COMMODITY STRATEGY RESEARCH

RBC Capital Markets

August 21, 2018

Oil Strategy: Nuances of the SPR Release

RBC Capital Markets, LLC
Michael Tran
Commodity Strategist
(212) 266-4020
michael.tran@rbccm.com

Helima Croft
Global Head of Commodity Strategy
(212) 618-7798
helima.croft@rbccm.com

Christopher Louney
Commodity Strategist
(212) 437-1925
christopher.louney@rbccm.com

Megan Schippmann
Associate Strategist
(212) 301-1531
megan.schippmann@rbccm.com

- **The offer to sell 11 mb from US strategic oil reserves is part of a larger congressional mandate. The timing of the release presents the façade that the President is helping to keep the economy humming with lower retail petrol prices, but prices typically trend lower heading into the fall anyway.**
- **This is not a publication rehashing the details of the release. Instead, we highlight three interesting nuances that caught our attention when poring through the official US Department of Energy Notice of Sale including the details around the delivery period, the pricing, and the potential SPR placement rate.**

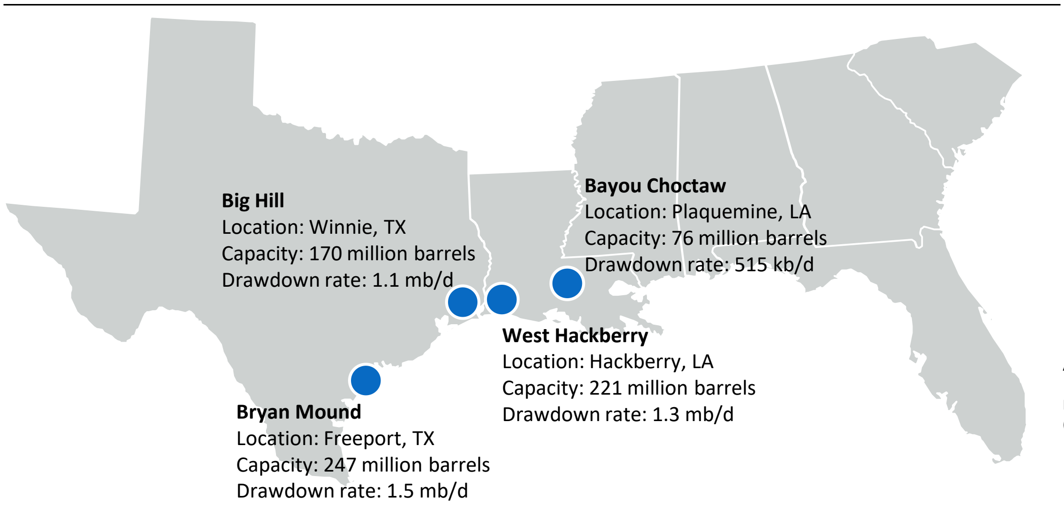
For further background, see "Implications of a US SPR Oil Release" (July 16, 2018).

The Strategy Behind a Strategic Release

Monday's announcement to offer a sale of 11 mb of sour crude from US strategic oil reserves is part of a larger congressional mandate, which collectively involves selling around 285 mb between 2017 through 2027, with most of the proceeds going toward different initiatives implemented through the US Treasury Department. This well-timed release will, at least optically, help President Trump appear to achieve his goal of lowering domestic gasoline prices. The truth is that retail gasoline prices always trend lower (see Figure 3) during the fall shoulder season, which also coincides with when domestic refiners head into seasonal maintenance. This means that the President can give off the impression of increased efforts to tackle high gasoline prices for his domestic base ahead of both US midterm elections and the ramp-up of Iranian sanctions come later this fall. With the SPR headline out of the way, at least for now, the market may view the headline as one less ambiguous Trump factor that has, to a certain degree, been de-risked. This means that the skittish market can revert to focusing on oil market fundamentals rather than administration-induced headlines.

To be clear, this is not a publication rehashing our expectations for how a release would play out in the market. For that review, click here. Instead, we highlight three interesting nuances that caught our attention when poring through the official US Department of Energy Notice of Sale.

Figure 1: US Strategic Petroleum Reserve Sites



Source: RBC Capital Markets, US Department of Energy

All values in USD unless otherwise noted.

Priced as of prior trading day's market close, ET (unless stated otherwise).

For Required Conflicts Disclosures, please see page 4.

Disseminated: August 21, 2018 00:15ET; Produced: August 20, 2018 23:00ET

1) Timing Is Everything

During emergencies, barrels can come to market in 13 days. During other times, requests for early delivery are encouraged…

The size and timing of SPR releases come at the discretion of the US government. Monday's announcement was met with little surprise given that many had anticipated such a headline to precede the upcoming US midterm elections. The timing of this SPR release presents the façade that the President is helping to keep the economy humming along by attempting to lower retail petrol prices. US refiners, currently running flat out at multi-decade highs, will be heading into maintenance season over the coming weeks, meaning that the physical churn into refined products will be lower, which brings into question the effectiveness of the release and whether the desired impact will be achieved.

