SISR Strategic International Securities Research Inc.
An Independent Research Firm

The Energy Weekly

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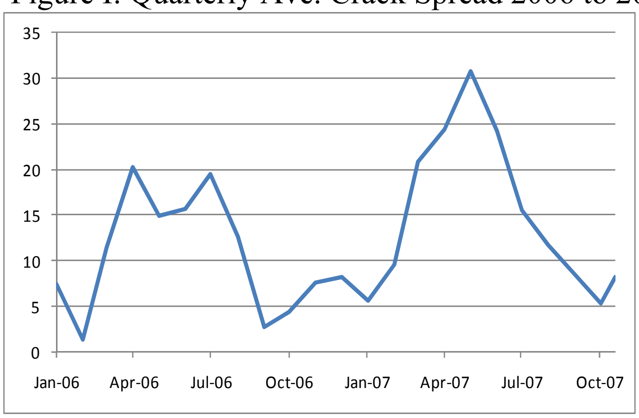
Refining Margins Improving: But still Tracking Worse Q/Q but Better Y/Y

Summary:

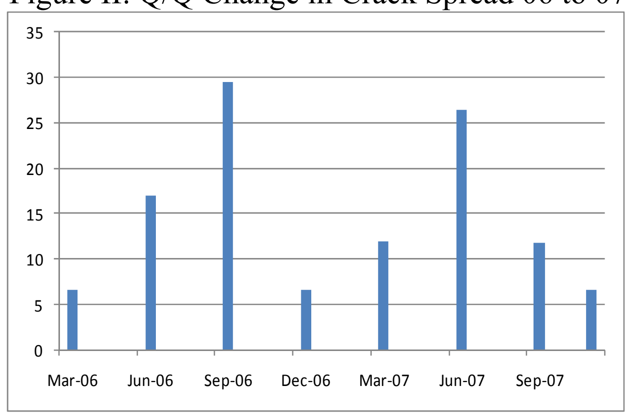
We are maintaining our overweight for both the major integrated oil companies and the refiners going forward. Refining margins have begun to improve over the last few weeks and are expected to continue to improve throughout this quarter. By Q108 we expect these margins to expand even more reaching the highs of early 2007. The margins, however are tracking worse than last quarter figure II, but better than a year ago, figure III. The crack spread margins are currently better than last month because gasoline prices have moved up relative to the price of crude. Given that we are already half way through the quarter Q4 07, this quarter is unlikely to be better than Q3 07, which was a very weak quarter for refiners. On the positive side, in comparisons to last year's Q406, the crack spread is significantly better in the current quarter Q407, than it was last year Q406, when the crack spread receded to a multiyear low.

