PORTLAND MARKET REPORT

THE TRENDS THAT SHAPE THE OIL INDUSTRY ARE NO DIFFERENT IN CANADA THAN IN THE UK

May update

Last month Portland was lucky enough to speak at Canada's annual Fuel Marketers' conference in Montreal (**www.cipma.org**) and the topic was (you've guessed it) oil prices! The global nature of the oil industry means that Canada's downstream industry ("downstream" being anything to do with refined oil, whilst "upstream" is all things crude oil related) is being buffeted by the same trends of over-supply, cooling global demand and tension in the Middle East as every other oil market in the developed world. In fact it was difficult not to be struck by just how many similarities there are between the Canadian downstream sector and its British counterpart.

In pricing terms Canada's downstream sector – like Britain – is an import market. That is to say that even though it has its own crude oil (and lots of it), that supplies an extensive local market, the price of fuel is still based on an external price index – in this case New York Harbour (NYH). This means that the starting point for all Canadian fuel is the published NYH price (eg, for gasoline, diesel etc), just as the UK is priced off the Rotterdam market.

The Canada-UK parallel continues in the methodology used to calculate "landed" costs. In the same way that the cost of fuel in England is based on the Rotterdam price plus the (often notional) cost of shipping, the Toronto Rack Price is made up of the NYH price plus the cost of pipe or rail freight to bring the product into Canada. Likewise, fuel prices in Canada's maritime provinces are based on NYH plus coastal shipping costs, whilst across the Atlantic, Scottish fuel prices are based on Rotterdam plus the cost of the small coastal ships that supply the ports of Grangemouth, Aberdeen and Inverness. Clearly these pricing calculations ignore the salient fact that both the Eastern Canadian seaboard and Scotland have their own refineries. But in the downstream world, alternative economics rule OK, and refineries will never sell below the regional index price (ie, NYH and Rotterdam) plus the cost of freight.

The structure and current outlook of the respective Canadian and UK oil industries is another area where valid comparisons can be made. Of course the woes of the exploration sector in each country are well known and where job losses and project cancellations are the order of the day. But cheap indigenous crude is boosting domestic refineries and in both geographies, this sector is enjoying a significant renaissance. What a different picture this is to the last 10 years or so, where creaking refining assets across Canada seemed to be in terminal decline due to expensive crude feedstocks, unsustainable margins and competition from more sophisticated refineries in the USA. This situation was a virtual replica of the UK (and Europe), where rudimentary refineries built in the 1950s seemed destined to lose out to more complex refining assets in the Middle and Far East.

Fast forward to the present day and what remains of the refining industries in Canada and the UK seem to be in relatively rude health. Firstly surplus capacity was stripped out between 2000 and 2015, through a string of refinery closures (Oakville, Montreal, Dartmouth in Canada and Thames, Tees, Milford Haven in Britain) and secondly, greatly reduced feedstock costs (as a result of rock bottom crude prices) mean more than simply cheaper raw material. Refiners are now greatly benefiting from the time lag between falling crude prices and falling product prices, such that whilst both have fallen greatly, crude has fallen a lot more, which has allowed refinery gross margins to increase by 28% in Canada and 24% in the UK.

This good news continues to filter down through the downstream supply chain, so that marketing margins (made up of commercial and retail sales) are up by about 12% in both countries – the only bleak spot being heating oil, where mild winters in both geographies have driven down both volumes and margin. And it is independent companies in both geographies that are benefiting most from this particular upward trend, rather than the major oil companies. Unlike refining where a handful of oil majors doggedly held on through the lean years, the touchy-feely side of the business (ie, things that involve customers) was jettisoned by Big Oil long ago. In fact just prior to the CIPMA conference itself, Esso had announced that it was to fully remove itself from owning petrol stations in Canada, meaning it would now have no assets beyond the refinery gate. This is a trend that the British market knows all too well (not to mention mainland Europe and Australia) and is indicative of where the majors see value in the oil markets. Dealing with each other on a "super-power" basis is all well and good, but engaging with "normal" customers anywhere in the world is no longer for them.

The trends that shape the oil industry are no different in Canada than in the UK or any other country with a mature petroleum industry. Current low oil prices have generated a complete re-evaluation of the "exploration only" model that has been so loved by the major oil companies over recent years. In turn, ageing refineries are now enjoying a new lease of life, although fears remain that the rays of sunshine will be as short-lived as a Nova Scotia or British summer. And finally down at the coalface, the independents – without major assets in either upstream or downstream – are fighting it out for market superiority in a sector previously dominated by much larger competitors. So after a long day at a conference and an even longer night at the bar – surrounded by Canadian voices with their unique North American cum Scots cum Lancastrian accent (and with a bit of French thrown in for good measure) – it would be easy to forget where you are in the world. But actually it doesn't matter, because when it comes to oil, the issues are all the same.

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