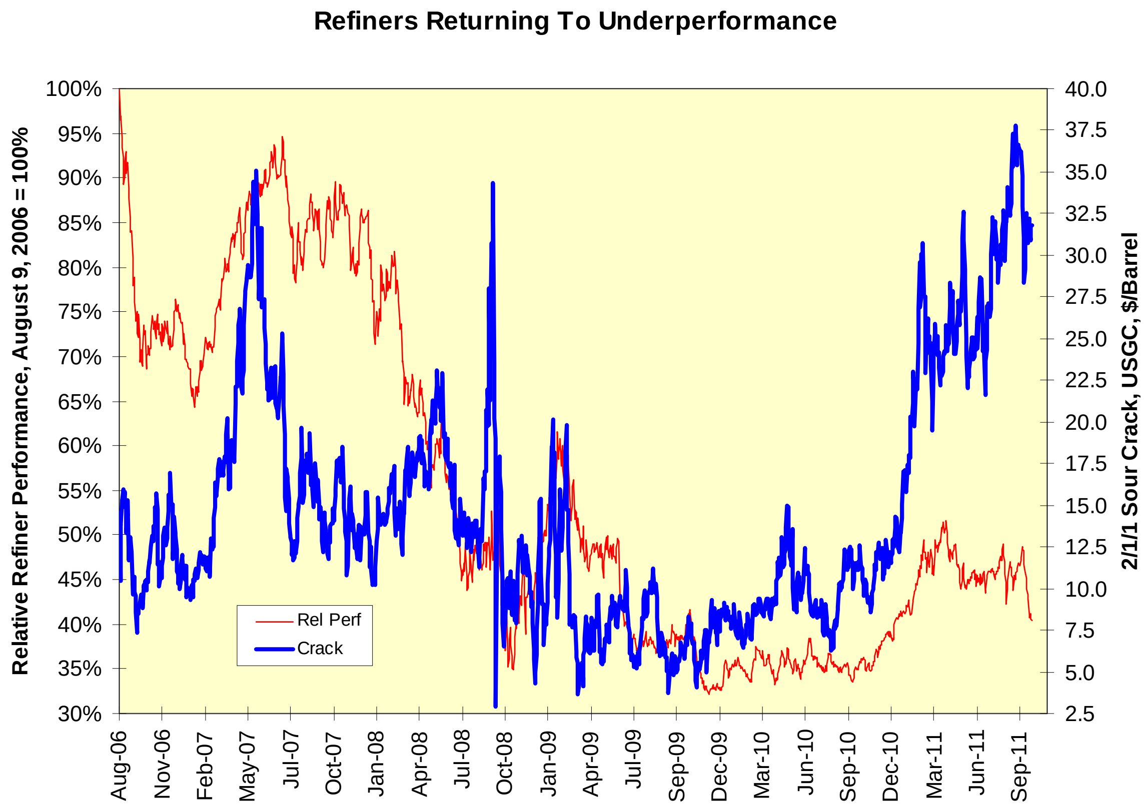
Refining Spreads Never Got Back To Normal

A key to planning is being mutually exclusive and collectively exhaustive in assessing potential outcomes. Mother Nature and Mister Market occasionally combine to produce figurative illegitimate offspring in the form of low-probability and high-impact events so persistent we have to change our assessment as to what is normal and what is unusual.

In the case of petroleum industry spreads, last discussed here in February, abnormal is becoming the new normal, as if we did not have enough new normality floating about in our lives. Much of the attention has been focused on the spread between North Sea Brent Blend and West Texas Intermediate (WTI) at Cushing, Oklahoma, but that is somewhat uninteresting after a point: WTI will remain at a discount until a pipeline moving from Oklahoma south to the Gulf Coast (USGC) is completed; for now, the discount simply rewards mid-continent refiners who have access to these supplies.

Of greater interest is the refining margin at the USGC for high-sulfur or "sour" crude oil. It has ballooned from what had been an aberrant \$26.20 per barrel to \$30.80 per barrel. It was this rising refining margin that pulled the relative performance of the S&P 1500 refining group higher last winter. That group includes Valero, Sunoco and Tesoro along with Frontier Oil, Holly Corporation and World Fuel Services.

