

FUEL PRICES OUT OF CONTROL!

Blame oil companies, the US, India, China and definitely governments

Today's fuel pump prices are the highest in Canadian history but not necessarily or solely because of greed on the part of the oil companies ... although there is certainly some truth in that view. Oil companies are businesses and are out to make a profit. However, a significant portion of the high prices of today can be laid directly to governments and environmental agencies on both sides of the border: They do not set rules that permit oil companies to plan ahead in many cases and the shortage of refining capacity is one example of what happens when governments are not responsive.

High refining margins or crack spreads (the difference between the cost of crude and the wholesale price) are at the heart of today's pump prices. So the question is: Why are these margins so high?

A key reason is that there is no excess refining capacity anywhere in North America and, worse, there are no approved plans for construction of a new facility in either Canada or the US. If demand is steadily increasing, why don't we have any new refinery construction? The answer is simple and this is where other factors come in: Governments are constantly changing the rules, i.e. the specifications for motor fuels in terms of things such as sulphur content, etc. In addition, environmental interests such as the EPA in the US are continually lowering the permitted emission levels for a refinery operation.

There is no quick solution: If an oil company decided to build a new refinery and chose a site, the cost would be about \$7 billion and would not produce a drop of fuel for nearly ten years ... (that is the rough cost for a 400,000 barrel per day production facility, one that is considered moderate in size). It is easy to understand the oil industry's reluctance to invest this amount of money when there is no guarantee from governments on what their future plans are for fuel specifications, emission standards and the like. And what is specified for today may not be the same next week, month or in the years following.

The ineptitude of governments can be seen in the following example: Petrocan chose to close its 80,000 barrel per day refinery in Oakville, Ontario in April of 2005 because Petrocan didn't want to spend the \$300 million necessary to update the facility to meet new gasoline emissions standards. So instead of our government offering incentives, they showed no flexibility, sat foolishly by and Petrocan is currently shipping the refinery to Pakistan one bolt at a time. If this refinery were still in operation at the time of the fire at ESSO's Nanticoke refinery in February of this year, the month long supply outages and the resultant high pump prices would not have occurred, or at least not to the extent that they did.

At the same time it's important to recognize that pump prices in Canada are not home-grown – they're driven by US-based pricing indicators. The key benchmark today is the US inventory of gasoline which is now 15 million barrels below where it was this time last year. Another indicator is operating level of the refineries. They are currently running at about 89% where normally they would be at 95% this time of year in order to stockpile supply for the driving season which starts in just two weeks. So we have a situation where storage supply is below the five-year average and refineries are having problems topping up the tanks.

Early spring is the normal time for refineries to shut down for maintenance and for the past ten years the supply slack has been taken up with imports of gasoline from Europe. This hasn't happened this year and is one key reason we're in such a supply crunch. Gasoline is not a straightforward product to produce: It has to be blended with many other components to meet government fuel specifications. One of the most important blending components for octane enhancement is naphtha ... which is also used extensively in the petrochemical industry ... and that is part of the problem. The exponential growth of the petrochemical industry in China and India has resulted in naphtha being redirected from gasoline to the petrochemical industry. As a result, European exports of gasoline to the US to date are down by 14 million barrels which accounts for almost the entire 15 million barrel gasoline inventory drop we see in the US today.

So we have a situation where we have low inventories, low refinery operation levels and low imports from Europe. On the other side, we have gasoline demands that are running about 2% higher than last year. The net result is an increase in prices in the US wholesale market. This in turn affects the price we pay at the pump in Canada because under NAFTA, if the US wholesale prices are higher, the Canadian oil companies can merely export the product to the US unless they are successful in raising wholesale prices in Canada. Therefore raising prices in Canada is exactly what they have done.

While the oil companies are certainly profiting off the current supply/demand predicament, let's not excuse our Canadian and US governments as they certainly have no visible plan of action to fix the problem.

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