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Tesoro's Transformation
CEO Smith talks about refining, gas prices in* Wall Street Journal *Q&A

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of a refinery in Los Angeles and more than 270 retail stations from Royal Dutch Shell. Tesoro also is adding 138 stations purchased from USA Petroleum earlier this year.

The company has multiplied its earnings by more than 10 times over the past 10 years. In recent quarters, profit has been better than ever as a shortage of gasoline supply has pushed refining margins to unprecedented levels. But high gasoline prices also have generated outrage from consumers and Congress, which is pushing to curb gasoline consumption. And after almost a yearlong lull, oil prices recently hit record highs, squeezing refining margins.

Still, Smith is betting on the strength of the refining sector in the long term. He believes producers will keep finding and producing oil, and that American drivers will continue to fill their tanks with gasoline for decades to come.

THE WALL STREET JOURNAL: Why did you decide to transform Tesoro from an oil company into a refiner?

MR. SMITH: We didn't have the skills to go out and be competitive in the exploration-and-production business. It had been the strength of the company, but we were going to have to rebuild it. I just didn't see how we could do it. We had one refinery that was in Alaska that was very successful. This was before refining became as popular as today, but this was a niche refinery in a market serving a purpose, and we saw an opportunity to take that one refinery and potentially build the company around it.

WSJ: Refining is now a better business and refineries are selling for a lot of money. Why are you buying when prices are high?

MR. SMITH: Our view is that the demand for petroleum products is going to continue to increase just as it has over time. That's partially population growth around the world, partially economic prosperity, partially things that you don't think about, such as people living in San Francisco farther and farther out, so that they're commuting greater distances and standing in traffic for longer periods of time. And there isn't significant expansion today in refining capacity.

If you translate that into the longer term, you have to believe that the difference between the price of crude and what petroleum products as a whole will trade for will continue to be at least at these levels and probably larger. So that makes buying a refinery today—which you still can buy at a discount to actually building a new one—a pretty good proposition.

WSJ: Are you worried that new refining capacity in the Middle East and Asia will increase world supply and lower refining margins?

MR. SMITH: Most of the refineries that we would buy would have been paid [for] before that supply hits the world markets. Does it concern us? It does, but if those refineries don't get built, the price of refined products will probably be markets. Does it concern us? It does, but if those refineries don't get built, the price of refined products will probably be so high that it will start to curb demand. If you look at the demand growth, we actually need some refineries to be built. We've taken that into account and it still looks to be a healthy business, certainly for longer than five to seven years, and it could be 10 to 20 years.

WSJ: Why have you chosen not to use your brand in your recently acquired retail stations?

MR. SMITH: Shell has a great brand, very widely recognized. They have a loyal customer base. If I took down all those Shell signs and put up a Tesoro sign, it would be a new brand in the marketplace, and many people might drive across the street to buy Chevron because it's a recognized brand. It costs hundreds of thousands of dollars to rebrand a station and you're liable to lose the trade that was associated with the product. The same thing is true with USA [Petroleum]. Our approach is more brand-neutral: Let's just get product to the customer and not be so sensitive about whether our name appears on every street corner.

WSJ: Refining margins have been at unprecedented highs due to limited gasoline supply and relatively cheap oil. Now oil is rising again. What can you do if oil prices stay at current levels?

MR. SMITH: We're no different than any other refiner in the sense of whether you've got a million barrels or 500,000 barrels of capacity. Ours is 660,000 barrels right now, and conceptually we're buying every single day 660,000 barrels. We have very little flexibility around what the initial price of our products is going to be because we're buying in the world market. That's one of the disadvantages of our business. If crude continues to go up, you're going to have higher and higher prices. Hopefully we don't have $100-a-barrel crude because at a certain point that will set a new level for gasoline prices and that will eventually curtail demand.

WSJ: Consumers are very unhappy about high gasoline prices. What do you have to say to them?

MR. SMITH: I understand consumers being unhappy about it. People have had to make changes in their lifestyle, and nobody likes that. In the past, the industry hasn't done as good a job of trying to explain what is happening in gasoline prices. We've done our share with employees. We've taken our message out to some of the very sensitive markets to try to make sure our employees understand why gasoline prices are where they are, in large part so that they don't feel bad about working for the company. We've done that with media.

There's this feeling that we're somehow artificially raising prices, but you can't manipulate the market. The consumer moves the market. The consumer has the power to either buy the product or not to. If he doesn't buy it, the product accumulates, you've got more supply and prices come down. We're on the right road to try and educate people on what they can do, letting them know more in advance of what could change price structure, but we don't control it. We buy crude oil, we manufacture it and we put it back in the marketplace, and in the middle we make a 20% plus return. It's not egregious, it's not a secret.

WSJ: Why were gasoline prices so high earlier this summer even if the price of crude oil was down?

MR. SMITH: Recently, we had so many of the refineries down for maintenance. Last year there were changes that were happening in fuel standards, and people put off maintenance programs until this year. Supply was down, demand was up and the margin above crude was higher.

When I bought the crude oil, I may have paid $60 a barrel and I'm not going to process that crude for 45 days. I have no idea what the price of crude actually is going to be on the day that I process the product and put that particular crude in the form of products into the marketplace. That's why you're buying crude no matter what the price is, and you sell product no matter what the price of the crude was when you bought it. We don't control the price of crude, we don't control the supply and demand.

WSJ: How big is the threat that hostility toward refiners will be transformed into laws that limit your business?

MR. SMITH: In the past, the government has made regulations that probably exacerbated the problem, but it is realizing that in some ways it has become its own worst enemy. Every time they ratchet it up a notch, they constrain more supply.

that in some ways it has become its own worst enemy. Every time they ratchet it up a notch, they constrain more supply. For instance, today one of the reasons that refineries aren't going to get built is because there's so much talk that in 10 years we're going to have all alternative fuels. Who's going to build a big refinery if you can't get a payout? By continually perpetuating a myth that we're going to have an enormous supply of alternative fuels, you don't solve the immediate problem because nobody's going to invest that type of money.

WSJ: What will American drivers be using as fuel 10 years from now?

MR. SMITH: If you look at the larger picture, adjustments will be necessary. You're going to have a little bit of hybrids, a little bit of conservation. You're going to have a little bit more ethanol. All of that is needed to be able to continue to have a balance if you have growing demand. But I don't think the world will be a lot different relative to the consumption of our products in 10 years. It's going to take a long time to find the technology and to figure out how to distribute it. We have an infrastructure here in the United States that distributes petroleum products. To duplicate that on a large scale will take more time.