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FUTURE OF EUROPEAN REFINING: IS IT SURVIVAL OF THE FITTEST?

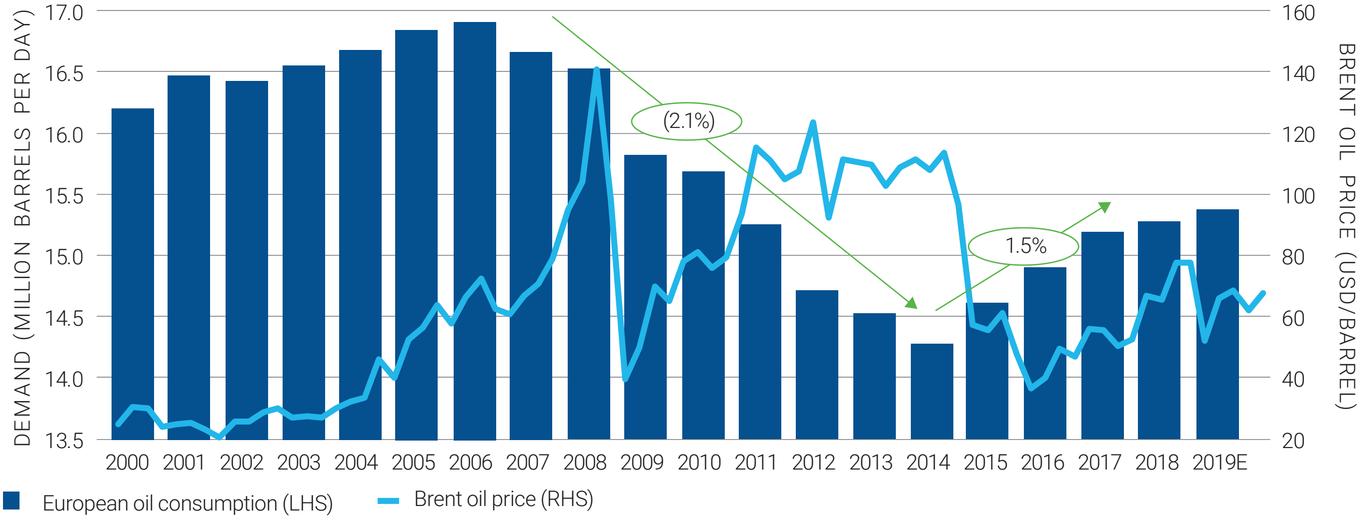
At the end of 2019, one may have forgiven European oil refiners for thinking they had made it through the worst of a challenging decade. It was the fifth straight year of growth in the region following eight consecutive years of decline in oil demand, and the upsurge was driven by lower oil prices and improved economic conditions.

But this much-needed profitability boost is now at risk of being a temporary respite as competition from newer and more complex refiners in the US and the Middle East continues to grow and the forecast for long-term local demand refuses to improve. In this challenging environment, refiners who want to stay in business must adapt and pursue a strategy of continuous improvement and organisational effectiveness.

THE FALL IN OIL PRICE BENEFITTED REFINERS SIGNIFICANTLY

Economic sluggishness on the continent, combined with high oil prices and regulatory efforts to reduce fossil fuel usage, led European oil consumption into a sustained contraction between 2006 and 2014. This trend shifted following the oil crash of 2014 when the low-price environment triggered an immediate rebound in demand for oil products. Oil consumption grew by 1.1 million barrels a day over the following five years (figure 1), with the greatest growth in demand coming in gasoil and other low sulphur fuel oils. Gasoline demand, however, continued to remain stagnant due to strict European Union fuel economy standards.

