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Diesel Demand Remains Strong

Some Refiners See Further Opportunity Despite Price Rise

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Oil and gasoline prices are again at new highs. But many in the U.S. refining industry are focusing on prices for another key liquid: diesel.

Crude oil continues to set records, reaching $108.75 in New York futures markets yesterday and pulling up the price of refined products to their own historic highs. Gasoline rose to an average of $3.225 for a regular gallon as of Monday, a record price, according to the Department of Energy.

Associated Press

The weaker dollar has pushed the price of light, sweet crude higher.

The Paris-based International Energy Agency said in its monthly report that "only a protracted and severe global recession would justify a sustained dip in oil prices" to less than $60 a barrel.

Diesel has followed the petroleum surge, ending yesterday at $3.82 a gallon, based on government data. Much as gasoline has pressured consumers, diesel is pressuring businesses that depend on the fuel.

But some in the refining industry see an opportunity. Their bet: Diesel is poised to take off. While skyrocketing prices have weakened demand for gasoline in recent months, global diesel demand has been growing.

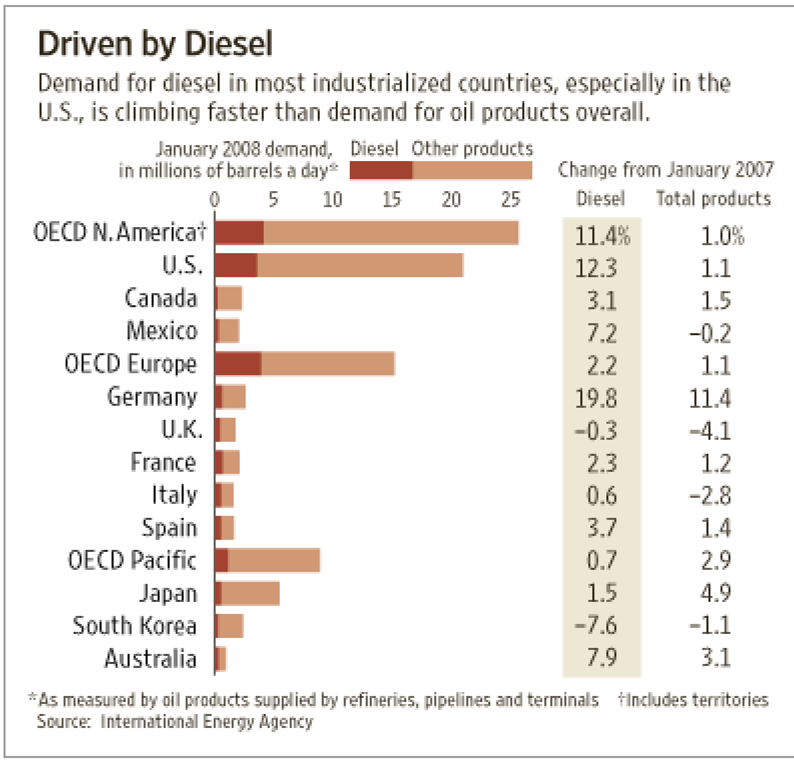
Some analysts expect continued strong diesel-demand growth. In Europe, diesel will continue gaining market share at the expense of gasoline as consumers switch to diesel-powered cars. Developing countries such as China and India are consuming more energy. Those countries often prefer diesel over gasoline because of its flexibility: the fuel can be used to power industrial plants as well as transportation.

In the U.S., demand is expected to grow as car manufacturers introduce more diesel-powered cars.

If U.S. consumers take to diesel, that would put them in line with drivers in place like Europe. As the current price dynamic for diesel and gasoline shows, that can be a mixed blessing. Because many refineries outside the U.S. are set up to produce more diesel, increasing U.S. reliance on that fuel means the U.S. would have more sources.

But those refineries are also feeding demand at home. As demand for diesel grows elsewhere in the world, consumers could increasingly find themselves in a tug of war over supplies -- a dynamic that is contributing to higher diesel prices today.

For 2008, the DOE's Energy Information Administration is expecting demand for diesel and related products, as well as gasoline, to grow less than 1% from the previous year. But in 2009, the EIA sees diesel demand growing 1.6%, twice as fast as gasoline.



Since Feb. 1, U.S. diesel prices have jumped 16%, compared with 8% for gasoline prices.

In the short-term, U.S. refineries that are set up mainly to produce gasoline have little flexibility to churn out more supplies of diesel. To increase capacity, refineries would have to invest heavily in new equipment. The U.S. will also have a hard time attracting barrels of diesel from abroad because of strong demand elsewhere, meaning the diesel market in the U.S. will continue to be tight.

Some North American refiners are beginning to place long-term bets on diesel. Newfoundland & Labrador Refining Corp., a Canadian company that is behind one of the few new refining projects in North America, is betting big on diesel. About two-thirds of the plant's production, which is expected to hit the markets in 2012, is expected to be diesel and related products. One-third of the output will be gasoline. The refinery will have the capacity to process 300,000 barrels of oil a day.

Marathon Oil Corp. is constructing an expansion to its largest refinery, in Garyville, La., that will increase its diesel production.

For refiners, the economics alone are persuasive. A barrel of diesel is fetching almost $28 more than a barrel of oil, according to Muse, Stancil & Co., a consulting firm specializing in the energy industry. The difference between a barrel of gasoline and a barrel of oil is $2.14.

For U.S. consumers, higher diesel prices mean higher costs for goods as retailers pass on some of the increase in transportation costs.