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ANALYSIS

Oil processing

The European refining industry, which is crucial for the production of transport fuels and all plastics, is being transformed as the big oil corporations retreat and more specialised entrants see opportunities in struggling refineries.

By Sylvia Pfeifer

Gary Klesch likes trouble. The American financier made his name in the City of London in the 1980s by buying debt in struggling companies, taking on groups such as Eurotunnel, Euro Disney and Heron International, the property group.

Today his €5bn Klesch Group empire is focused on industrial commodities but his appetite for businesses in trouble is unabated. Just as some of the world's biggest oil and gas companies are scrambling to get out of European refining, Mr Klesch is trying to get in.

After a golden age between 2005 and 2008 in which many refineries enjoyed big profit margins because of strong demand from China and the Middle East, the European industry is struggling. Weak domestic demand, overcapacity and competition from more modern, larger Asian refineries have prompted a shake-out. Big oil companies including BP, Royal Dutch Shell and France's Total have sold large chunks of their refining portfolios to focus on a smaller network of strategic plants. They have also ploughed resources into more profitable activities, such as exploration for new oil and gasfields. Impending EU legislation is another cloud on the horizon.

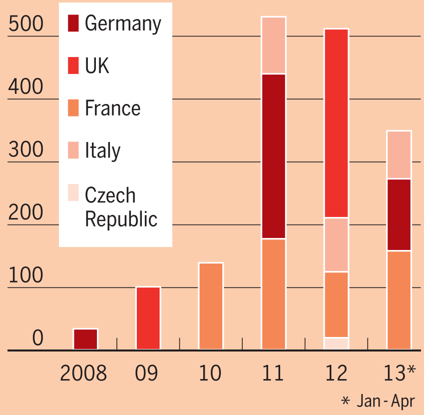
It is just the kind of market that Mr Klesch, 66, the Cleveland-born son of a boxer, has learnt to love. He gained his first taste for the bankruptcy business during his time at the US Treasury in the 1970s when he led the restructuring of Penn Central Railroad. He became an adviser to President Gerald Ford before moving to Europe to make his name seeking out companies in distress.

Klesch Group was founded in 1990 and is today focused on the production and trading of chemicals, metals and oil. It bought one of Shell's refineries in Germany in 2010. Mr Klesch is now on the hunt for more. He looked at plants offered for sale after the collapse of Petroplus, Europe's largest independent refiner, last year and although he did not buy at the time, he is in talks to buy others.

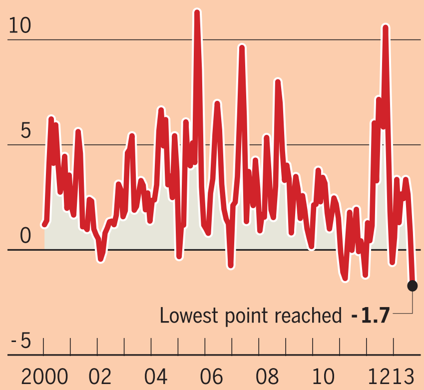
The image of an industry in decline, says Mr Klesch, is exactly one that "suits my book". His recipe for success is simple: focus. Unlike the big oil groups, which are involved in exploration, production, refining and marketing, often with multiple refineries, he concentrates on one plant.

"The economic theory is when you focus you get to optimise better than somebody who is integrated. There is some proof of that. Whenever you disaggregate the chain . . . your focus is such that you are free of constraints."

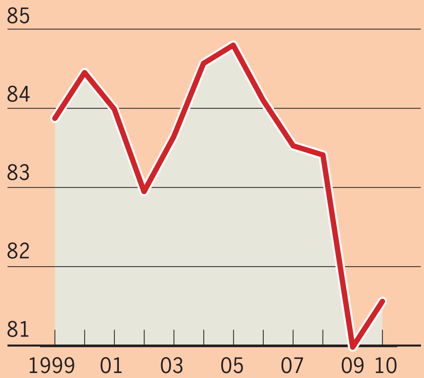
The former Shell refinery is no longer loss-making. Its first full-year of operation



Northwestern Europe gross refining margin
Monthly averages ($ per barrel)



Utilisation rate of European refineries
Per cent



Sources: IEA; Wood Mackenzie; Europia

as a profitable entity was in 2011. So what does Mr Klesch know that Shell, Europe's biggest oil and gas company by market capitalisation, did not? It all comes back to focus. "I am free of any constraints of a portfolio management," he says, but admits that "it's a lot of little steps".

The refinery today is more flexible. Under Shell it used to process eight to 10 different types of crude. Today "we can test it up to 50 crudes", he says.

His group's aim is to invest in refining assets and build its trading business around them. His team in charge of the oil business is led by a BP veteran. "Our focus, whether we buy a refinery in a port or an inland refinery is in developing the local inland markets where it still pays a premium for good service as opposed to the cargo market," says Mr Klesch. "The inland market is not simply retail petrol sites but large commercial and industrial customers."

Refineries area largely invisible to the general public – except, perhaps, when petrol stations run out of fuel – but they are nationally strategic assets. They take raw petroleum and turn it into the gasoline, diesel and aviation fuel that power the world's transportation system. They make much of the feedstocks for the world's plastic. Every plastic item we use, from cellophane to the parts of the seat on which you sit, begins life in a refinery.