FIGURE 1: RISING OIL DEMAND OVER THE LAST FIVE YEARS AFTER A PERIOD OF DECLINE

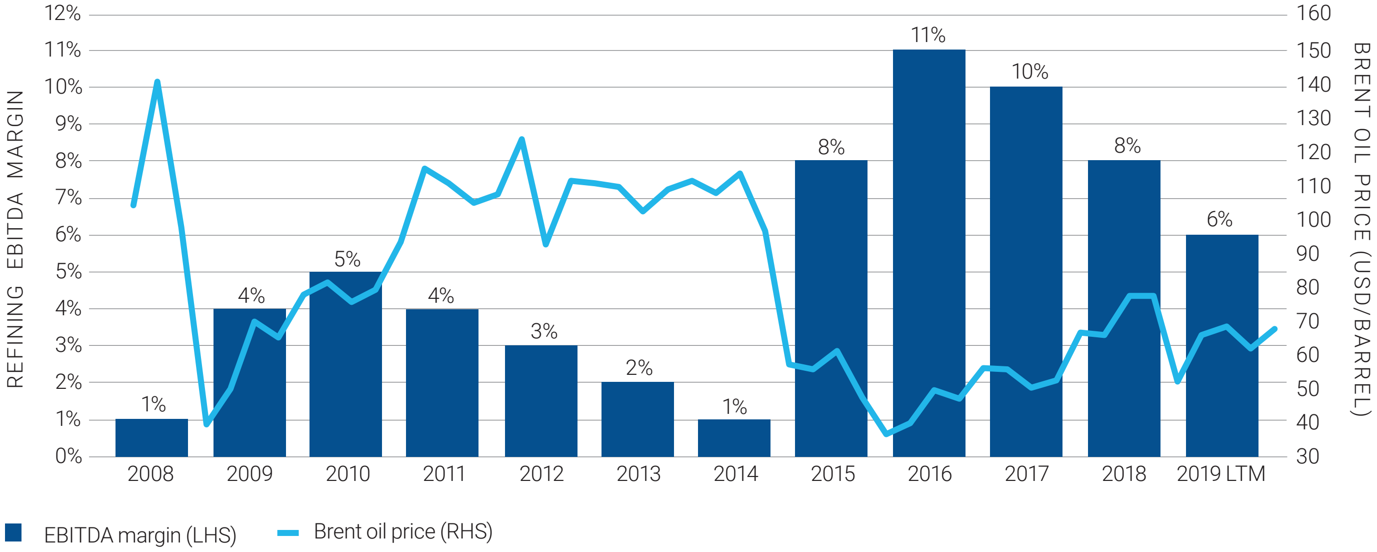


Source: BP Statistical Review of World Energy June 2019, IEA; AlixPartners analysis

Standalone refiners are usually more susceptible to oil price volatility than oil majors – the integrated nature of the latter group's operations means that they benefit from increased profitability from upstream exploration and production operations even when their downstream operations suffer, and vice versa.

An AlixPartners analysis of nine European downstream companies whose operations are primarily concentrated in the refining market confirmed that the economic environment following the oil price crash helped business. Many refiners had sharply reduced capacity between 2006 and 2014 in order to cope with the difficult conditions. As demand increased after 2014, reduced capacities meant that refinery throughput increased, and utilisation levels rose to above pre-2008 levels. These favourable conditions resulted in strong earnings performances. Reduced operating costs from falling feedstock and energy costs lifted EBITDA margins to ~10%, although they eventually fell back to ~6% (figure 2).

