MORNINGSTAR®

American GulfCoast Select Launched As WTI Rival

Cushing meltdown prompts new U.S. crude marker.

Morningstar Commodities Research
6 July 2020

Sandy Fielden
Director, Oil and Products Research
+1 512 431-8044
sandy.fielden@morningstar.com

Data Sources for This Publication
EIA
CME Group

To discover more about the data sources used, click here.

Attempted Coup

Last month a group representing independent producers gave impetus to a new benchmark crude launched by price reporting agencies Argus and Platts. The producer's goal is to establish trade support for their American GulfCoast Select brand as the default reference for United States light sweet crude exports. To succeed, they must eclipse long-established West Texas Intermediate crude, delivered to Cushing, Oklahoma, the grade underpinning dominant CME Nymex futures. This attempted coup in the crude world order was prompted by two factors. First the lack of a domestic price mechanism for U.S. crude exports led buyers to rely on overseas marker Brent. Second, the domestic WTI market reflects pipeline delivery centered on landlocked Cushing that doesn't suit overseas buyers. The trigger for this attack on WTI is the Nymex futures price meltdown in April 2020 that battered confidence in the incumbent. This note reviews the new benchmark and challenges to its success.

Futures Contest

We've previously discussed efforts to establish a representative Gulf Coast contract to price U.S. crude exports following the lifting of a federal ban on most overseas shipments in December 2015 (see our November 2018 note Quality and Location Count for WTI Contracts and follow up in April 2019 Auctions Offer Houston Crude Exporters a Half-Baked Solution). There have been competing attempts to launch a Houston-based futures contract for WTI by CME Group that owns the dominant Cushing contract and ICE Futures that own rival London-based ICE Brent Crude Futures. In the Houston spot market, a pipeline delivery contract based on Magellan's East Houston, or MEH, destination terminal for their Longhorn and BridgeTex pipelines from the Permian Basin as assessed by Argus, has emerged as the most liquid WTI instrument on the Texas Gulf Coast. A related Argus MEH futures contract listed on CME's OTC Clearport platform has attracted a significant trade volume that averaged 2,700 contracts/day in June. That's still only a fraction of the average 868,000 contracts/day traded on CME's flagship Nymex WTI in June, but Argus MEH Clearport has fared considerably better than either CME Houston or ICE Permian WTI futures that only traded an average 48 and nine contracts/day respectively last month.

Permian Quality

The major market concern addressed by the MEH contract is crude quality. Overseas refiners became wary about quality at the Gulf Coast after cargoes sold as domestic light sweet crude matching Nymex WTI delivery specifications, turned out to be blended grades containing unwanted contaminants. The experience led to CME Group tightening WTI delivery specifications at Cushing and Houston, as well as buyers demanding crude proven to originate in the West Texas Permian Basin. Emphasis is now placed on understanding the provenance of crude delivered from the Permian—something the MEH terminal

guarantees. Rival Houston terminals such as Enterprise Product Partner's ECHO facility imposed higher-quality specifications on WTI crude delivered from Cushing storage on the Seaway pipeline and offer Permian quality crude via their Midland to ECHO pipeline system.

Cushing Complex

By early 2020, pipeline delivery systems were bringing Permian quality crude into export terminals in Houston, Nederland and Corpus Christi on the Texas Gulf Coast that were considered a fungible grade with a fairly narrow range of specifications. But the trading mechanism for these grades is still firmly rooted in pipeline delivery and pricing is linked more or less directly to the Cushing WTI benchmark. Traders base transactions on ratable monthly pipeline deliveries of so many thousand barrels/day. While the system lends itself to refinery operations it isn't compatible with loading export cargoes that typically hold 500-750 thousand barrels. Pipeline trades are settled at location or quality price differentials to Cushing WTI that is, in turn, priced off the CME futures contract (see our April note Crushing Cushing–Wider Impact of Negative Crude). Despite price reporting agencies providing waterborne Gulf Coast assessments for export cargoes. these are still classed as WTI Houston trades, linked to the Cushing complex.

Most U.S. exporters are shipping crude long distance to Europe or Asia. Although Argus WTI MEH meets their quality requirements, the link to WTI Cushing exposes buyers to the price spread between WTI and destination crude markets. In the case of Europe, that means Brent prices dominate international trades and are easily hedged using ICE Brent futures. In Asia some pricing is Brent-related but most use Mideast Dubai and Oman crude grades that are linked back to Brent via the Brent/Dubai swaps markets. As a result, U.S. export buyers prefer using a Brent-based price that is easier to hedge at the destination rather than managing basis risk between Brent and landlocked WTI Cushing.

