Refiners Good…For Now

Oil industry veterans can recall many cycles where refiners were loved and unloved, not necessarily in that order. The end of 1970s-era price controls and what were known as "entitlements" led to the closure of many small refineries in the early 1980s and the passage of the Clean Air Act Amendments led to another wave of closures in the early 1990s. By the mid-2000's, refining capacity was a classic scarce asset and refiners such as Valero, Sunoco and Tesoro became stock market stars.

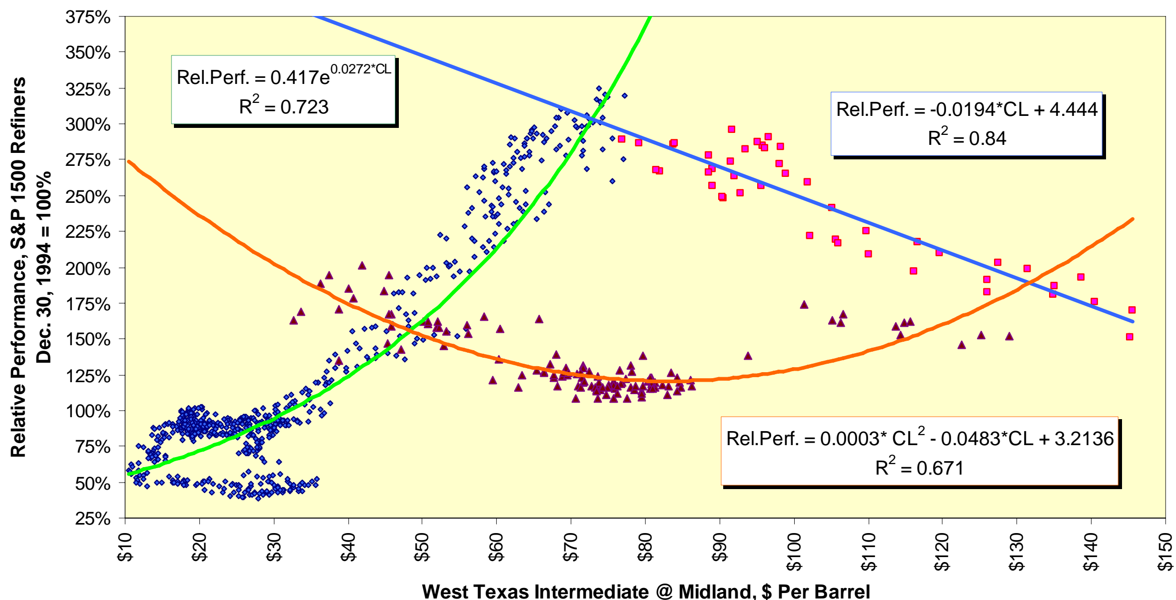
That boom ended as all booms do, and by late 2007 the entire sector was in a retreat. The surge higher in crude oil prices between August 2007 and July 2008 led to a slowdown in demand for refined products, and the ensuing recession certainly did not help matters much. That refineries can struggle always surprises many lay people as gasoline, the product with which they are most familiar, is bought and not sold. What is a product that is sold and not bought, you ask? Life insurance is a classic example.

Neither New Nor Normal

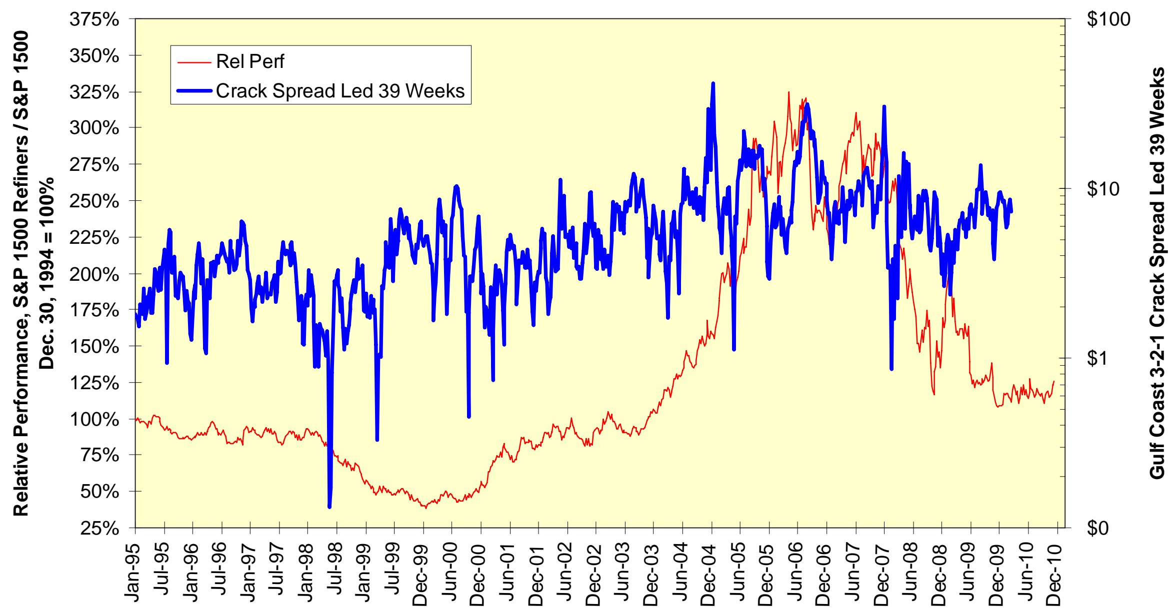
Let's illustrate the nature of refining stocks by mapping the relative total returns for the S&P 1500 refining index, which includes Frontier Oil, Holly Corporation and World Fuel Services along with the trio mentioned above to the S&P 1500 Supercomposite itself as a function of West Texas Intermediate at Midland, Texas. I chose Midland instead of the Cushing, Oklahoma, basis for the futures contract as WTI from Midland can supply U.S. Gulf Coast refineries.

The relationship from 1995 through August 2007 was an exponential one reflecting the then-prevailing scarcity nature of refining. It then shifted into a negative relationship into the July 2008 peak and is now in a quadratic relationship, marked below with the orange curve. We should expect refiners' relative performance to improve at both higher and lower prices for crude oil.

Refiners' Performance As A Function Of Crude Oil Changed Twice After August 2007



The lackluster nature of refiners' relative performance has been reflected to a large extent in refining margins or "crack spreads." The relative performance of refining stocks leads the 3/2/1 crack spread (three barrels of crude oil into two of gasoline and one of heating oil) at the U.S. Gulf Coast by 39 weeks on average, consistent with the six-to-nine month lead-time often associated with equities. At present, the refiners' relative performance is signaling flat crack spread, somewhere between $7-9 per barrel, well into 2011.



As much of the global demand for refined products is occurring outside of the U.S., domestic refiners are faced with global competitors who can bid the price of crude oil higher. In addition, the continued use of crude oil in contango storage as a financial asset is keeping the cost of crude oil higher than it would be otherwise. Refiners may wish for that lower crude oil price scenario, but wishing for anything never seems to work, does it?

Despite a burst of recent good performance by the sector and by all resource-related stocks following the global money-printing extravaganza, the refining sector is unlikely to revisit its glory days anytime soon. Like everything else associated with the oil business, that is nothing new.