FIGURE 2: PERFORMANCE OF EUROPEAN REFINERS OVER THE LAST DECADE

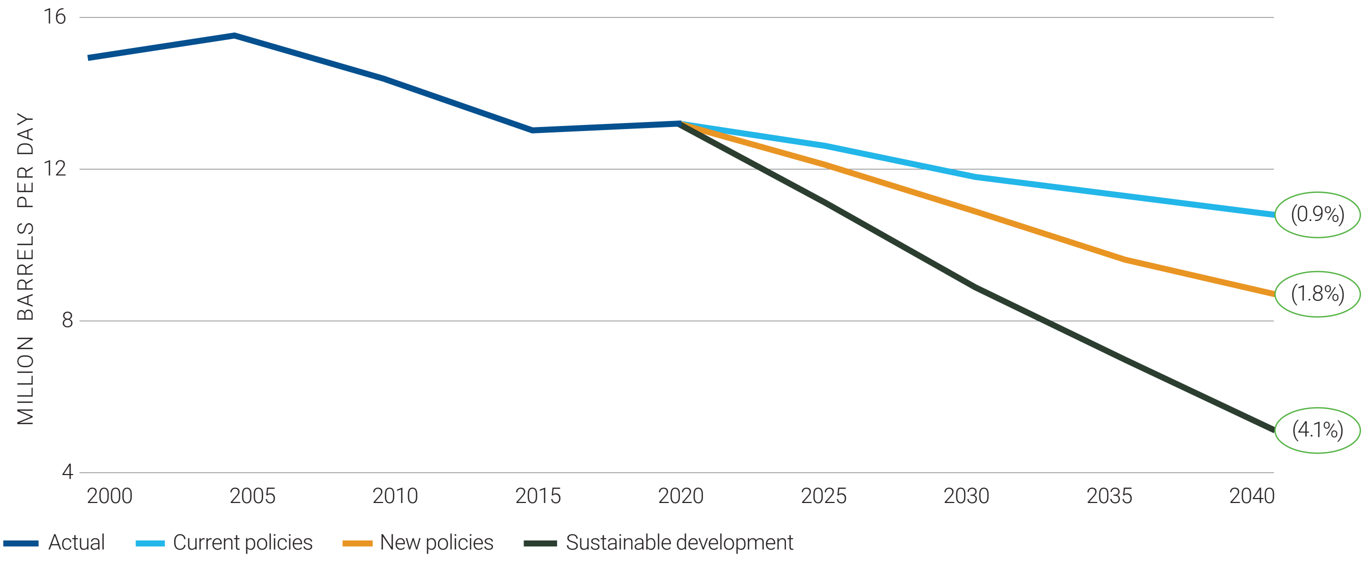


Source: Company data; AlixPartners analysis
Note: Data covers nine Europe-based downstream companies

WHAT DOES THE FUTURE HOLD?

Looking ahead, European refiners stand to face several macroeconomic, regulatory, and political challenges, with limited levers at their disposal to mitigate the risk. Among the first are the sweeping new global rules governing shipping fuel from the International Maritime Organization, which came into effect January 2020, and ban ships from using fuels with sulphur content above 0.5%, down from the earlier permissible levels of 3.5%. Smaller, less complex refineries that dedicate large proportions of their production to high sulphur fuel oil and gasoline will be hit the hardest.