…but the current notice of sale includes a clause emphasizing that early deliveries are not an option

With Labor Day around the corner, the end to summer driving season is quickly approaching, which is when retail fuel prices typically wane heading into the fall. The offers for purchase are due at 2 pm Central Time on August 28, but one nuance highlighted in the DOE's notice of sale was the pre-defined delivery period for the October to November time frame, which coincides with seasonal refinery turnarounds. Not only does this raise questions of whether refiners can absorb the barrels, but **a clause was included specifying that early deliveries will not be available**. This emphasizes a stark difference from the previous springtime SPR sale mandate, which highlighted that requests for early delivery ahead of the predetermined period of sale were encouraged and accommodated to the maximum extent possible. In this instance, the barrels are being held, puzzlingly enough until a time during which a high absorption rate is questionable. Typically, during emergencies, the four SPR facilities have the ability to deliver barrels to market 13 days following a US Presidential decision.

Figure 2: US Refinery Runs

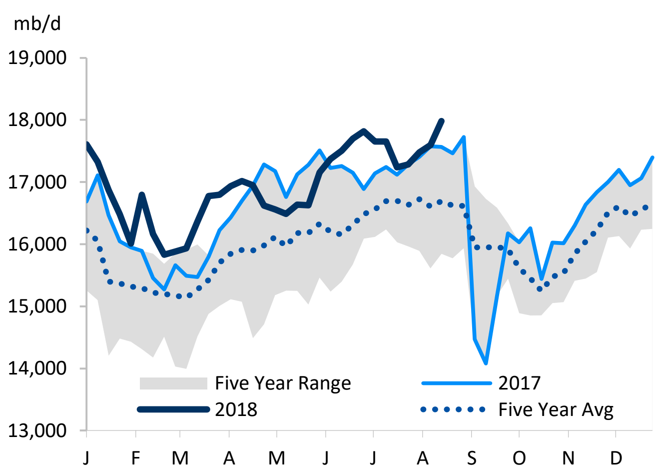
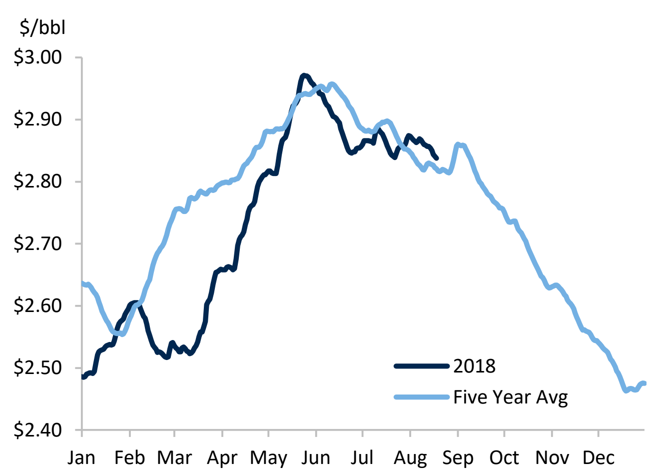


Figure 3: Daily US Average Gasoline Prices, Regular Unleaded



Source: RBC Capital Markets, EIA, American Automobile Association

2) No Sample Sale

The government will not be offering samples prior to delivery…recent sales have resulted in complaints due to contamination

The offer of 11 mb of sour crude will stem from three SPR facilities: Bryan Mound, West Hackberry, and Big Hill. While rare, there have been several reports of contaminated crude containing high levels of H2S sold from the reserve. Three recent and separate incidents have been linked to the Bryan Mound Storage facility, meaning that buyers of SPR barrels from that site would likely require further price concessions in order for interest to emerge given that contamination removal would have to take place before processing through refineries. The storage site, located in Freeport, TX, is also the nation's largest government storage facility with the quickest drawdown rate. **The government noted that samples are not available prior to delivery.** While past sales have often included similar stipulations, the recent contamination headlines from earlier this year may result in further markdowns beyond the typical discount associated with SPR sales to entice buyers.

3) Beware of Hung Deals

An inability to place the pre-announced 11 mb would suggest that the market is not short of barrels

During the release earlier this spring, the DOE offered to sell 7 mb barrels of crude from strategic reserves, but through the submission of offer process, only 5.2 mb were ultimately sold. Put another way, either a lower than anticipated amount of offers to purchase were deemed acceptable or there was simply a dearth of buyers. The crude quality (the barrels offered in the spring were light, sweet crudes compared to the current offer of light, sours) may have played a factor in the inability to sell the entire pre-announced float. A lower than fully subscribed deal this time around or the government's inability to fully place the announced 11 mb would punctuate a key message to the Trump administration that the market does not currently require additional barrels. While such a realization may not curtail the tweet storms about high oil prices, at a minimum it would potentially fortify a fundamental price floor once the market has spoken.

