The 2016 U.S. refining market proved to be a very challenging environment, as evidenced by refining margins roughly half of their 2015 levels. A few independent refiners experienced losses in 2016. Demand for refined products, specifically gasoline and diesel, remained generally flat over 2015 levels, nor did the U.S. see an overly strong summer driving season.

The supply side of the downstream market was the root of refiners’ challenges in 2016 as the availability of advantaged Bakken, Canadian and shale crude gave refiners the misplaced incentive to produce. Utilization rates remained well over 90%, effectively at full capacity. However, without increased demand the markets saw a dramatic increase in gasoline stocks through the first half of the year.

Refiners received a bit of a market reprieve with the Colonial Pipeline outage in September, impacting about 1.3 MMbbl/d of product supply into PADD (Petroleum Administration for Defense District) I (U.S. East Coast). So while overall gasoline stocks are still above expected levels, inventories in PADDs I and III (U.S. Gulf Coast) did drop in the third quarter as the market sought any way possible to bring supply into the East Coast markets.

Vertically integrated downstream companies—those with marketing channels, as well as midstream operations—fared better in 2016 than the pure-play merchant refiner selling at the rack. Marketers saw strong margin uplift through their branded channels and midstream operations provided ratable income.

Renewable Identification Numbers (RINs) continue to be a lightning rod for the industry as estimated costs for the refining industry are $1.8 billion, making Renewable Fuels Standard (RFS) compliance the largest operating expense for refiners. And, given the margin pressure in 2016, refiners not fully RFS-compliant will be stressed to meet compliance deadlines.

2017: Where is the U.S. refining cycle?
Absent the refined product inventory drawdown experienced in the fall of 2016, U.S. refiners would clearly be looking at a very tight market highlighted by stressed margins. The product export market could absorb some of the excess inventories, but with reduced demand in Asia, uncertainty with Europe and potential departures from the EU post-Brexit, it is not expected that product demand will rise.

Irrespective of inventory levels going into 2017 there are several themes emerging around the 2017 U.S. refining market.

Intensified focus on cost reduction
Refiners relentlessly manage capex and opex spending, and 2017 will be no different. Companies will seek to do “less with more” and many will expand the use of outsourcing of non-core functions, including in some cases portions of their commercial activities (i.e., middle office, risk, etc.). While not early adopters of technology, refiners have been adept at leveraging information systems to streamline their business functions and optimize headcount where possible.

Should an extended low refining margin cycle persist some refiners would be best served at utilizing zero-based budgeting to right size their organizations to be leaner. Low-hanging fruit in organizations’ general and administrative budgets tends to suffer annual 5% to 10% or more reductions, but many downstream organizations would do well to start from a zero-basis and build to a minimum needed to run the business.
RFS, RINs’ impact on margins

Without changes to the existing RINs markets, namely sensible mandates and increased transparency of the RINs market itself, U.S. refiners will continue to be short-squeezed. Higher blending mandates proposed by the federal government for 2017 will result in higher RIN prices next year. The federal government proposes to increase the 2017 mandate compared to 2016. The higher mandate makes it more difficult for blenders to comply, requiring them to use RINs from prior years, putting upward pressure on prices.

Value chain integration

With the advent and rapid growth of several independent refiners (i.e., Tesoro, HollyFrontier, PBF Energy and Delek) over the last five to 10 years, most now find themselves with a far more geographically diverse asset base to manage and optimize. Many have leveraged MLP structures to drop down midstream operations, including truck racks, rail facilities and even individual refinery processing units. Nearly all have invested significant money and efforts to establish an IT platform to support commercial and accounting activities.

With more diverse assets and markets to serve these downstream organizations have far more commercial optionality. Optimizing crude sourcing, storage “plays” and even logistics alternatives all create opportunities to drive greater shareholder value. Enabling these opportunities will require downstream organizations to foster cross-functional collaboration and decision-making, supported by a shared view of current and forward markets, prices and production capabilities.

Value chain integration may mean downstream or upstream. On the downstream side, companies such as Tesoro will likely continue to invest in their marketing channels, which so far has resulted in stronger margin uplift.

Moving upstream may afford downstream organizations the option to become non-operating interest holders in selected oil producing assets, which comprise a portion of its ratable crude slate. With E&P asset valuations still at historic lows, and many E&P companies themselves on the brink of bankruptcy, this continued stressed oil market may present a buying opportunity for a subset of the refining market.

Expanded trading capabilities

The U.S. downstream market is characterized by a wide range of supply and trading capabilities; in one sense are organizations that are essentially supply functions with trading personnel “procuring” crude for their refineries, and in another are more robust asset-backed trading houses with an ability to take positions in multiple commodities while still serving its refining needs.

In an attempt to grow earnings in a depressed downstream cycle some organizations will look to expand their supply functions into conducting more asset-backed trading. This obviously creates capital requirements on those organizations along with an increased need for commodity and financial risk management, controls and governance.

Continued M&A in downstream

Expect the U.S. refining market to see continued divestment of non-core downstream assets by the majors in 2017 with several sites having been on the market for years now. Bid-ask spreads remain wide for selected assets and new entrants to the refining space present sellers with new options. Of particular note will be a continued press by international players to enter the U.S. downstream market through refining opportunities or through more traditional marketing channels.

Refiners are accustomed to the margin cycles and how production rates and inventories impact markets. The “golden era” of independent refiners may be waning, but opportunities to build and operate commercially successful downstream businesses is alive and well. The key is to operate efficiently, exploit vertical integration options and leverage scale when possible.

Matt Flanagan is a partner with Opportune LLP in Houston. Flanagan’s primary focus areas include mergers and acquisitions, energy trading and risk management, supply chain optimization and business transformation initiatives.