

Refiners In A Sweet Spot

If you ever get a chance to visit a refinery, do so. I will assure you of one thing, and that is you will depart the premises wondering how these things ever stay intact. Say “hot hydrocarbons under pressure” to yourself over and over to enhance the experience. Consider there are 206 refineries in North America and 43 of them have some form of unplanned outage at the time of this writing including three whose stint on the DL is ascribed to “explosion/fire.”

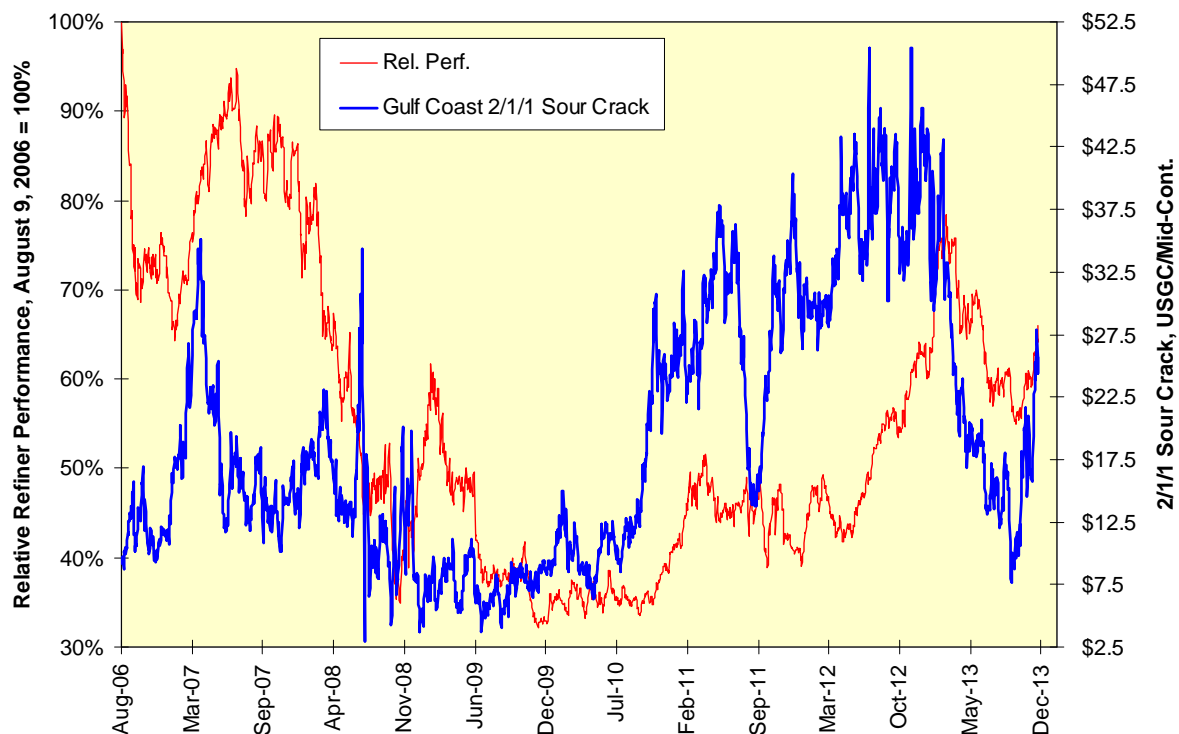
This is somewhat different than the imbalance seen for farmers. If a drought hits, say, the Western corn belt, prices rise but only a few farmers can take advantage of it as their crops have wilted, too. If a refiner’s neighbor starts putting on a fireworks show; well, let’s just say one firm’s unplanned outage is another firm’s unplanned price-boost.

Strong Recent Performance

The S&P Refiners group, home to Valero (VLO), Tesoro (TSO), Phillips 66 (PSX) and Marathon (MPC), has had some long periods of out- and underperformance in recent years. They were taking it on the chin vis-à-vis the broad market between March and September 2013 as crude oil acquisition costs rose and as gasoline demand was slack.

The higher crude oil feedstock costs led refiners to draw down inventories and postpone incremental purchases of crude oil; this process led first to backwardation in the crude oil forward curve and then to a narrowing of the spread between Brent and West Texas Intermediate crude oil. By September, the whole process started to reverse as rising distillate fuel oil exports led to expanded refining margins from the revenue side and as increased availability of shale oil from Texas’ Eagle Ford formation expanded margins from the cost side. Relative performance reversed and has advanced by 19.9% since September 23, 2013. This is in a mature industry, not some high-tech gizmo that will be here today and gone tomorrow.

Refiners Rising With Margin Expansion



Those rising exports of distillate, a category inclusive of heating oil, diesel fuel and jet kerosene are an interesting phenomenon themselves. The U.S. has been willing, by law, to be very restrictive of crude oil exports on the indefensible grounds such a move would benefit U.S. consumers. This logic led to Alaska North Slope crude oil being shipped to West Coast refineries when it could have been shipped more economically after the costs of retrofitting for the highly naphthenic crude oil were taken into account. Similar and equally foolish arguments have

been made with respect to natural gas exports; one might think few in Congress are familiar with the 18th Century principles of comparative advantage in trade.

Refiners can add value to crude oil and then export these products. This does not work as well for less-fungible gasoline, though. The net effect is higher refinery utilization rates than would exist with slow U.S. demand growth, gasoline production as a credit to the export of distillates and downward pressure on gasoline prices for the U.S. motorist. Refiners are capturing the economic rent of increased U.S. crude oil production and are aiding the U.S. trade balance as a positive externality. Not bad for a day's work, is it?