It is not just bargain hunters such as Mr Klesch who see value in Europe's underperforming refineries. Gunvor, the Russian commodity trader, last year bought two from Petroplus, one in Antwerp and another in Ingolstadt, Germany.

"The utilisation rates of Europe's refineries are below what might be seen as optimal," says David Fyfe, head of market research and analysis at Gunvor. "From a big-picture perspective, this can look quite depressing but not all refineries are in the same situation and there are opportunities."

Commodity traders such as Gunvor have had to cope with tighter margins. One way to ease the pressure is to look up the chain to where commodities are processed. While some are investing in exploration and production, Mr Fyfe says Gunvor sees "clear synergies between our logistics and storage capability and refining".

Other new entrants include Essar Energy, the Indian oil and group, which bought the Stanlow refinery in the UK from Shell in 2011. St1, a privately held Finnish group that produces biofuel and runs petrol stations across Scandinavia, has emerged as another entrant, snapping up Shell's Nordic plants in 2010.

The new participants can afford to invest. Refineries' former owners, with their integrated structure, were often dissuaded from investing because they would usually earn more putting money into a new oil or gasfield. The new entrants have no such conflicting demands.

Anthony Lobo, oil and gas partner at KPMG, says: "Many of the new refining entrants have invested in the assets to an extent that would not traditionally have made sense for the majors, given the higher returns available on exploration and production assets. The new players are also very focused on costs and typically run the assets with lower levels of working capital which significantly affects the level of financing needed."

In Europe, the beating heart of the refinery industry can be found on a 40km finger of land that protrudes into the North Sea from Rotterdam port. Standing on a platform at the top of ExxonMobil's "flexicoker" – a 60m tower that processes heavy residual oils into gasoline and diesel – one gets a bird's-eye view of Europe's refining hub. Tankers move up and down the peninsula and its endless line of refineries, delivering and loading different types of fuel. The frenetic activity does not suggest an industry under pressure.

Similarly, while some of the oldest parts of Exxon's facility could do with new paint – it had its official opening in 1960 – it has continued to prosper. The flexicoker was constructed in the mid-1980s and other upgrades have ensured that the plant, whose main end-product is low-sulphur automotive diesel, is as efficient as possible. The refinery and chemical operations are highly integrated. The site resembles an enormous chemistry set, with pipes connecting different processing units and distillation towers.

> **'It all comes back to focus. I am free of any of the constraints of a portfolio management'**

Exxon's plant, along with some others dotted along the peninsula owned by the likes of Shell and BP, are proof that there is still life and money in refining – provided you have a refinery that is efficient and flexible.

This year Total approved a €1bn modernisation project for its Antwerp refining and petrochemical plant, in part to meet demand for "greener" products and be able to convert heavy fuel oil into de-sulphurised diesel and ultra-low sulphur heating oil. Patrick Pouyanné, Total's president of refining and chemicals, says the company has "tried to develop and bet on the integration of refineries and petrochemicals in order to have large platforms where you can generate synergies. These large platforms will be the best positioned for the future."

But the market remains depressed. In Europe, the trend away from gasoline to diesel has had one of the biggest impacts on the industry. A few years ago, European refineries would normally have exported the surplus gasoline to the US and west Africa. However, with higher refinery outputs in the US, in part due to the shale gas boom that is providing cheap gas as fuel, the US is importing less gasoline and starting to compete with Europe in the export markets.

Mr Pouyanné says demand has dropped 2 per cent every year over the past five years. On average, Total expects demand to drop between 0.5 per cent and 1 per cent every year for the foreseeable future. While there have been rationalisations and closures of some of the older and less flexible plants, there is still about 1m barrels a day of overcapacity.

Recent months have been "very bad" for European refiners", says Jonathan Leitch from Wood Mackenzie. The consultancy's benchmark refining margin showed negative margins of $1.70 a barrel in September. "This is a record monthly low according to our records, which go back to 1995. For comparison, the same benchmark margin averaged positive $4.10 per barrel in 2012," he says.

There are "not a lot of bright spots" for the European industry, says Chris Beddoes, director-general of Europia, a trade association representing the oil refining and marketing industry in Europe. He highlights the "strong competitive pressure" the industry faces. High energy costs represent more than 50 per cent of its operating expense so any improvement would help it become more competitive.

Yet apart from factors such as weak demand and international competition, Mr Beddoes cites a swath of current and impending legislation, including directives on industrial emissions and fuel quality, as a crucial challenge.

A study for the UK industry association this year calculated that the cost of proposed UK, EU and global legislation to UK refiners would add about $2.50 a barrel from 2015-20, of which an estimated $1.30 a barrel "might be passed on to the consumer as global competition from non-EU refiners would limit this". The study concluded that "required capital expenditure over this period is estimated at £5.5bn, most of which would not generate any return on investment".

Mr Beddoes says: "Legislation is not the whole picture but when you're in a deep hole you don't keep digging. EU legislation is piling on the pressure." But this "does not mean we don't need a robust industry that is prepared to invest", he adds.

Most companies and analysts predict that more consolidation is inevitable as the industry adapts to a changing environment. While the big players may have retreated they will not disappear altogether. In the meantime new, hungry and nimble entrants, often focused on specific sites, such as Mr Klesch, will come in and form a second tier of players.

Mr Klesch says: "Old economy assets have a lot of opportunities around them to do things differently.