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## 2016 US Refined Products News Round-up

### Contents:

- › Exports kept US refiners afloat in 2016
- › Colonial faces multiple challenges in 2017
- › Mexico unveils transitional fuel price system
- › Texas-to-Louisiana oil eliminates price gap
- › Analysis: Midcontinent refiners look eastward in 2017
- › Analysis: US refining framework put to test in 2016



illuminating the markets

## 2016 US Refined Products Viewpoints & News round-up

### Viewpoint: Exports kept US refiners afloat in 2016

Houston, 28 December (Argus) — Steady crack spreads and export demand sustained US refiners for most of 2016, although run rates are showing signs of moderating.

US refining utilization peaked in early September at 93.7pc of capacity. That is down from 2015, when US refineries hit 96pc utilization in late July and spent most of the summer well above 92pc.

The biggest unknown that could disrupt exports in 2017 is possible new regulations that could emerge from president-elect Donald Trump's administration.

The rise of US exports has been fueled over the last few years by declining US demand amid declining Latin American refinery utilization rates. The US also has benefited from a lower cost advantage because of cheaper crude prices and historically low natural gas prices.

The extra incentive for US refiners and blenders to export came from a US environmental landscape that encouraged the domestic consumption of renewable fuels along with shipping fossil fuels overseas. Exporting finished gasoline and diesel allows US refiners and blenders to avoid paying the Renewable Volume Obligation (RVO). This cost savings also can help domestic refiners undercut foreign producers. This advantage should continue in the coming year. In 2016, the RVO peaked at 11.5¢/USG and bottomed out at 6.6¢. Comprised of the of the combined cost of US government renewable fuel mandates, when this amount can be avoided by US producers, they will normally pass some or all of the savings onto to foreign buyers.

Some industry players are concerned that Trump will reduce the Environmental Protection Agency's mandate for renewable fuels. Shaker domestic demand for gasoline in 2016 was a key issue. Despite an uptick in exports during the summer, the US spent most of the year well supplied in gasoline.

While the trendline for gasoline demand across the US steadily rose to almost 9.5mn b/d the appetite for fuel appears to have stabilized at the end of 2016 with hints of a possible decline loom-

ing. If the current declining shift in the US auto fleet continues, this could pull domestic demand higher again in 2017. For the first time since 2013, the US fleet's efficiency dipped solidly below 25 mpg in the fall of 2016.

Diesel exports of 1.2mn b/d in through into the fall of 2016 outpaced the year-prior's rate by nearly 40,000 b/d, according to the Energy Information Administration (EIA). Increased demand for US gasoline in Latin American markets boosted those exports even more, by 97,000 b/d from the same period last year to 573,000 b/d, with a vast majority coming out of the Gulf coast as usual.

The 3-2-1 crack spread for the Gulf refiners based on benchmark Light Louisiana Sweet (LLS) crude has averaged \$14.30/bl into December of 2016 compared with \$11.22/bl for all of 2015. Nymex futures contracts indicate the crack should run \$14.50-\$15.25/bl during the first three months of 2017.

The liberalization of Mexican energy markets could create more demand from newly permitted private importers during 2017, and volumes to Mexico could rise if refinery output at state-owned Pemex continues to flounder.

Cross border moves by rail, truck and pipeline should continue to rise in 2017 and may let US exporters push above September 2016's 9.5mn b/d of gasoline record.

### Viewpoint: Colonial faces multiple challenges in 2017

Houston, 29 December (Argus) — Colonial Pipeline struggled this year with a fatal explosion, lengthy outages and widening inquiry on how it operates the largest US products pipeline.

In 2017, the midstream operator must satisfy safety agencies and a Federal Energy Regulatory Commission (FERC) wary of how Colonial allocates space on its key 5,500-mile (8,851km) system supplying the southeast and east coast markets.

Efforts dating back to 2013 to balance longstanding customers and a growing number of demanding new players culminated this year in FERC launching a sweeping review of how Colonial administers its pipes.