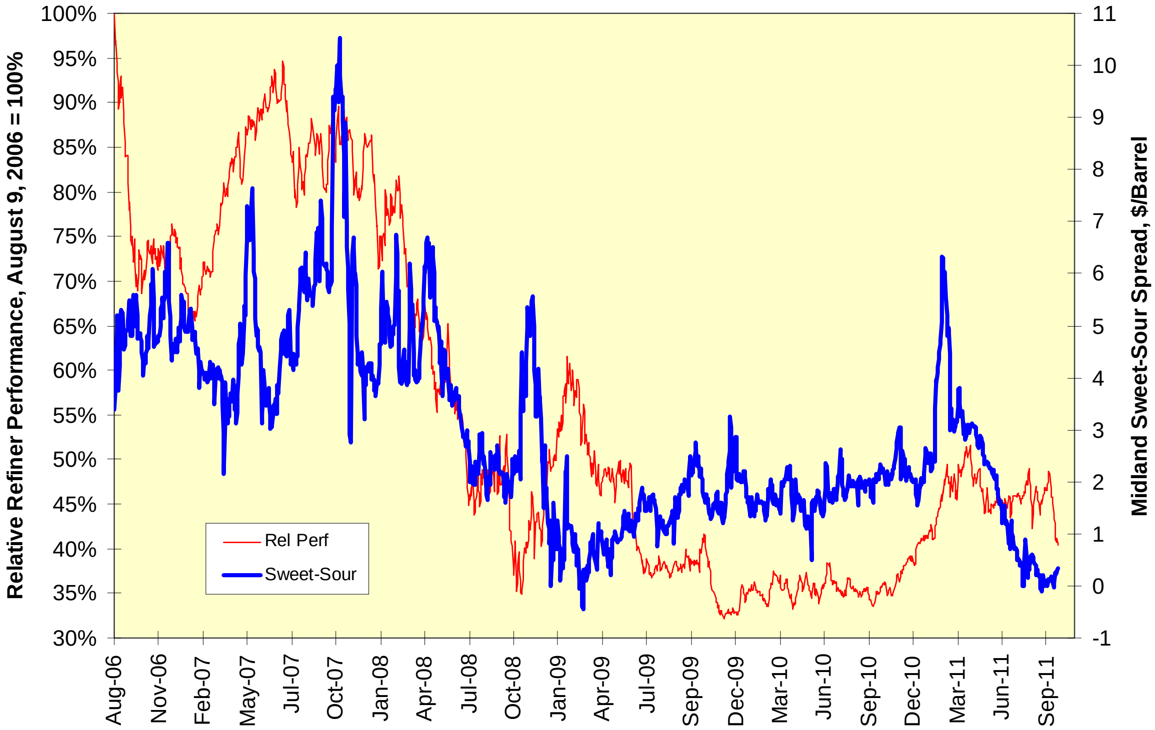
Relative performance for this group peaked in April and has been declining as lower refining margins elsewhere, particularly on the U.S. East Coast (USEC) are reduced. USEC refineries cannot access WTI and cannot bid competitively for incremental crude oil cargoes in the Atlantic Basin priced off of Brent Blend.



The Sour Smell Of Non-Success

The spread between low-sulfur or "sweet" crude oil is a good barometer of marginal demand in the refining sector. As demand rises, the lower-efficiency units added to the processing stream generally require sweet crude oil. This spread has collapsed down to historically low levels, signaling the refining system has excess capacity. A previous long-term downturn in the sweet-sour spread between 2007 and 2009 coincided with a period of underperformance by the refining group.

Narrowing Sweet-Sour Spread Not Supportive For Refiners



The solution for any industry plagued by excess capacity is simple and Darwinian: You mothball the excess capacity. This is underway in the USEC refining space already. At some point the pendulum will swing back and refineries will be a scarce asset once again. For now, it is simply one other industry in trouble.