May 28, 2020

US Domestic Fundamentals Struggle to Return to Normalcy and Could Structurally Hurt Refiners

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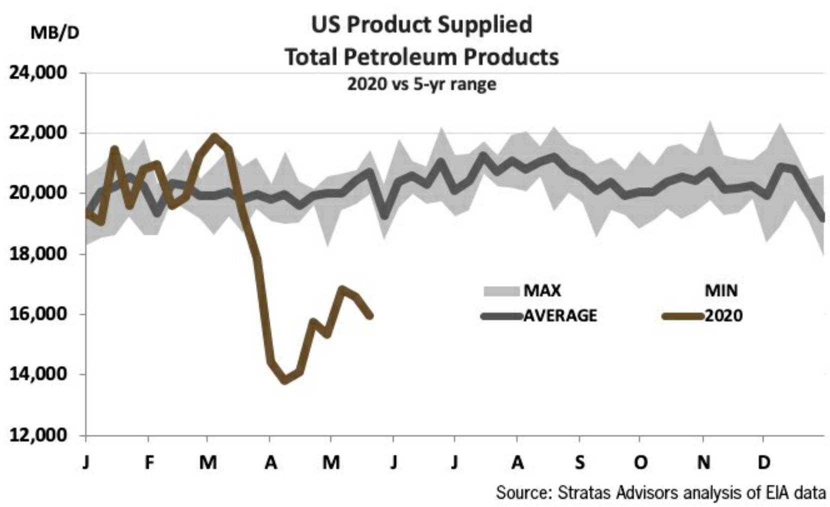
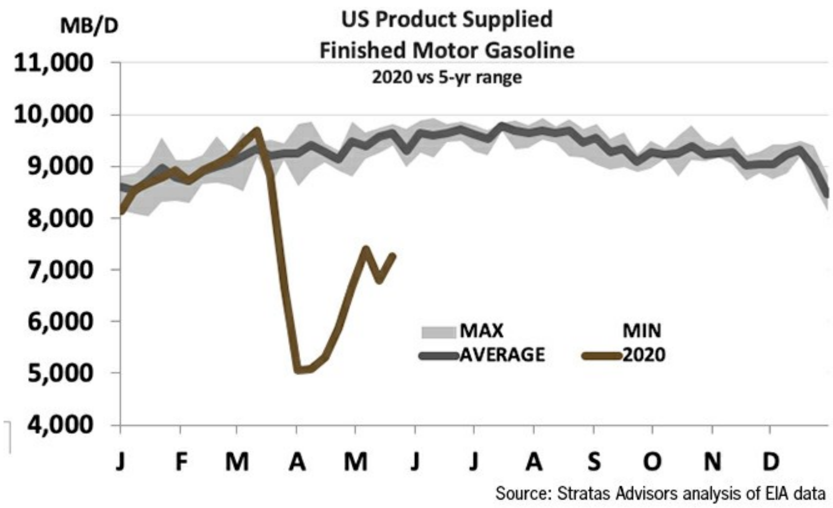
Crude production decreased for the 11th consecutive week in the US, bringing total lost production to 1.7 million B/D – and is a factor that provides strength to crude prices. However, this is about the only variable across the US oil spectrum that has responded linearly. It is an important factor indeed, as crude production and stocks impacted WTI pricing, and has been the biggest concern for global markets for the last several weeks.

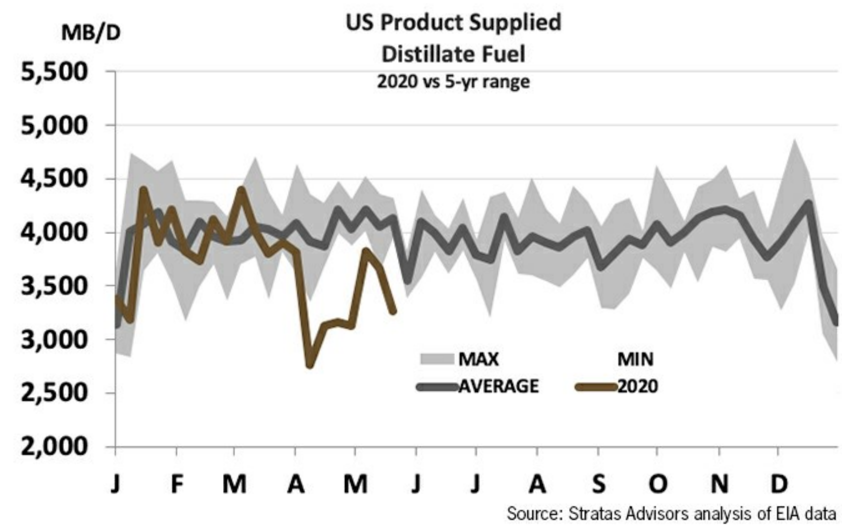
The attention will now necessarily shift to product balances and the linkages between consumption, stocks and refinery runs, and this is where the challenge not only lingers, but is threatening to have a structural impact the US refining industry in a way that could force capacity rationalization – the longer it takes for demand to rebound.