The meltdown in Cushing prices this past April, when May futures contract values turned negative the day before expiration (see Crushing Cushing–Wider Impact of Negative Crude), cast doubt on the suitability of WTI Cushing as the benchmark behind most domestic prices. The price crash was a consequence of swelling inventories caused by oversupply as coronavirus lockdown precautions destroyed downstream demand. More importantly, the meltdown exposed producers to negative prices that meant paying buyers to take away their crude even if it was delivered hundreds of miles from the Cushing hub. That experience left a bad taste in producers' mouths about the central role of Cushing and the pipeline pricing mechanism in the U.S. crude market.

Task Force

Concerns about the Cushing price bust and the lack of an accepted U.S.-based Gulf Coast price benchmark serving the international market prompted the formation of the American GulfCoast Select Best Practices Task Force Association. This group of independent U.S. producers, led by Continental Resources CEO Harold Hamm, trademarked the name of their organization as well as the American GulfCoast Select brand on June 17. They were then instrumental in persuading Argus and Platts to launch price assessments for a new AGS domestic benchmark–designed to supersede WTI Cushing.

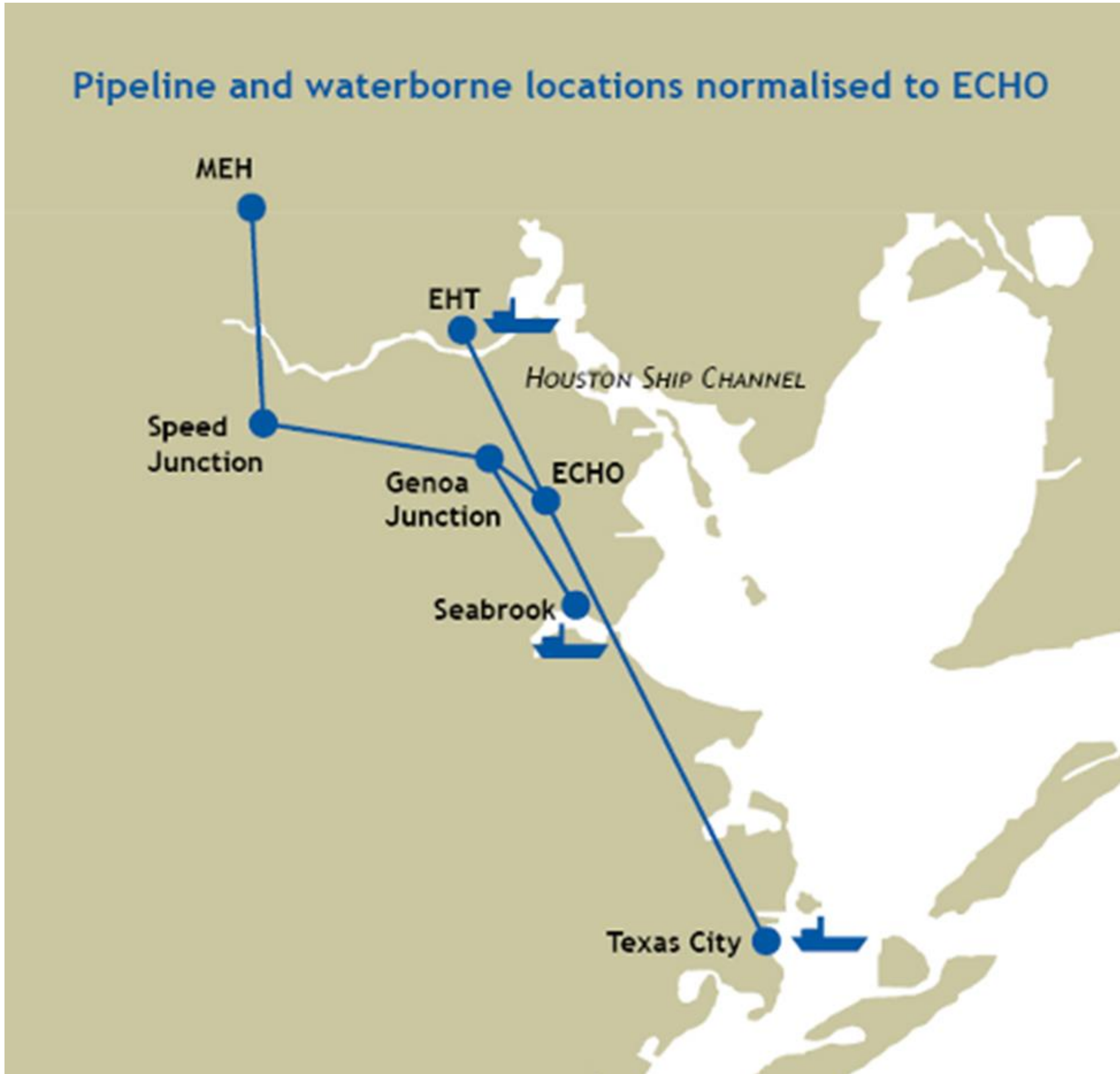
The AGS benchmark is an outright price–meaning it isn't derived from or linked to Cushing WTI trades. It's also a waterborne price–serving the export market–meaning that trades can be for Aframax tanker size parcels of at least 500 thousand barrels. The producer group behind AGS will help legitimize the index by submitting their trades to Platts and Argus as part of the assessment process.

