Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist
Terry Higgins, Refining and Petroleum Products Advisor

MACROCOSM

The Border Adjustment Tax and Its Victims

Friday, February 10, 2017

Michael Warren, Terry Higgins and Donald Luskin

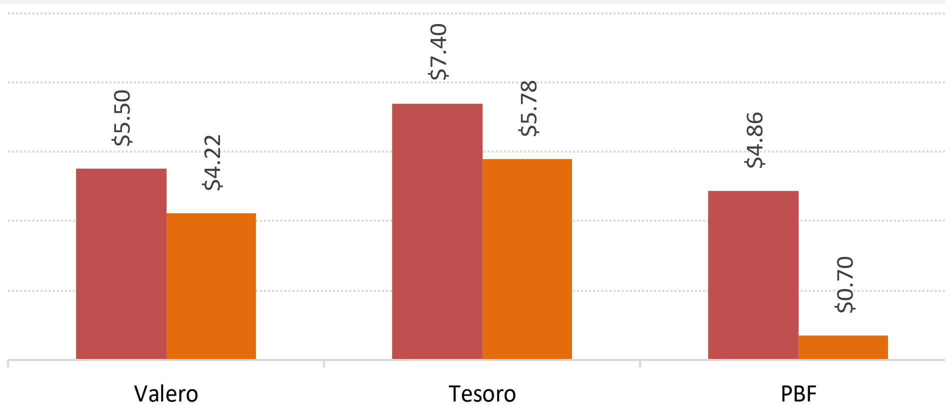
When is a tax cut a tax hike? When refiners and other firms get hit with the BAT.

Yesterday President Donald Trump said extemporaneously that the White House's corporate tax reform plans are "way ahead of schedule," and that "something…phenomenal" will be announced "over the next two or three weeks." After Trump's hint in an interview on Sunday that Obamacare reform could wait until late this year or early next, we have a re-prioritizing of two difficult issues – important, because it defers the more difficult one.

But there is little visibility on what "phenomenal" will be. Will it be the pro-growth masterstroke that Trump put forward in the campaign – just cutting the top rate for all businesses to 15%? Or will it be the so-called "Better Way" promoted by the Republican House of Representatives: a cut to 20%, with a border adjustment tax (BAT) that would make exports tax-free and effectively put a 25% tariff on imports (see "For Free Traders, Trump's Corporate Tax Cut Is the Better Way" January 18, 2017)?

- Obviously there would be winners from "border adjustment" – entirely domestic firms, or those that export a lot and import a little.
- *But some firms – with no choice but to export a little and import a lot – would be major losers.* The independent refiners Valero, Tesoro and PBF are salient examples. All would be losers under a BAT regime, even at a 20% tax rate (please see the chart below).