Required disclosures

Conflicts disclosures

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of the member companies of RBC Capital Markets and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets and its affiliates.

Conflicts policy

RBC Capital Markets Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on request. To access our current policy, clients should refer to https://www.rbccm.com/global/file-414164.pdf or send a request to RBC Capital Markets Research Publishing, P.O. Box 50, 200 Bay Street, Royal Bank Plaza, 29th Floor, South Tower, Toronto, Ontario M5J 2W7. We reserve the right to amend or supplement this policy at any time.

Dissemination of research and short-term trade ideas

RBC Capital Markets endeavors to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. RBC Capital Markets' equity research is posted to our proprietary website to ensure eligible clients receive coverage initiations and changes in ratings, targets and opinions in a timely manner. Additional distribution may be done by the sales personnel via email, fax, or other electronic means, or regular mail. Clients may also receive our research via third party vendors. RBC Capital Markets also provides eligible clients with access to SPARC on the Firm's proprietary INSIGHT website, via email and via third-party vendors. SPARC contains market color and commentary regarding subject companies on which the Firm currently provides equity research coverage. Research Analysts may, from time to time, include short-term trade ideas in research reports and / or in SPARC. A short-term trade idea offers a short-term view on how a security may trade, based on market and trading events, and the resulting trading opportunity that may be available. A short-term trade idea may differ from the price targets and recommendations in our published research reports reflecting the research analyst's views of the longer-term (one-year) prospects of the subject company, as a result of the differing time horizons, methodologies and/or other factors. Thus, it is possible that a subject company's common equity that is considered a long-term 'Sector Perform' or even an 'Underperform' might present a short-term buying opportunity as a result of temporary selling pressure in the market; conversely, a subject company's common equity rated a long-term 'Outperform' could be considered susceptible to a short-term downward price correction. Short-term trade ideas are not ratings, nor are they part of any ratings system, and the firm generally does not intend, nor undertakes any obligation, to maintain or update short-term trade ideas. Short-term trade ideas may not be suitable for all investors and have not been tailored to individual investor circumstances and objectives, and investors should make their own independent decisions regarding any securities or strategies discussed herein. Please contact your investment advisor or institutional salesperson for more information regarding RBC Capital Markets' research.

For a list of all recommendations on the company that were disseminated during the prior 12-month period, please click on the following link: https://rbcnew.bluematrix.com/sellside/MAR.action

The 12-month history of SPARCs can be viewed at https://www.rbcinsightresearch.com/

Analyst certification

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

Third-party-disclaimers

References herein to "LIBOR", "LIBO Rate", "L" or other LIBOR abbreviations means the London interbank offered rate as administered by ICE Benchmark Administration (or any other person that takes over the administration of such rate).

Disclaimer

RBC Capital Markets is the business name used by certain branches and subsidiaries of the Royal Bank of Canada, including RBC Dominion Securities Inc., RBC Capital Markets, LLC, RBC Europe Limited, Royal Bank of Canada, Hong Kong Branch and Royal Bank of Canada, Sydney Branch. The information contained in this report has been compiled by RBC Capital Markets from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Capital Markets, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC Capital Markets' judgement as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The investments or services contained in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about the suitability of such investments or services. This report is not an offer to sell or a solicitation of an offer to buy any securities. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. RBC Capital Markets research analyst compensation is based in part on the overall profitability of RBC Capital Markets, which includes profits attributable to investment banking revenues. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. RBC Capital Markets may be restricted from publishing research reports, from time to time, due to regulatory restrictions and/ or internal compliance policies. If this is the case, the latest published research reports available to clients may not reflect recent material changes in the applicable industry and/or applicable subject companies. RBC Capital Markets research reports are current only as of the date set forth on the research reports. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. To the full extent permitted by law neither RBC Capital Markets nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of RBC Capital Markets.

Additional information is available on request.

To U.S. Residents: This publication has been approved by RBC Capital Markets, LLC (member FINRA, NYSE, SIPC), which is a U.S. registered broker-dealer and which accepts responsibility for this report and its dissemination in the United States. Any U.S. recipient of this report that is not a registered broker-dealer or a bank acting in a broker or dealer capacity and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report, should contact and place orders with RBC Capital Markets, LLC.

