know, but the path of least resistance is lower."

Most analysts agree, but are cautious. "There is a lot of skepticism on how the Iran talks will go," says Phil Flynn, senior market analyst at Price Futures Group. "One of the things that is going away is the fear that there will be an imminent attack on Iran. For years there was this thought that an attack on Iran from the Israelis was inevitable."

The point being, when you talk geopolitical risk, it now cuts both ways. "[That's] exactly right," says Dominick Chirichella, founding partner at Energy Management Institute. "Sometime within the next six months we are going to see more Libyan oil coming back. That is bearish."

In fact, with so much production shut-in, the risk is on the side of a supply spike.

Flynn says, "There is still instability in Iraq, but if the political instability calms down there is a possibility of a major increase in both countries. This is causing concern within the cartel on how they are going to handle increased production."

The last time we discussed energy fundamentals, we noted how the increased U.S. production had offset the impact of production disruptions in the Middle East (see "Top dog once again," right). We

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did not see a massive reduction in price with increased U.S. production; however, we did not see a huge spike in prices despite most of Libyan production being shut-in, a worsening Iraqi situation, continued sanctions on Iran and the threat of a U.S. strike against Syria.

Those factors still exist and U.S. production continues to increase. So for the first time in a long time, there is perhaps more risk of a sudden increase in production than a shortfall.

While this is not yet being reflected in the price of crude, it certainly is showing up in the options market according to Kramer, who trades a volatility program. "We are definitely seeing more put buying," Kramer says. "This is a relatively new phenomenon. The put skews are steep while call skews are quite negative."

OPEC losing clout

The chance of a significant spike in global production is a concern for OPEC.

"They are sending a message to Iran and Iraq that you can't just dump oil on the market," Flynn says. "It is going to cause more friction in the cartel, which has been seeing more friction over the years – and we are not even talking about increased U.S. production. OPEC definitely has some challenges."

Protec Energy Principal Todd Garner says that Saudi Arabia and other OPEC members have grown accustomed to $100 crude. "Brent crude has to be over $100 to completely fund those countries the way they fund them. The only way to keep Brent high is for the Saudis to cut back production," Garner says. "If we did this deal with Iran, and Iran started ramping up production, now you have a battle between all of these Middle East producing countries where OPEC falls apart."

Of course, OPEC will take action. "I don't think OPEC is going to sit and let the price of oil go down significantly, they will cut production strongly," Chirichella says. "We saw what they did in 2009 when they cut production by 4.5 million barrels a day. OPEC certainly will defend the price of oil if we see Brent drop below $100 (WTI below $90); we will see OPEC getting very aggressive."

But with increased North American production, the Saudis may not have the leverage they once did. "Ten years ago they could control the market because the [United States] was a huge importer; that is not the case anymore," Garner says.

Flynn adds, "The increased U.S. production could take some options away from Saudi Arabia and OPEC as production cuts could lead to a loss of market share."

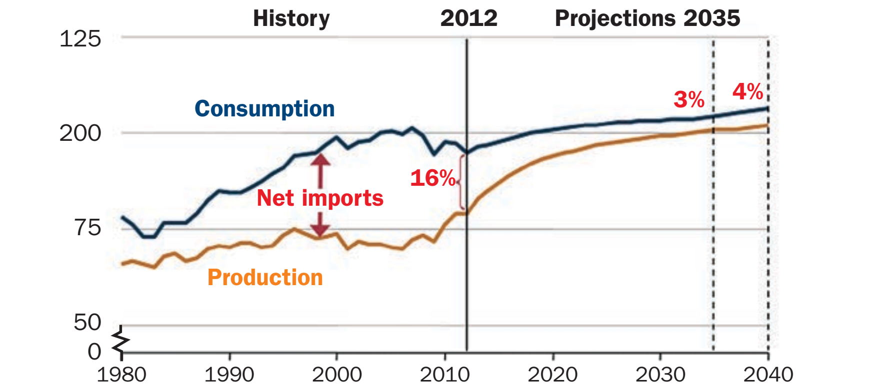
Chirichella, however, believes the Saudis still can dictate price to some extent. "Unless the law is changed, we can't export crude oil," he says. "The [United States] is producing the maximum amount of oil it can produce right now. It is going to grow, but at a slower pace. OPEC easily can cut a couple of million barrels a day out of production and it will have a strong impact on prices."

