

If You Can't Beat Them, Don't Join Them, Either

Live long enough, and look what happens: Bell-bottoms are back in style, *Shaft* has been remade, and politicians are blaming something called Big Oil for all sorts of nefarious deeds. At least we have some hope for the clothes and the movies.

Our task is not to sit in the mud, weep, and point fingers. That's for non-investors. If refiners now have pricing power, and they do in the current market, maybe we can take advantage of this situation and seek successful investment opportunities based thereon. After all, a single decent stock trade can outweigh your higher fill-up costs in a hurry.

That's the wonderful thing about the stock market: We all have the opportunity to get our share of those excess profits. Whether we should want to in this instance, however, is debatable.

Gross refining margins, or "crack spreads," are the difference between the cost of crude oil and the price of the refined products. Crack spreads are affected by many factors, including seasonal swings in demand between gasoline and heating oil, the forward curves of both the crude oil and refined products markets, (see "Backwardation in Oil Stocks Rewards Patience," March 8, 2000) and refineries' capacity utilization rates. Like most industrial process spreads, these margins have stayed within general bounds for years.

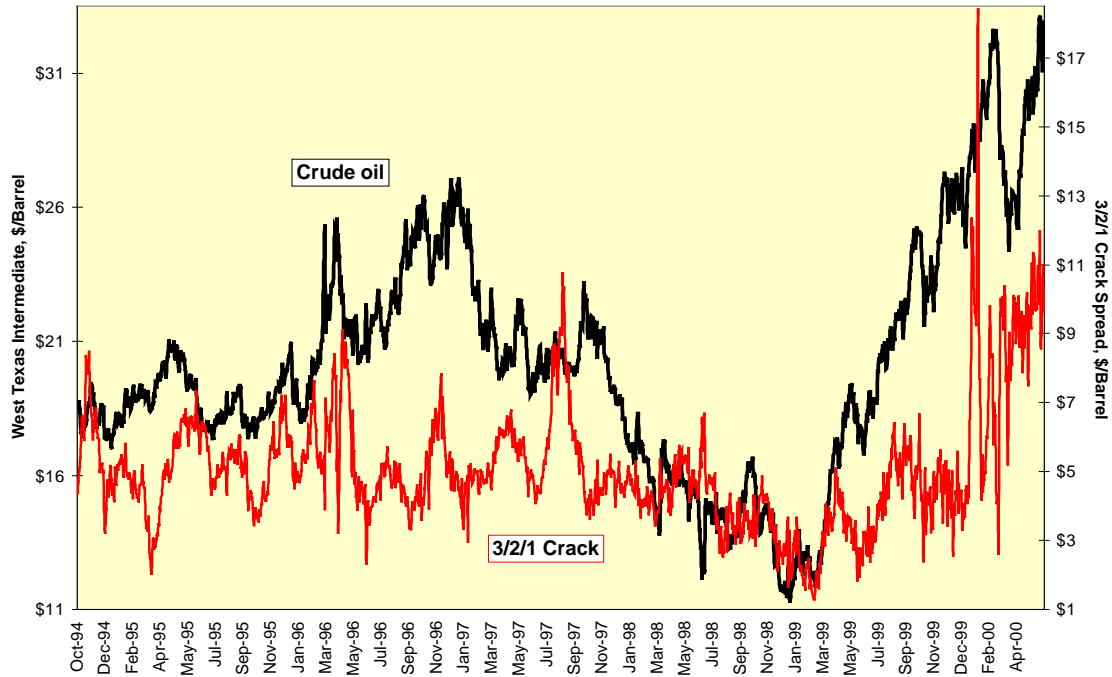
Net refining margins present a much more complex problem. Refineries are huge natural gas consumers; the first step in refining is heating a stream of crude oil to about 900° in a vacuum tower, so the recent doubling of natural gas prices has been an unpleasant surprise. As refiners strain at utilization rates over 95% to produce more gasoline in response to the current high prices, their operating efficiencies start to decline, and they also produce more of the products not in high demand.

Think: Do You Run Better On Ethanol?