To Canadian Residents: This publication has been approved by RBC Dominion Securities Inc. (member IIROC). Any Canadian recipient of this report that is not a Designated Institution in Ontario, an Accredited Investor in British Columbia or Alberta or a Sophisticated Purchaser in Quebec (or similar permitted purchaser in any other province) and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report should contact and place orders with RBC Dominion Securities Inc., which, without in any way limiting the foregoing, accepts responsibility for this report and its dissemination in Canada.

To U.K. Residents: This publication has been approved by RBC Europe Limited ('RBCEL'), which is authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority ('FCA') and the Prudential Regulation Authority, in connection with its distribution in the United Kingdom. This material is not for general distribution in the United Kingdom to retail clients, as defined under the rules of the FCA. RBCEL accepts responsibility for this report and its dissemination in the United Kingdom.

To German Residents: This material is distributed in Germany by RBC Europe Limited, Frankfurt Branch, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

To Persons Receiving This Advice in Australia: This material has been distributed in Australia by Royal Bank of Canada - Sydney Branch (ABN 86 076 940 880, AFSL No. 246521). This material has been prepared for general circulation and does not take into account the objectives, financial situation or needs of any recipient. Accordingly, any recipient should, before acting on this material, consider the appropriateness of this material having regard to their objectives, financial situation and needs. If this material relates to the acquisition or possible acquisition of a particular financial product, a recipient in Australia should obtain any relevant disclosure document prepared in respect of that product and consider that document before making any decision about whether to acquire the product. This research report is not for retail investors as defined in section 761G of the Corporations Act.

To Hong Kong Residents: This publication is distributed in Hong Kong by Royal Bank of Canada, Hong Kong Branch, which is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission ('SFC'), RBC Investment Services (Asia) Limited and RBC Investment Management (Asia) Limited, both entities are regulated by the SFC. Financial Services provided to Australia: Financial services may be provided in Australia in accordance with applicable law. Financial services provided by the Royal Bank of Canada, Hong Kong Branch are provided pursuant to the Royal Bank of Canada's Australian Financial Services Licence ('AFSL') (No. 246521).

To Singapore Residents: This publication is distributed in Singapore by the Royal Bank of Canada, Singapore Branch, a registered entity licensed by the Monetary Authority of Singapore. This material has been prepared for general circulation and does not take into account the objectives, financial situation, or needs of any recipient. You are advised to seek independent advice from a financial adviser before purchasing any product. If you do not obtain independent advice, you should consider whether the product is suitable for you. Past performance is not indicative of future performance. If you have any questions related to this publication, please contact the Royal Bank of Canada, Singapore Branch. Royal Bank of Canada, Singapore Branch accepts responsibility for this report and its dissemination in Singapore.

To Japanese Residents: Unless otherwise exempted by Japanese law, this publication is distributed in Japan by or through RBC Capital Markets (Japan) Ltd. which is a Financial Instruments Firm registered with the Kanto Local Financial Bureau (Registered number 203) and a member of the Japan Securities Dealers Association ("JSDA").

Global Macro, Economics & Rates Strategy Research Team

Europe

RBC Europe Limited:

Vatsala Datta	UK Rates Strategist	+44 20 7029 0184	vatsala.datta@rbccm.com
Cathal Kennedy	European Economist	+44 20 7029 0133	cathal.kennedy@rbccm.com
Peter Schaffrik	Global Macro Strategist	+44 20 7029 7076	peter.schaffrik@rbccm.com

Asia-Pacific

Royal Bank of Canada – Sydney Branch:

Su-Lin Ong	Head of Australian and New Zealand FIC Strategy	+612-9033-3088	su-lin.ong@rbccm.com
Robert Thompson	Macro Rates Strategist	+612 9033 3088	robert.thompson@rbccm.com

North America

RBC Dominion Securities Inc.:

Mark Chandler	Head of Canadian Rates Strategy	(416) 842-6388	mark.chandler@rbccm.com
Simon Deeley	Rates Strategist	(416) 842-6362	simon.deeley@rbccm.com

RBC Capital Markets, LLC:

Michael Cloherty	Head of US Rates Strategy	(212) 437-2480	michael.cloherty@rbccm.com
Jacob Oubina	Senior US Economist	(212) 618-7795	jacob.oubina@rbccm.com
Tom Porcelli	Chief US Economist	(212) 618-7788	tom.porcelli@rbccm.com

Commodities Strategy Research Team

North America

RBC Capital Markets, LLC:

Helima Croft	Global Head of Commodity Strategy	(212) 618-7798	helima.croft@rbccm.com
Christopher Louney	Commodity Strategist	(212) 437-1925	christopher.louney@rbccm.com
Michael Tran	Commodity Strategist	(212) 266-4020	michael.tran@rbccm.com
Megan Schippmann	Associate	(212) 301-1531	megan.schippmann@rbccm.com