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Colonial offers the cheapest access for the massive US Gulf coast refining complex through the southeast and up into the New York Harbor market. The company's gasoline-bearing Line 1 and distillates-bearing Line 2 pipelines, stretching 2.5mn b/d of capacity from Houston, Texas, to Greensboro, North Carolina, have operated at nearly full for roughly four years.

Colonial added 175,000 b/d of combined capacity to the lines over the same period through pump station upgrades and other adjustments. But the the midstream company exhausted such expansions, and faces an uncertain case for building expensive new capacity amid an anticipated decline in US petroleum fuel demand.

Demand for the existing pipeline has only increased, giving rise to offsetting trades called line space that at times encourage companies to ship at a loss.

There is also a market for bundling and selling winning lotteries for space to new shippers hoping for more stable access. Longstanding shippers chafed at a rising number of new shippers whose scramble for access eroded the volumes historic users could move across the lines. New shippers meanwhile cried foul at lottery and shipping systems that they argued favor entrenched market players.

FERC in 2014 firmly rebuffed a Colonial proposal to convert its common carrier pipeline to contract service, and this year rejected changes to shipping lotteries and batch sizes the pipeline operator proposed. Related new shipper complaints over Colonial's use of extra-tariff administrative rules led FERC in September to launch a broad and ongoing review of whether the company had ran afoul of the Interstate Commerce Act.

The deadliest and longest-running pipeline outage in decades this fall reminded Colonial's service region of the stakes.

A rural Alabama leak in September halted the flow of 1.3mn b/d of gasoline for more than 12 days in the single-longest outage since at least 1998, based on federal records. An October explosion and fire ignited as contractors began permanent repairs to the September leak killed two, the first fatality on a Colonial project since a contractor death during work on a tank in 1998.

The unprecedented shutdown revealed the extent of the southeast's dependency on the Colonial system. Terminal operators scrambled to reach still-supplied tanks fed by Kinder Morgan's Plantation Pipeline or by waterborne barrels. Murphy USA chief executive Andrew Clyde said the retailer reached as far as Nevada to supply its southeastern stores. Some operators went dry amid the tight allocations.

"It is incredible, by the way, the risk profile we have with one

pipeline carrying half the gasoline supply to the east coast, 70pc in many southeastern states," US energy secretary Ernest Moniz said in September.

National Transportation Safety Board investigators began a probe into the fatal October accident, and Pipeline and Hazardous Material Safety Administration investigations continue into both the September and October releases. Colonial said this month it was assessing its safety programs and had sped implementation of a hazard identification program similar to those used by refineries.

"We have always had and will continue to have a relentless focus on safety and operations in everything we do, and we will absolutely continue this focus in 2017 and beyond," Colonial said.

Did you know Argus was the first to create price assessments to provide valuable insight to the Colonial Line space premiums?

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### Mexico unveils transitional fuel price system

Mexico City, 27 December (Argus) — Mexican retail fuel prices will increase by 14.2-20.1pc on 1 January under a transitional pricing mechanism leading to full liberalization in 2018, the finance ministry said today.

Maximum prices will average around 15.99 pesos (\$0.77) per liter for 87-octane Magna gasoline, 17.79 pesos/l for 93-octane Premium gasoline and \$17.05/l for diesel.

The new pricing formula is based on three elements, adding transparency to the current mechanism, the ministry said. Maximum prices, which will vary across 90 different regions, will reflect state-run Pemex's logistical costs, international reference prices and commercial margins for retail outlets.

The reference prices will be derived from the US Gulf coast, the source of Mexico's growing fuel imports.

At present, the ministry sets maximum prices on a monthly basis using an opaque formula partially tied to international prices, with a 3pc band around 2015 Mexican prices.

"It's an important change that allows us to speak for the first time... of a gasoline market, a market in which we've already shared cost elements, and not of a government that could maintain prices artificially low, or artificially high, according to circumstances," finance secretary Jose Antonio Meade Kuribrena said today.



## Argus US Refined Products News Round-up

In December, Magna costs a maximum of 13.98 pesos/l, Premium 14.81 pesos/l and diesel 14.63 pesos/l.

The new pricing formula will be implemented on 1 January and updated on 4 February and 11 February, the ministry said. Starting on 18 February, maximum prices will be updated every day in each of the 90 regions, until market-driven prices are implemented nationwide.