FIGURE 3: FORECAST FOR EUROPEAN OIL DEMAND OVER THE NEXT 20 YEARS

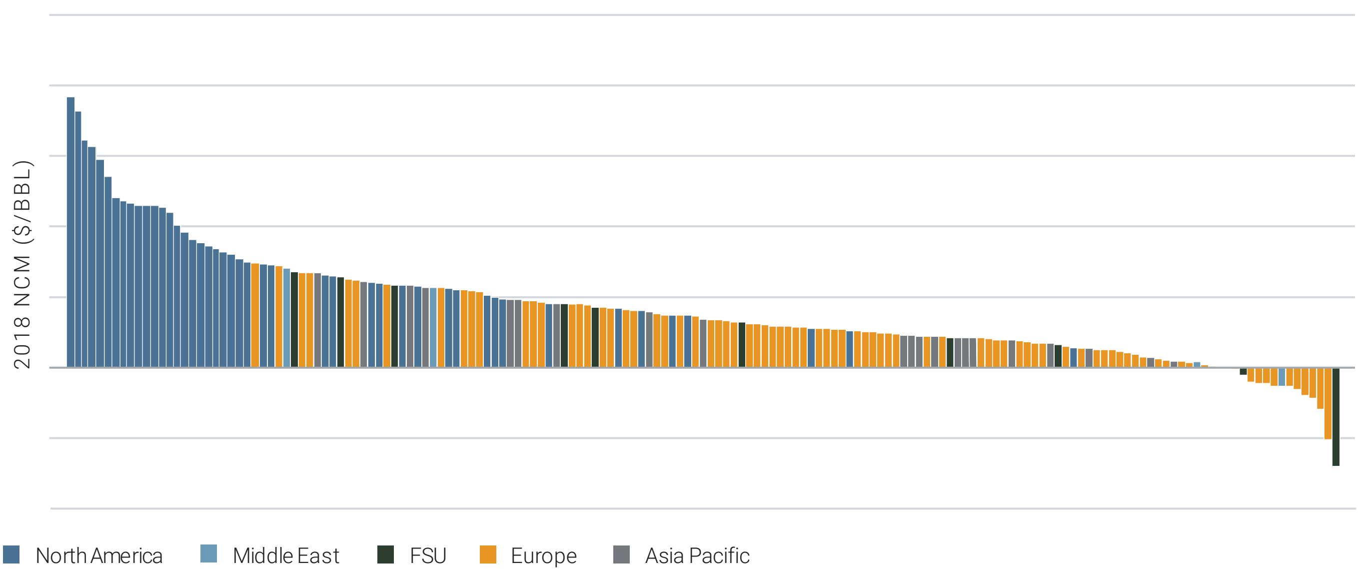


Source: IEA World Energy Outlook 2019, AlixPartners analysis

Second, and substantially less predictable, is the combined market fallout from the COVID-19 pandemic and the oil price war between Russia and Saudi Arabia, both of which flared to unprecedented levels in February and March. Similar to the price crash of 2014, refiners may see a benefit to refining margins from the tumbling oil price. But volatile and stalling demand is equally likely to lead to reduced throughput and pressure on the bottom line for underutilized refiners. The period and degree of the impact is yet to be measured, but even before factoring in this disruption, a year-on-year decline is already predicted for long-term European oil demand even in the most optimistic scenario (figure 3). This is attributable to Europe's stringent fuel economy standards and ambitious CO2 emission targets for 2021.

So, what does this mean for European refiners? Figure 4 is a stark illustration showing European refineries heavily skewed to the less profitable right side of the chart. Many European refiners already lag their global competitors in their ability to generate refining margins owing to their lower-complexity operations and higher average operating costs than any other region (particularly the US and the Middle East). Furthermore, low-complexity refiners are only capable of producing lower product yields, typically commanding lower margins.

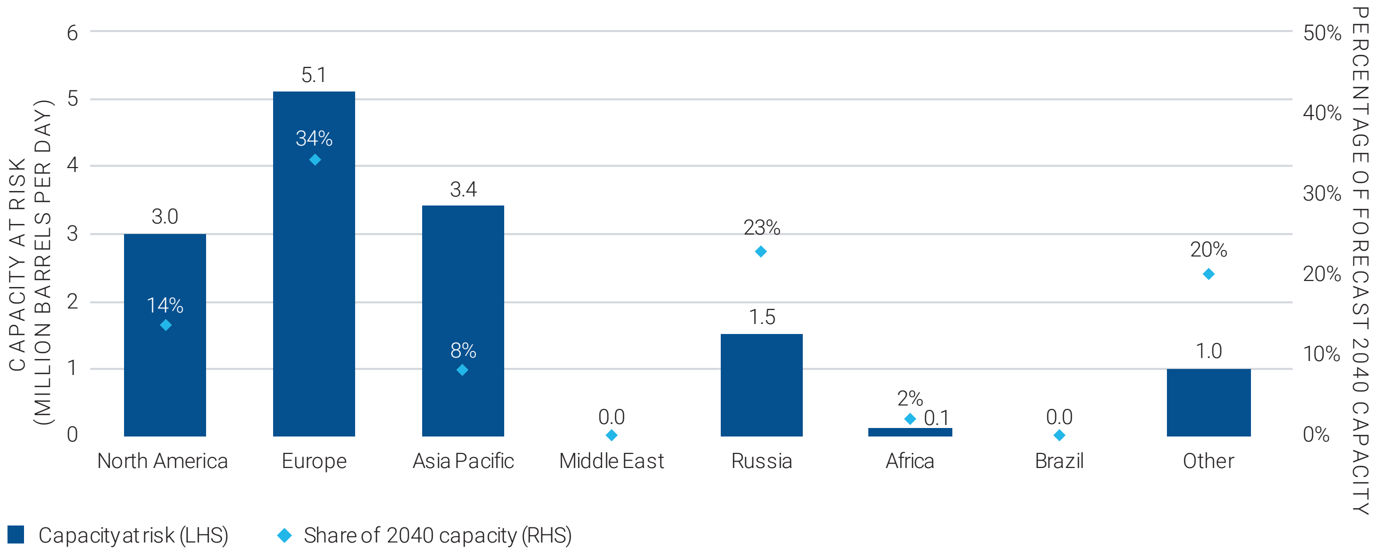
FIGURE 4: EUROPEAN REFINING ASSETS ARE SITTING ON THE TAIL END OF THE MARGINAL COST CURVE