Figure I: Quarterly Ave. Crack Spread 2006 to 2007



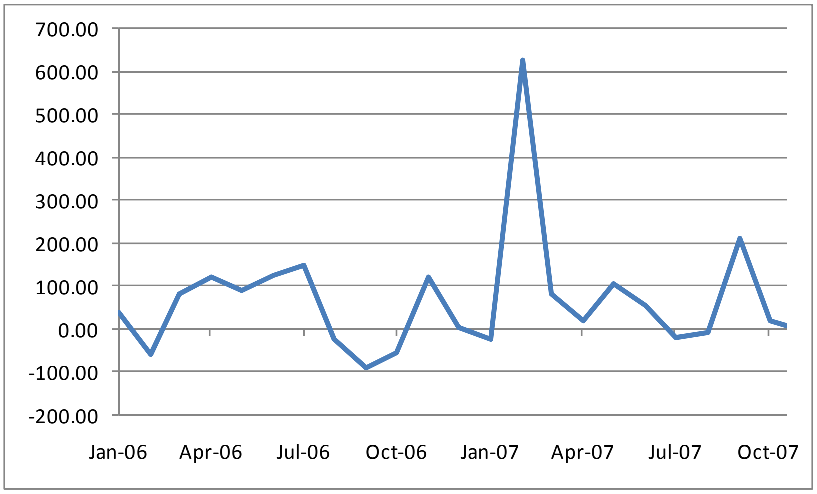
Source: EIA, SISR

Figure II: Q/Q Change in Crack Spread 06 to 07



Source: EIA, SISR

Figure III: Y/Y Chang in the Crack Spread 2007 -08



Source: EIA, SISR

I. Q4 07 Tracking Worse than Last Quarter but Better Last Year

Q3 07 turned out to be a very weak quarter for the oil industry due to the very poor crack spread between gasoline and crude oil. Q407 is shaping up to be even slightly worse for the refiners and flat for the major integrated oil companies. The recent run up in the price of crude however, has helped the major integrated oil companies, but since the price of gasoline lagging behind the conventional parity with the price of crude, the refiners have been struggling. The oil companies would need to have gasoline in the $3.30 range in the next few weeks for the average daily crack spread for the current quarter to be greater than the average daily crack spread in Q307. Many of the oil companies reported weaker than expected earnings, as a result of the weak crack spread in Q3 07, and this quarter Q407 looks no better.

Most investors and analysts however, concentrate on Y/Y results, and only secondarily on a Q/Q reporting. The reason for this is that it is very difficult to calculate the seasonal adjustment factor for these companies. The obvious example is that during the driving season there are more products sold than during the non driving season. Ironically, even though the Q/Q period is looking weak, following a weak quarter to an even weaker quarter, the Y/Y results for Q407 will stack up well against Q406 which was one of the worst quarters in recent years for crack spread margins. As a consequence we expect that both the refiners and the major integrated oil companies will show better Y/Y earnings, leading us to maintain our overweight for both the major integrated oil companies and the refiners, going forward.

II. Q1 08 & Q208 Likely to be Very Strong Quarters

Projecting forward, we expect that crude oil to remain relatively high, but to pull back to the 80 to low 90 dollar per barrel range. With respect to gasoline, however, we would expect that during the early winter and the driving season that the price of gasoline would stay high in the $3.20 to $3.30 range for regular gasoline at the pump. Maintaining gasoline prices above $3 has been problematic for the oil companies in the past, because there has been a shift in the demand curve from extreme elasticity to modest elasticity at these prices above $3.00. This is what occurred last year when gasoline hit their highs in the $3.50 range. The key question for this entire analysis is: was there sticker shock last year that will go away, or will people adjust to these prices? We believe that people will adjust better to $3.50 a gallon of gasoline this time around than last time, and we expect that regular gasoline at the pump to be in that range by driving season next year. It is on this basis that we have maintained our overweight for this sector.

Future Work

We are currently in the process of working on various projects:

1. **Elasticity of demand for Gasoline**: Developing a model to test the elasticity above $3.00 for gasoline, to determine if in fact the elasticity of demand declines or becomes more elastic as the price goes up. We believe that currently in the intermediate run gasoline is relatively inelastic below $3 but above $3.00 it becomes more elastic, but with time less so.

2. **Real World Price of Crude, the Currency Effect**: We are developing a measure called the real as opposed to nominal world price of crude oil. Our measure similar to an inflation adjustment metric, but we concentrate on the effect of currency changes given that oil is priced in dollars. We are currently developing a market basket of currencies based on the current world consumption of crude oil.

3. **Demand Function for Crude Oil:** In the last half decade and in the 80ies there has been a clear geopolitical risk component in the price of crude. We model the demand function for oil considering four basic variable: 1. geopolitical risk; 2. traditional demand supply inventory considerations for both crude and gasoline; 3. U.S. political risk that may affect the price of gasoline or crude, like elections and various bill that congress is considering that can affect oil companies profits; and 4. currency factors, which include interest rates, both for the exchange risk to these international companies, but also the currency effect, since crude is traded in dollars.

4. **What is the true price of Crude Currently:** Just like any business that has inventories, as cost go up companies often price their old inventory at the new cost basis for sale. Oil Company's work in the same way, just because they are lucky enough to have built a well in 1980 that is still functioning; their value of capital should be based on the current replacement value of this well in today economy. We can then use that price plus an expected return on capital to determine what the true price of oil should be today. From there we use the other factors in our model to determine geopolitical risk, political risk, and demand and supply distortions based, on inventory and temporary events.

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2 – Overweight – The stock is expected to outperform the equal weighted expected total return of the sector coverage. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

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5 – Rating Suspended – The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when SISR Inc. is acting in an advisory capacity in a merger or strategic transaction involving the company.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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