



## Can Suncor Energy Inc.'s Refining Segment Protect it From Falling Oil Prices? The Surprising Answer

### Description

**Suncor Energy Inc.** ([TSX:SU](#))([NYSE:SU](#)) is renowned for being a large, integrated player. That is to say, Suncor has the ability to produce crude at its upstream operations, refine it, and then market it through its Petro-Canada retail chain.

One often-cited benefit of integration is that refining operations provide a natural hedge against low oil prices, because as the price of crude drops, so does the price of feedstock for refineries, effectively lowering its costs and boosting margins.

Let's take a look at how Suncor's refining margins have been influenced by falling crude prices.

### How refining operations benefit from cheap crude

Refining operations generate profits by purchasing various grades of crude oil as inputs, refining them into high-value products like gasoline and distillates, and then selling them. This profit is referred to as the "crack-spread" (a term referring to the cracking of hydrocarbons that must occur during refining), and is absolutely central to the success of refining operations.

Typically, refined products sell based off global Brent-crude pricing, but they sell at a premium since they are more valuable than crude. Suncor's refineries, however, are fed largely by inland crude, which is purchased at lower WTI prices.

Over the past several years, rapid production growth from the U.S., coupled with limited pipeline capacity to carry the oil to refineries and export hubs in the Gulf Coast, has resulted in a massive oversupply situation, with the U.S. producing 1.1 million barrels a day more than it is consuming. This supply glut has caused WTI prices to fall relative to Brent prices, widening the differential between them. So far, this has been a boon to refining operations.

As oil prices collapse, Suncor should be able to continue purchasing cheap WTI-based crude, while selling it at higher Brent prices, therefore benefiting from the strong WTI-Brent differential. In addition, Suncor would benefit from the fact that refined product prices typically fall at a much slower pace than

crude. The result should be better refining margins, or crack spreads.

### **What actually happened?**

Unfortunately, this has not been the case. In Q4 2014, Suncor saw its net earnings from refining and marketing fall 63% to \$173 million.

Why has Suncor not been able to benefit from the slower drop in refined product prices relative to crude? The answer lies in the WTI-Brent spread. Over the course of 2014 (Q4 2014 specifically) the WTI-Brent spread declined significantly from \$11.78 at the beginning of 2014 to \$1.46 at the end.

This means that WTI prices rose relative to Brent prices even as prices for both were falling. Since Suncor essentially purchases at WTI prices and sells refined products based off Brent prices, this means that much smaller margins were noted. This change is largely due to the fact that more crude was able to make it to the Gulf Coast and eastern Canada for export due to better pipeline capacity, as well as increased refining demand.

To make matters worse, the premium that gasoline trades at to Brent was also eroded due to seasonal declines in gasoline demand and more production from refineries.

The overall result is that contrary to expectations by many, Suncor's refining operations weren't able to serve as a hedge against falling oil prices.

### **What does this mean for Suncor's shareholders going forward?**

Fortunately, this may be a temporary condition, and the Brent-WTI spread has been widening since the beginning of 2015, and this trend may continue. This is due to the fact that U.S. domestic supply exceeds demand by 1.1 million barrels per day, and this excess supply also happens to account for nearly all the global excess supply.

With some analysts predicting that the U.S. could run out of storage space by mid-April, the WTI should trade at a discount to Brent and provide much better refining margins for Suncor's shareholders in Q1 2015.

This demonstrates that while Suncor's refining segment certainly can protect against falling oil prices in certain conditions, investors should not assume it always reduces downside risk for Suncor in the event of oil price declines.

### **CATEGORY**

1. Energy Stocks
2. Investing

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1. Editor's Choice

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