The crude oil being pumped out of the ground is the same stuff it was twenty years ago. Refined products other than gasoline have improved gradually over time. Gasoline, however, has undergone radical changes in its mixture. In the aftermath of the Clean Air Act, gasoline had to be reformulated to include a greater degree of oxygen; this has been accomplished by adding chemicals such as MTBE (methyl tertiary butyl ether, as long as you're asking) or ethanol. The difficulties involved with ethanol transport and blending are considerable, and are one reason behind the extraordinary retail gasoline prices in the Midwest.

These mandated changes in gasoline have complicated statistical analyses of past crack spreads, but the government never had much use for financial writers, anyway. Traditionally, crack spreads expanded when crude oil costs were weak and contracted when crude oil costs were high; this risk was offset in part by vertical integration in the oil industry between crude oil producers and refiners. This inverse relationship has not held well in recent years. The present combination of high crude oil prices and soaring gross refining margins is quite unusual. The "3/2/1" crack spread -- three barrels of crude oil against two barrels of gasoline and one of heating oil -- seldom rose over \$8 per barrel. It has been hovering near \$10 per barrel for months.

Refining Margins With Reformulated Gasoline

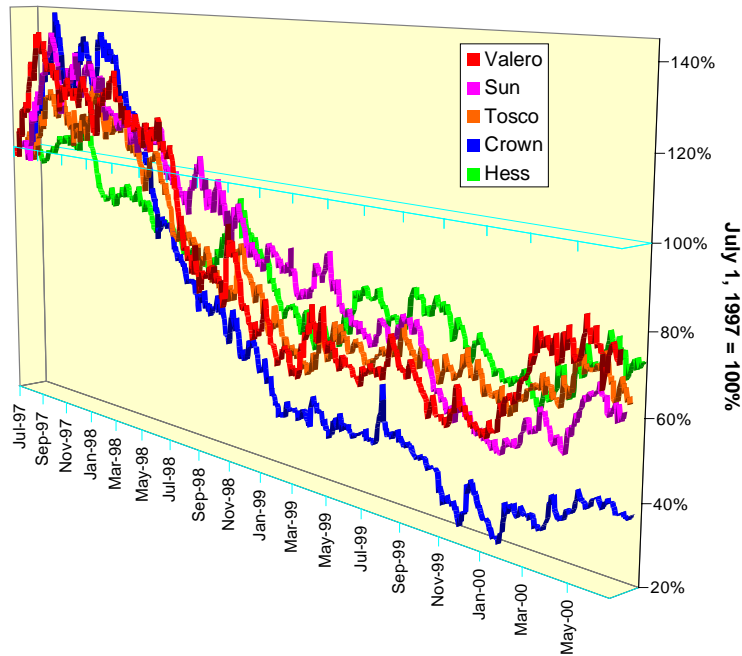


Where Are The Stock Gains?

Several factors are behind this high price/margin combination, including strong demand produced by global economic recovery and OPEC production discipline. The experiences of the 1970s and early 1980s showed petroleum supply and demand to be very price-inelastic in the short-term, but significantly elastic in the long term. In other words, producers and refiners may have the advantage now, but the higher prices will stimulate conservation and new efficiencies on the demand side and new reserves on the supply side. After all, if those monsters of Big Oil could charge whatever they wanted whenever they felt like it, how come so many of them have been merged out of existence since the early 1980s?

The stock market is not being fooled by the current high refining margins. A sampling of five domestic refining companies over the past three years indicates this sector has been underperforming the S&P 500 since the spring of 1998. The recent surge in margins has pushed the group's relative performance off its lows, but nothing major.

Relative Performance Of Domestic Refiners To S&P 500



Markets are discounting mechanisms; we pay for future earnings. We see little to suggest the current surge in gross refining margins was anticipated in the recent past, nor do we see a great deal of optimism about the future. In other words, the higher gross margins may not translate into significantly higher earnings, and if they do, the duration of these higher earnings won't be very long.

This describes the experience of the early 1980s. High prices and earnings led to a huge downturn in demand growth, a large increase in operating expenses and questionable capital investments in the industry, and a subsequent collapse in prices that led, the interruption of the Persian Gulf War aside, to nearly two decades of declining real prices. The beleaguered oil industry underwent massive consolidation as household names such as Gulf, Conoco, Marathon, Amoco, Sohio, Arco, and Getty all disappeared. Even Exxon and Mobil had to merge, and Chevron and Texaco came very close to tying the knot.

Should you hedge your gasoline bills with refining stocks? Don't bother.