“In the history of the country, gasoline has almost always – except with a few exceptions last year – gone up and never reflected a lower-price scenario,” Meade said. “What we will see now...is that at times gasoline will go up, at times it will go down, following market conditions.”

The fuel market opening is among the most politically sensitive and complex aspects of the 2014 energy reform that dismantled Pemex’s monopoly. From the government’s perspective, the enormous undertaking that kicks off next month should lead to a stable predictable price structure by general elections in July 2018. The reform established that fuel prices had to be liberalized by 1 January 2018 but the Mexican government decided to move the process forward, extending it over a two-year transitional period.

In 2015, a unique national fuel price was replaced by the current maximum pricing system. In the regions near the US border, the government keeps prices lower to reduce a gap with lower prices in the US, in order to encourage Mexicans to fill their tanks locally. A fixed fuel import tax, known as the IEPS, was introduced in 2016.



Both were maintained in the ministry’s new system. The IEPS is especially controversial because it has effectively undermined the economics of fuel imports by companies other than Pemex.

As announced earlier this month, the gradual and regional liberalization of prices will begin in the northern border states of Baja California and Sonora on 30 March, after Pemex inaugurates its first

open season for fuel pipelines and storage terminals on 15 February.

Other northern border states will be next, followed by Baja California Sur, Durango and Sinaloa, then most of the rest of the country, and ending with the states of the Yucatan peninsula in December.

Mexico’s energy regulator CRE and competition watchdog COFECE will maintain some control in the event of significant price gaps that could create supply distortions. One unintended consequence of the impending price adjustment is panic buying. As of yesterday, Pemex had identified San Luis Potosi, Zacatecas, Guanajuato and Michoacan as critical states with low inventories and shortages.

“We are seeing panic buying even though we still have products in the terminals. In San Luis Potosi, demand went up by 20pc to 40pc,” Pemex downstream director Carlos Murrieta Cummings said yesterday in a radio interview.

Another contributing factor to fuel shortages, Murrieta says, is illegal oil tapping, which can lead to the shutting down of pipelines for up to eight hours.

Pemex says it frequently replenishes inventories and monitors for shortages, using alternative transport when oil pipelines are down, such as trucks and railways.

### Viewpoint: Texas-to-Louisiana oil eliminates price gap

Houston, 28 December (Argus) — Pipeline expansion projects that increased the volume of Texas crude available in Louisiana during the second half of 2016 will further eliminate the price gap between key regional grades at the US Gulf coast.

Light Louisiana Sweet (LLS) crude averaged a \$1.57/bl premium to the US light sweet crude futures contract from June through November while West Texas Intermediate (WTI) at Houston, Texas, averaged a \$1.23/bl premium. That 34¢/bl spread narrowed to near parity by December as the two grades began competing with each other more directly.

Operations commenced in early September on Zydeco pipeline’s new 125,000-150,000 b/d connection to Sunoco Logistics’ terminal at Nederland, Texas, allowing more WTI Houston to travel east. Shell Midstream had already completed a Zydeco expansion project in August that added 100,000 b/d of crude capacity from Houma, Louisiana, to Clovelly, Louisiana.

Shortly after, Sunoco began transporting crude on the 100,000 b/d Delaware Basin Extension project from Energy Transfer Partners

## Argus US Refined Products News Round-up

(ETP) gathering assets to Midland, Texas, with expectation it would be in full service by the end of the year. Sunoco's new Permian, Longview and Louisiana Extension (PELA) pipeline, which started up around the same time frame, can then carry that crude from Midland to the east Texas crude hub at Longview, where it can access Exxon-Mobil infrastructure to make the trip to Anchorage, Louisiana, near Baton Rouge.

At Longview, the crude can also access ExxonMobil's North Line, which was reversed a year ago to serve the Shreveport, Louisiana, area. From there, Sunoco Logistics has said about 80,000 b/d of service would be available to Shreveport and Anchorage, home of a tank farm that supplies Exxon's 500,000 b/d Baton Rouge refinery.