US Total product supplied was down by -4% last week, and diesel was down by a whopping 11%. The decline occurred in a week in which many of the states returning to some degree of normal activities, so consumption for motor fuels was expected to hold, or at least not to drop to such levels.



Gasoline consumption increased by 7%, but considering that gasoline consumption was hit the most during the peak of the pandemic, this recovery is consistent with expectations for last week.

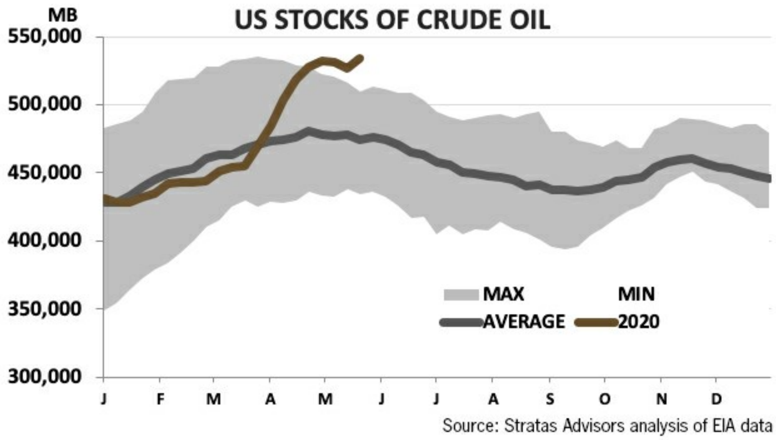




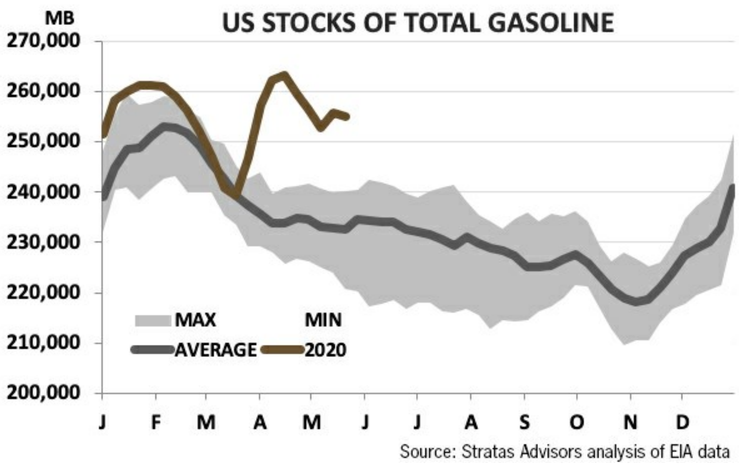
As can be seen from the above charts, distillates consumption is closer to the 5-year range, whereas gasoline consumption still has room to recover. But more importantly, as demand picks up in some areas and new waves of infections hinder demand in other areas, the consumption side of the oil balance is poised to be a bouncing target for a while – and the resulting supply chain challenges will impact refinery distribution and ultimately refinery margins.

Consumption recovery is not expected to be a one-way road, as has been the case with decline in crude production, but instead, will be a tumbling convergence that will respond to regional social distancing, prices, weather, seasonality, travel restrictions – and the trajectory of the economic activity. The largest impact of all this is seen in product stocks, as can be seen in the next section.

US crude stocks increased by only 2%, but, in a wider perspective, the level is just 5% higher than the 5-year average. Lower crude production, along with reduced refinery runs have kept crude stocks close to the normal levels.



Gasoline stocks did not move from the week prior but compared to the 5-yr average, they are still way higher. The same is true for diesel, and in both cases stocks have continued to rise for over 10 straight-weeks, despite refinery runs being reduced at moments.



This clearly lays out the biggest challenge for the US industry today: if product consumption remains lower than normal due to restricted activities for the next few months, then refinery runs will need to decrease significantly in order to prevent high stocks levels. But this is not a linear challenge because gasoline and diesel consumption were not hit in the same proportion by the COVID-crises, and gasoline follows a seasonal pattern whereas diesel is driven more by economic activity, trade and agriculture cycles.

As long as product stocks are not reduced, their prices will not be able to increase in proportion to crude and therefore refining margins will be structurally low. In this scenario, refiners with enough operational flexibility (i.e. deep conversion capabilities along with sizeable hydrocracking capacity) will have the upper hand, and those refiners with lower conversion capabilities or FCC-Reforming configurations will be forced to minimize runs.

In many states the relaxation of stay-at-home orders will mean some degree of normalcy for the residents, but for oil markets there is plenty of road to cover prior to the industry moving back to normal operations.