Chirichella is referring to the ban on exporting U.S. crude oil, which has been in effect since 1975. It is a topic of discussion because U.S.-produced light sweet crude is trading at a discount within the United States because the refineries have become used to the heavier grades.

"Refineries have grown accustomed to refining sour crude oil and are now flooded with U.S. sweet, which is trading at a $10 discount within the [United States] vs. international markets, says Hai Chen, managing director of Principle Capital Management.

TOP DOG ONCE AGAIN

U.S. crude oil and natural gas production are expected to continue to increase and bring the U.S. close to energy independence.



Source: EIA

Senator Lisa Murkowski (R. Alaska), ranking Republican on the Senate Energy and Natural Resources Committee, has called for repeal of the ban.

Wrong way crude?

The fact that lifting the ban on crude exports even is being considered is testament to how much the space has changed in a short period of time.

While increased U.S. production stands to simplify our energy needs in the long run, in the short run it is causing logistical headaches. In fact, in addition to geopolitical concerns, crude has stayed stubbornly high because the U.S. infrastructure was not built to move crude – or natural gas for that matter – from the new areas it is being produced (see "Redrawing the map," page 26).

"We have to rewrite everything we thought about oil in the last 30 years," Flynn says. "How are we going to get supply from point A to point B? Last year the big story was when we opened the Seaway Pipeline (between Cushing, Okla. and the Texas Gulf Coast). This year we have the Southern leg of the Keystone pipeline bringing oil down to Texas. The infrastructure is getting in place slowly for the U.S. changing from being an importer to a major exporter."

Chirichella adds, "We have gone a long way in reversing the South to North pipeline from the Midwest. Keystone coming on-stream in January will produce 700,000 barrels going from Cushing south. More oil is moving by rail. The logistics are different, we are exporting a lot of refined products. That said, it is a long way to go before we would see the U.S. becoming a large exporter of oil."

What this means for traders is that there is a whole new set of fundamentals to follow. While global demand and geopolitics still are in play, energy speculators will need to follow domestic logistics issues. "The whole logistic system is changing and it is going to continue to change," Chirichella says. "The U.S. logistics system was built on oil coming into the gulf coast and moving north; now we are focused on moving oil from the North to the South: Canadian oil, North Dakota oil, the whole pipeline network for crude is at a massive changing pattern."

He continues, "You have to watch carefully to see if the U.S. government budges on two things: Making the export of crude oil [legal] and waiving the Jones Act to allow foreign vessels to shuffle crude around the [United States]."

"There are a lot of moving parts right now," Garner says. "It is one of the hardest times to trade in the 30 years I have been trading. There are so many paradigm shifts going on all over the world that can go either way."

Cautiously optimistic

Despite all the potentially bearish fundamentals, most analysts only see crude

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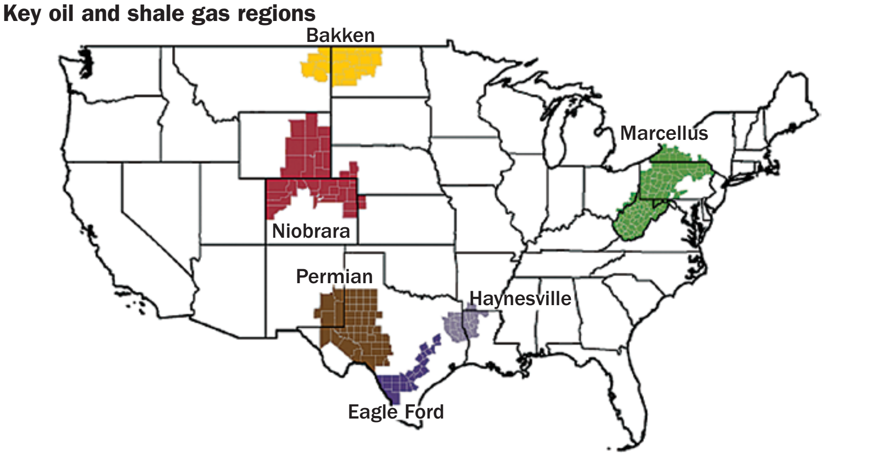
REDRAWING THE MAP

Key new oil & gas production regions are causing havoc on logistics.