Rival Assessments

The two reporting agencies adopted different AGS methodologies. Platts American GulfCoast Select, launched June 26, is straightforward. It covers waterborne cargo trades at export terminals along the Gulf Coast at Nederland, Houston and Corpus Christi (and others as they evolve) based on 500-thousand-barrel parcels loading 15-45 days out. The crude must be delivered on named pipelines from the Permian–implying Permian quality.

Argus launched its AGS assessment on the same day, also based on crude delivered from specified Permian pipelines. Argus AGS select is a daily high/low range based on trades for deliveries to Houston area terminals that are a mixture of pipeline destinations and export docks (see Exhibit 1). Argus will assess pipeline trades as well as waterborne cargoes. A related Argus AGS Select Marker index is a daily volume weighted average of prices. Pipeline trades for 1,000 barrels/day used in the AGS Select assessment will be tallied up to monthly totals (for example 30,000 barrels) for the volume weighted average Marker index.

Exhibit 1 Houston Region Crude Delivery Terminals



Source: Argus Media Group.

The Argus assessments use fixed-location differentials between Houston terminals (Exhibit 2) to normalize trades back to the Enterprise ECHO terminal. These location differentials, based on historic averages, will be updated over time.

Exhibit 2 Argus AGS WTI Location Differentials to Enterprise ECHO

Houston Terminal	WTI Differential to ECHO ($/barrel)
ECHO Enterprise	0
Magellan East Houston	-0.25
Genoa Junction	-0.1
Speed Junction	-0.15
Enterprise Houston Ship Channel	-0.45
Texas City	-0.45
Seabrook	-0.45

Source: Argus Media Group., Morningstar.

Assessment Analysis

The Platts assessment is an outright waterborne price designed to compete head-to-head with Brent and is quite distinct from the U.S. domestic market. The quote plays into Platts' strength in the European market where it owns the waterborne physical Dated Brent Price Assessment that underlies the ICE Brent Crude Futures contract. This approach to AGS should appeal to European and Asian buyers because there's less exposure to geographic and logistic differences influencing the domestic U.S. market. That means the price spread to Brent should in theory just reflect freight differentials.

The more complex Argus assessment links U.S. domestic and waterborne pricing. Outright prices using their marker index represent both domestic and international factors. This approach should appeal to sellers looking for the best deal among domestic and international buyers. It should also appeal to buyers seeking a competitive outright price for surplus domestic crude being cleared into the export market. The Argus methodology plays to the company's strength in the Houston MEH market with the added bonus of widening the trade base to terminals throughout Houston, including Enterprise ECHO.

New assessments rely on market acceptance to succeed. The producer group behind AGS can provide liquidity to help gain market share but they are predominantly sellers, Ultimately U.S. crude buyers need to link their deals to AGS for it to succeed. For buyers to be comfortable linking to AGS it has to be credible and attract volume. These processes take time, so adoption won't be an overnight process. Traders will follow the new assessments closely to see how they track Brent and WTI prices at Cushing and in Houston. A critical element missing from the initial AGS concept is a related futures contract. Without it, buyers using AGS will be exposed to the basis risk between AGS and whatever hedging instrument they use instead–in this case most likely ICE Brent Crude Futures. If you're going to use Brent as a hedge, using a Brent assessment for the initial trade makes more sense.

There's a long way to go before AGS topples WTI Cushing from its dominant position in the U.S. crude market. In our upcoming analysis we'll look at the growing influence of the Gulf Coast region versus

Cushing in U.S. crude trading and how that factors into this debate. We'll also dig deeper into the options for an AGS futures contract.

About Morningstar® Commodities Research™

Morningstar Commodities Research provides independent, fundamental research differentiated by a consistent focus on the competitive dynamics in worldwide commodities markets. This joint effort between Morningstar's Research and Commodities & Energy groups leverages the expertise of Morningstar's 23 energy, utilities, basic materials, and commodities analysts as well as Morningstar's extensive data platform. Morningstar Commodities Research initially will focus on North American power and natural gas markets with plans to expand coverage of other markets worldwide.

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individuals, financial advisors, and institutions. Morningstar's Commodities & Energy group provides superior quality market data and analytical products for energy data management systems, financial and agricultural data management, historical analysis, trading, risk management, and forecasting.

For More Information

+1 800 546-9646 North America
+44 20 3194 1455 Europe
commoditydata-sales@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA

©2020 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use.

Investment research is produced and issued by subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with and governed by the U.S. Securities and Exchange Commission. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, call +1 312 696-6869.