Source: Wood Mackenzie Refinery Evaluation Model 2018, AlixPartners analysis
Note: Data shows refining net cash margins of European refineries versus a select group of their competitors in 2018. The net margin is the gross margin minus operating costs per barrel of refined product sold.

While the overall market is shrinking, competition from other regions continues to grow. Forecasts anticipate a 13mbd net increase in refining capacity from Asia Pacific and the Middle East by 2040 on the back of new, state-of-the-art, complex refineries in these areas. The International Energy Agency expects Europe to take the greatest impact of increased competition brought on by these developments, both in terms of absolute barrels per day and as a percentage of total capacity for the region (figure 5).

FIGURE 5: A THIRD OF EUROPEAN REFINING CAPACITY WILL BE AT RISK BY 2040



Source: IEA World Energy Outlook 2019; AlixPartners analysis

It's apparent that the European oil market will become more competitive over the coming years as more refineries compete for their piece of the shrinking pie. While some may not be able to survive under the added pressure, many can remain competitive providing they take quick action to reduce their cost structure and work on organisational effectiveness.

Each refinery has a specific cost structure based on the type and complexity of its operations, the cost characteristics of the region where it is based, and other unique refinery features. However, a broad range of improvement areas is available – from organisational effectiveness to gross margin improvements.

Here are some broad-spectrum examples of possible improvement opportunities:

1 **Organizational effectiveness enhancement:** This includes taking a closer look at the organization's structure, roles, and culture and evaluating talent as well as the processes and operating models.

2 **Energy optimisation:** This can be achieved through assessing systems such as furnace operations, fuel gas, steam and condensate, and electrical.

3 **Routine maintenance standardisation:** Among the available levers are productivity, equipment segmentation and maintenance strategies**,** and materials management.

4 **Turnaround maintenance improvement:** This can include scope management, turnaround interval extension, etc.

5 **Operating cost optimisation:** Can be achieved through assessing fixed costs such as contracts, variable costs such as laboratory and rental expenses, as well as functions including information technology, procurement, human resources, finance, and administration.

6 **Gross margin enhancement**: Can be achieved through process optimisation, waste management, control systems changes, etc.

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Undertaking most of these will require discipline, but can be achieved through the following fundamentals:

Set the right ambition: Internal and external benchmarking is a useful tool to gauge the current cost structure and can help in identifying and setting the proper ambition and target levels. It will not, however, help in generating, identifying, and delivering the cost savings.

Create the right team: To properly challenge the demand levers, refineries must create a multifunctional project team where the presence and activity of the technical functions (e.g. maintenance, engineering, production) will be key to the identification and execution of the initiatives by focusing and critically addressing demand levers.

Ensure strong governance: Management should provide strong leadership and commitment that prioritises effective implementation, as well as set up tight periodical progress reviews and proper monitoring tools.

European refiners need to use the runway the last few years of good business has provided to make the necessary adjustments that will ensure competitiveness in a market environment likely to become more challenging.

CONTACT THE AUTHORS:

Marcus Connew
Senior Vice President
+44 20 7332 5029
mconnew@alixpartners.com

Michael Gould
Vice President
+44 20 7098 7580
mgould@alixpartners.com

Cosma Rolando D'Amato
Vice President
+39 02 360 16205
cdamato@alixpartners.com

FOR MORE INFORMATION, CONTACT:

Clemente Honorati
Managing Director
+39 02 360 12057
chonorati@alixpartners.com

Peter Oppitzhauser
Director
+44 20 7332 5167
poppitzhauser@alixpartners.com

ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.