Key oil and shale gas regions

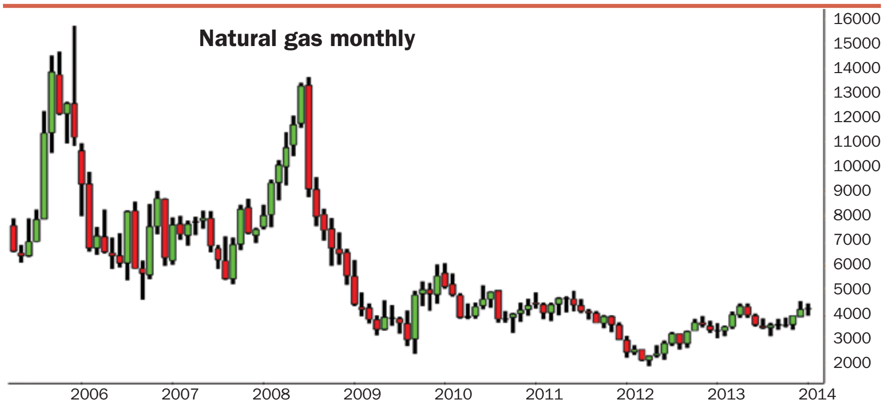


Source: EIA

SUPPLY EXPLOSION

Few analysts expect crude to drop dramatically, but natural gas may have set a precedent.

Natural gas monthly



Source: eSignal

dipping to the $80 level, if at all in 2014.

Garner expects (WTI) crude to trade between $90 and $100 throughout the year. "We could get back to $100 and we can see some sub-$90. If we can get all the infrastructure in line, we are in pretty good shape. The biggest problem we have right now is the infrastructure in the Northeast. They're still having to buy Brent because they can't rail enough oil into the Northeast."

"I don't see a strong move [in either direction]," Chirichella says. "Barring an Iranian deal, we are in a $90 to $105 range for WTI, maybe $5 to $8 higher for Brent."

Chen expects crude to be flat in 2014 as new demand will eat up added supply.

Flynn, who called for $80 crude last fall, is a little bolder but doesn't expect a dramatic drop. He says it can drop to $80 or lower if all the bearish fundamentals fall into line.

Despite the prospect of large production increases, no one else expects crude to breach $80. "I don't think there is anything magical about [the $80 level]," Chirichella says. "Oil could go below $80 per barrel given the right circumstances: Given Iran, given Libya coming back, given instability in Iraq [stabilizing], given U.S. production continuing to grow. You put all of those pieces together and you could see $75 to $80 oil going forward. I don't think they all are going to happen."

As for a dramatic drop to the more traditional $40 level, few would bite. "It's possible," Flynn says, "I don't think it is going to happen. Usually it does not collapse that quickly. It will be more of a slow move down; I don't think it could get to $40 in one year. To have a $30 drop, it's usually an event that gets you there, something big."

But you only need to look at natural gas to see such a dramatic move. Natural gas dropped from above $13.50 in mid-2008 to below $2.50 a little over a year later (see "Supply explosion," left).

Gas steps up in class

Natural gas has been risng steadily since its 2012 low below $2 thanks to the revolution in hydraulic fracking and some ill-advised "use 'em or lose 'em" production sharing arrangements that kept gas flowing despite historically low prices. It has had a nice run because of an unusually cold fall and early winter. "I am not as bearish as I was two months ago because of the cold weather," says Chen, who expects it to move back to the $4 level.

In addition to stronger production, gas has languished because of several years of cooler summers and milder winters. Flynn says, that the early start to winter and the January cold snap are putting upward pressure on natural gas. "According to forecasts, we are going to be much colder than normal this winter," he says.

"We are about 25% above where we were last year, and production continues to rise," Chirichella says.

Despite all this, there is an unusual calm in the gas market. Nearly all our analysts acknowledged that the type of cold snap that occurred throughout the United States in the early part of January would have created a more dramatic move in the past.

"The kind of volatility we used to have, those days are gone," Chirichella says. "I don't expect to see $3, $4, $5 rises in natural gas because of cold weather. The fact is, supply is still robust; as long as supply remains robust the upside will be a calculated move not a wild and crazy move."

Perhaps a similar paradigm shift is in the offing for crude.

"The [United States] is going to be the epicenter for energy once again," Flynn says. "We are going to be a major importer, a major exporter and a major producer. Overall the trend for both markets will be down. The better supplied the market is, the easier it is to get the product to where it needs to be. Ultimately, that is going to lead to lower prices for everybody and that is going to be good for the global economy." F