Refiner margins, $/barrel ■ **Current tax regime** ■ **20% rate plus BAT**



Source: Various, TrendMacro.Energy calculations

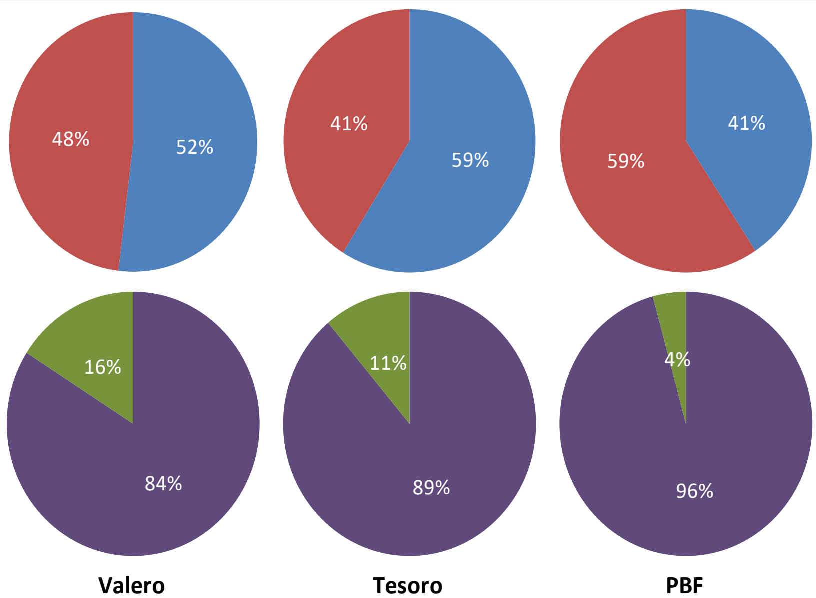
Update to strategic view

US RESOURCE STOCKS, US STOCKS, OIL: The proposed border adjustment tax poses an existential threat to any firm that imports a lot and exports a little. The refining industry is right in the crosshairs, with little scope to source more crude inputs domestically or to export more given domestic demand. For Valero, Tesoro and PBF – refiners representing three distinct operating regions – margins under a BAT regime, even if the top rate is reduced to 20%, fall sharply from their levels under the present 35% rate. This would be ameliorated, but not cured, by exempting Canadian and Mexican oil. The political situation is fluid, but we don't think that a BAT regime will be imposed. But the stakes are enormous for the entire economy, and especially the energy industry.

[Strategy dashboard]

- *A close look at these refiners opens up an analytic paradigm applicable to a broad class of US companies – across many industries and sectors – which through no fault of their own would find themselves arbitrarily subjected to extreme earnings pressure.*
- *The paradigm is simple. For all three of these refiners, product exports are such a small part of their sales mix that the zero tax on them can't overcome what is effectively a 25% tariff on imported inputs, which make up a large part of their cost mix* (please see the charts below).

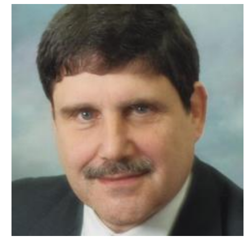
Crude inputs: **Imported** **Domestic**
Product sales: **Exported** **Domestic**



Source: Various, TrendMacro.Energy calculations

- The particular extent of the reduction in profitability across these refiners varies considerably depending on how bad this mismatch is in each case – by the luck of pre-existing circumstances established over many years and with no expectation of a BAT regime.
- **Valero** is the largest independent refiner in the US and has 75% of its throughput capacity located in the Gulf coast, where most US refined exports originate. Over the past few years pipeline capacity additions have significantly increased market liquidity and crude competition in the Gulf coast, but imported crude still constitutes 48% of Valero's refining throughput.
- Valero enjoys a slight advantage over the other two refiners in its ability to export from the Gulf coast. Valero exports the largest share of its product mix, much of which is high-end gasoline and diesel, fetching nearly double the price of residual fuel oil barrels that Tesoro exports. Despite that, because Valero's crude import share is far greater than Tesoro's, its margins end up being eroded more on a percentage basis.
- **Tesoro** has 80% of its throughput capacity on the west coast. It imports 41% of its crude feedstock – the smallest share of the three

Meet Terry Higgins



Terrence Higgins is Refining and Petroleum Products Advisor to TrendMacro.Energy.

Over a 45-year career in energy, he has been a consultant to domestic and international refining companies, trade associations, technology providers, governments, the United Nations, the International Energy Agency, and the US Department of Energy.

Most recently Terry managed the World Refining and Fuels Service of Hart Energy.

He holds a B.S. in Chemical Engineering from the University of Notre Dame.

refiners – with more than 80% of that originating in Latin America and the Middle East. Tesoro has tried for several years to build a 360,000 barrels per day rail facility at the Port of Vancouver, to completely replace light oil imports with Bakken crude. It could reportedly deliver Bakken crude to the west coast for $3 to $4 per barrel less than what east coast refiners pay. From Vancouver, Tesoro could ship Bakken volumes to its refineries along the west coast and sell the balance to other domestic refiners looking to displace foreign crude. Unfortunately local environmental and other activist groups have stymied the project. This illuminates the problem that even if a BAT regime succeeds in shifting incentives toward use of domestic crude, it will all be for naught without the ability to get transport projects green-lighted.