As Texas crude supply available in Louisiana continues to increase while commercial crude flow ramps up on these lines, both LLS and WTI Houston may be pressured amid an overall increase in available regional supply. The rise in volume would also open the door for more exports of LLS, which is poised to gain more international popularity in 2017 since it is the only US light sweet crude to have strict, stable quality specifications.

LLS averaged a \$1.59/bl premium to WTI in the first 13 days of December while WTI Houston averaged a premium of \$1.57/bl. The two grades are expected to hover around parity to each other for the near term as Louisiana refiners now have their choice of light sweet alternatives.

Sunoco's new 235,000 b/d Bayou Bridge pipeline from Nederland to Lake Charles, Louisiana, came on line in April and will be expanded to the pricing hub of St James, Louisiana, by mid- to late-2017, competing with LLS and crude from the Zydeco line.

Zydeco's enhancements, Bayou Bridge, PELA and the North Line total about 415,000 b/d of new capacity from Texas to Louisiana that was not in place in 2015.

### Analysis: Midcontinent refiners look eastward in 2017

Houston, 27 December (Argus) — US midcontinent refiners will exploit new pipelines to target new East coast products markets in 2017.

The trend will give midcontinent refiners like BP, Marathon Petroleum and Husky space to maintain high refining rates without overwhelming local markets while eroding traditional destinations for teetering Atlantic coast refiners.

Midstream operator Buckeye Partners plans to complete by 2018 a partial reversal of its Laurel Pipeline system to move product from Pittsburgh to Altoona, in central Pennsylvania. Switching directions on the tapering pipeline system that today moves product from Philadelphia to Pittsburgh was once assumed too awkward to pursue. The mainline shrinks from a 24-inch diameter pipe in eastern Philadelphia to 18 inches as it approaches its terminus in the west.

Sunoco Logistics's



85,000 b/d Allegheny Access pipeline, which last year began moving products out of western Ohio to just across Pennsylvania's western border, had cut into Buckeye's volumes out of Philadelphia, senior vice president Bob Malecky said in August.

Buckeye committed in October to expanding its own pipeline project connecting Michigan and western Ohio into Pennsylvania, a project that will reverse Laurel between Pittsburgh and Altoona.

Midcontinent refiners with ready access to cheap shale production but lacking suitably cheap access to export markets risk flooding their bottled-up region. Overseas opportunities for US Gulf coast refiners have offered some relief, as those companies turn their attention away from historic inland markets. Magellan Pipeline's mid-continent system gave Group 3 refiners new access to Little Rock, Arkansas, in July, and plans to add jet fuel service to that market in the first half of next year. The company made a line from southern Oklahoma to the Dallas, Texas, market bidirectional in 2013.

Buckeye described the reversal project as another incremental move matching the potential flows out of Ohio and Michigan.

"Our steps are really kind of right now measured through central Pennsylvania, and I think that's probably more balanced with what the market requirements necessitate," Buckeye senior vice president Khalid Muslih said in August. "But it is something, down the road, that could be evaluated."

## Argus US Refined Products News Round-up

Michigan and Ohio refiner access to the New York Harbor could pressure the waterborne imports that make up the current marginal supply to the northeast. Volumes across the Colonial Pipeline, which offers the cheapest path between the efficient and complex US Gulf coast refining complex and New York Harbor, has remained full for roughly the past four years.

Increased midcontinent volumes could stress US Atlantic coast refiners. Philadelphia-area refiners have struggled with the loss of exuberant midcontinent shale production volumes that offered an advantage against overseas competition in 2014 and 2015. Delta Air Lines subsidiary Monroe Energy expects to lose \$100mn at its 185,000 b/d refinery in Trainer, Pennsylvania, this year. Privately-held Philadelphia Energy Solutions withdrew plans to go public and laid off workers at its 330,000 b/d refinery in Philadelphia. North Atlantic Refining, which supplies some of the US northeast from its 115,000 b/d refinery in Come-by-Chance, Newfoundland, has also sought layoffs, citing poor margins.

