MARMORE
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## Cut to the Chase

# Negative Oil Prices


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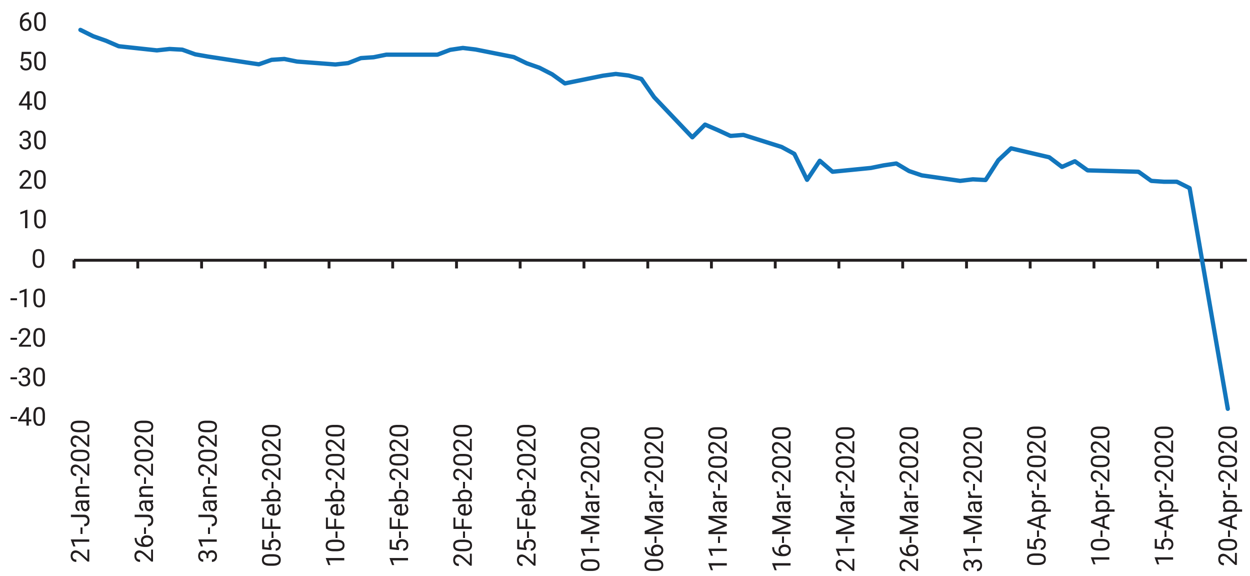
# **What** happened in the U.S Oil market?

US Crude Oil prices turned negative for the first time in history on April 20, 2020. More specifically, the price of West Texas Intermediate (WTI - the benchmark for US crude) May Futures fell more than 100% to end the day at negative $37.63/barrel, meaning producers would pay traders to take the oil off their hands.

**Exhibit: WTI May Futures – Closing Values for past 3 months (USD/bbl)**




***Source: Refinitiv***

# **Why** did the Oil prices turn negative?

This historic price plunge is due to a combination of plummeting oil demand, lack of storage capacity in the US and more importantly the nature of the oil futures markets.

In this particular case, the WTI May futures contract was slated to expire on April 21. Upon expiry, WTI Futures contracts are settled by physical delivery of the oil to the owner of the contract. So as expiry approaches, many traders roll their positions into further-out contracts to avoid delivery. In this case, by selling the May futures (to traders with storage capacity who buy on behalf of clients like refiners) and buying the June Futures. But the demand destruction caused by coronavirus led to refiners with a glut of inventory and they did not want to take physical delivery of more crude than necessary. Besides, the main oil storage hub in the U.S. in Cushing, Oklahoma was nearing its estimated capacity of 79 million barrels. Traders were fast running out of storage space for oil.

All these factors would come to a head on April 20, as traders without physical storage capacity scrambled to sell their May contracts to non-existent buyers before the next day's expiry. They were basically paying other traders with storage capacity to take the oil off their hands!

## **How** investors participate in the trade?

Though the prices are low, financial investors may not be able to take advantage of the situation. Only those market participants who could take physical delivery could stand to benefit from it. However, going by the market information it appeared that there were very few in that category. The paucity of bidding meant that once the CME - the exchange through which WTI futures are traded - allowed negative pricing, negative prices were inevitable as there were virtually no buyers.

## **Is** the problem specific to the U.S Oil market (WTI Futures)?

The nature of WTI futures market with the physical delivery clause is probably the main factor behind the negative prices. The international benchmark for oil prices - Brent crude - does not require physical delivery at the time of settlement, ended the day down 8.9% at $25.57/barrel, far from negative territory. Brent is also less affected by storage issues since it is a seaborne crude enabling traders to easily ship it to areas of higher demand. Due to this, Brent crude prices are always a few dollars higher than WTI. But the 'spread' between the two has rarely reached the levels seen on April 21. Also to be noted is that spot price of WTI did not reach negative on the same day and was closer to the June WTI futures prices. The June WTI Futures fell 18% to end at $20.43/barrel. Again, the spread between the front month (May) and the second month (June) for WTI futures was also the widest in history.

# Implications for the future

The negative prices for May WTI futures seen this month can be partly attributed to unsophisticated traders 'buying the dip' - making speculative bets that oil prices would go up. However as expiry approached, the markets basically froze as institutional investors had exited their positions and the remaining traders had to resort to negative prices instead of taking delivery of oil. Now, will this be repeated again next month when the June contract expires? Unlikely, since traders will avoid speculative positions now that they know negative prices are a reality and not just theoretical. Still, the negative prices have sent shockwaves in both the oil industry and wider markets. Storage capacities are unlikely to increase in such a short time. And output cuts by OPEC+ are still not enough to compensate the fall in demand. All these indicate more pain ahead for crude oil.

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