- While Tesoro imports a smaller share than Tesoro, it exports a smaller share, too – mostly low-value residual fuel oil and distillates, and high-end gasoline, diesel and jet fuel only opportunistically.
- **PBF** has had most of its capacity on the east coast, until two recent acquisitions on the Gulf and west coasts. It requires a large medium/heavy input component in its refineries, so its 59% import share is the largest of the three refiners. That share has risen with the acquisitions, but pricing has played a role, too. In 2012, PBF's Delaware refinery was one of the first to rail Bakken crude – displacing mostly African imports – to exploit the then-prevailing large pricing gap between WTI and Brent benchmarks, a gap which has since mostly disappeared.
- PBF has a refinery in the key export PADD of the Gulf coast, yet as a whole it only exports 4% of its refined product. With *both* the largest import share *and* the smallest export share, PBF's margins nearly vanish entirely under a BAT regime, even at a 20% tax rate.

Even assuming away the kinds of problems that Tesoro is facing in trying to access domestic crude, the hard reality is that there is nowhere near enough to replace imports – US production would have to nearly double. Even if it could do so, much of today's refining capacity would have to be substantially re-engineered to handle the relatively light crudes produced by domestic frackers. Without that, there's only scope for about 640,000 barrels per day of domestic-for-imported substitution (see "2017: Making American Crude Again" December 29, 2016).

- *It should be clear that many other industries and sectors face similar structural challenges in responding to the incentives embedded in a BAT regime. An importing giant like Walmart is simply not in a position to domestically source many of the goods it imports from overseas in the volumes it requires.*
- So if the BAT regime is to be implemented without disastrous economy-wide disruptions, there would have to be all manner of complexities – and responses to special pleadings by firms, industries and their lobbyists – involving grandfathering, phasing, and exceptions.
- The refining industry – with so little scope to substitute for imports, and so much domestic demand crowding out exports – would be

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

Terry Higgins
Ocean View DE
571 271 7743
terry@trendmacro.energy

[About us]

within its rights on grounds of necessity to ask for a total exemption. Or perhaps it could argue for a limited exception for crude imported from our neighbors, Canada and Mexico. That alone would build back $0.50 of lost margins for Valero, $1.06 for Tesoro and $1.37 for PBF. That would help, but what's the point of "tax reform" if it results in as much complexity – and as much crony-capitalist bargaining – as the current code?

- What exemption would Walmart ask for? On anything from China?

In the present highly fluid political environment, pin-point policy predictions are subject to error. *But based on what we are seeing and hearing now, we think it is unlikely that a BAT regime will ultimately be imposed.* It does not meet Trump's preference for simplicity, it imposes too many burdens on too many firms, it is too widely opposed by extremely influential political interests like the Koch brothers, and its flaws – especially for the energy industry – are too obvious to administration insiders like former Exxon CEO Rex Tillerson, now Secretary of State.

About all its proponents can say in favor of BAT it is that it is "revenue neutral." Or that it helps America compete with the nations of Europe that use a VAT tax system that has some characteristics in common with BAT (making the first time that Republicans have advocated a policy on the grounds that France does it).

This is politics. All that could change. Stay tuned – as we will.

Bottom line

The proposed border adjustment tax poses an existential threat to any firm that imports a lot and exports a little. The refining industry is right in the crosshairs, with little scope to source more crude inputs domestically or to export more given domestic demand. For Valero, Tesoro and PBF – refiners representing three distinct operating regions – margins under a BAT regime, even if the top rate is reduced to 20%, fall sharply from their levels under the present 35% rate. This would be ameliorated, but not cured, by exempting Canadian and Mexican oil. The political situation is fluid, but we don't think that a BAT regime will be imposed. But the stakes are enormous for the entire economy, and especially the energy industry.