Those refiners will have new access to upstate New York across Buckeye's system as the western Pennsylvania market closes. But Marathon Petroleum, which operates 662,000 b/d of midcontinent refining capacity and almost 200,000 b/d of that in Michigan and Ohio, expects to someday reach right up to their refinery gates.

"First, we're looking to Altoona," chief executive Gary Heminger said in October. "But yes, eventually, I would see it going all the way to the east coast."

### Analysis: US refining framework put to test in 2016

Houston, 28 December (Argus) — A push last month to reorganize Marathon Petroleum capped a year of tests on fundamental structure and strategy of US refining operations.

Integrated retail and refining companies such as Marathon and Phillips 66 faced shareholder pressure to split their portfolio into while regulatory pressure led merchants Valero and PBF to reconsider their manufacturing focus.

Hedge fund Elliott Management Corp released a letter to shareholders in November pushing for one of the largest US east coast refiners to spin off its retail and logistics businesses into a trio of standalone entities. Shareholders lost the value of the two associated enterprises in Marathon's downstream integrated model, the

presentation by portfolio manager Quentin Koffey said. "We have worked extensively to attempt to understand the merits of integration for Marathon, and we, along with our advisers, have not been able to quantify any significant benefits," Koffey said. Marathon Petroleum began operations in 2011 as a spin off from

Marathon Oil. That upstream-focused company unburdened itself of a fuel and pipes business just in time for oil prices to plummet and US downstream fortunes to soar on a tide of booming,

stranded shale crude. Elliott Management successfully pushed a similar spin off of Hess in 2013.

Marathon defended its value proposition to shareholders and said it was considering ways to highlight and improve its growing logistics business.

"We have delivered substantial value through our integrated and diversified model," chief executive Gary Heminger said in response to the Elliott proposal.

Merchant refiners may offer investors both a clearer view and more exposure to the ups and downs of the industry. Refining margins that broadly trailed both year-ago and five-year-average levels in the peak summer months and federal policy cast the downs this year in sharper relief.

Congress did not intend US biofuel mandates to force refiners to change their business structure, the Environmental Protection Agency (EPA) said last year as it set domestic blending requirements. But rules that insist refiners and importers, more than blenders, keep responsibility to meet the standards have led some of the industry's largest merchant refiners to reconsider strategy.

PBF Energy in July began plans to shift some of the capacity of its 210,000 b/d railed crude offloading infrastructure at Delaware City, Delaware, to receive ethanol for distribution at east coast racks. The company sought permits to convert a storage tank at the facility in order to move 10,000 b/d of ethanol through its associated docks, according to a filing to state regulators. Delaware regulators weighed approval of the project in late December.

Valero, the largest US refiner and one of the largest US ethanol producers, had for years moved away from the retail and marketing segments that blend the two products together. The company sought blending infrastructure this year, chief executive Joe Gorder, said in July.

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## Argus US Refined Products News Round-up

“The obvious operating strategy is to try and go ahead and find ways to blend more,” Gorder said. “Acquiring terminal assets would provide that opportunity.”

President-elect Donald Trump raised uncertainty over whether that pressure will continue in 2017. Trump campaigned in favor of domestic energy and ethanol, the chief US biofuel by volume. But Oklahoma attorney general Scott Pruitt, his nominee to head the EPA, was a steady critic of the program. Carl Icahn, an activist investor who owns 80pc of merchant refiner CVR Energy and a Trump adviser on federal regulation, remains outspoken against the program.

“That’s my quintessential example of what is wrong with regulation,” he said last week.

The downstream integrated model, meanwhile, will continue to grow next year.

The strategy employed by Marathon and shared by Tesoro and Phillips 66 can smooth out the volatility of each downstream business component while dampening high-performing revenue generators. Tesoro would not consider any acquisition that did not include a retail component, chief executive Greg Goff said this year. The US independent refiner plans to close on its acquisition of Western Refining’s products, retail and pipeline business in 2017.

The combination would help drive very high refining utilization rates, linking their facilities to cheaper crude and a more than 3,000-site retail network, Goff said in November.

“We’ve always stated, just like Western, that we want to have high integration around our refining systems with our marketing business,

and that remains unchanged,” Goff said.

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