Oil Market Report – February 2012

It seems that many of you have paid close attention to previous Portland reports, as the last article on Petroplus generated many responses. The general gist of these responses was along the lines of:

"In your January report, you talked extensively about poor European refining margins and how this spelt disaster for Petroplus. Yet in several recent reports, you have pointed to an acute shortage of certain fuel grades (in particular Diesel and Jet Kerosene) in Europe. Surely if this was the case, refinery margins would be much healthier?"

On the surface this seems a fair point – yes, Europe is short of Diesel and Jet (Kerosene) and yes, margins on these grades are attractive. But for every litre of Diesel and Jet produced, a European refinery must also churn out many more litres of Petrol, Gasoil and Fuel Oil. It is these grades – more akin to distressed sales because of their surplus – that lose more for the refineries than the profitable grades make in profit.

In their 2003 – 2007 refinery buying spree, Petroplus typically acquired unsophisticated, oil major "discards" with industry complexity ratings (The "Nelson" Index) of around 4 to 7. This is very much in line with the average European rating of 6.5, but weaker than the USA figure of 9.5 and much weaker than the latest offering from India – the Jamnagar refinery (Gujarat) with a score of 14. Such a lack of technological sophistication in Europe means only certain crude oils can be used to meet high European demand for Diesel and Jet. The alternative is to import these grades into Europe, already refined (see Portland Reports Aug 2010, Feb 2011 and Sep 2011).

The solution to this problem of course is to carry out a major overhaul of European refining, so that yields of Diesel and Jet (ie, products that Europe increasingly uses) are maximised, whilst production of Petrol, Gasoil and Fuel Oil (ie, grades that Europe has grown out of) are minimised. But such a move would have a huge cost and there lies the rub. Why would any oil CEO invest in old European equipment, when for the same price, a brand new refinery could be built in the booming East? Worse still for Europe is the fact that the relatively simple economics of capital investment (ie, build costs being cheaper in the East) are of nothing, when compared to the economics of future demand.

To illustrate the latter point, let us travel back to Britain in the 1950's. The lean years of the war and post-war period are slowly dissipating and consumer prosperity is growing. The manifestation of this new burgeoning wealth is the "working man" buying his first car and discovering the joys of independent mobility. It was against this backdrop that the oil majors invested in UK (and European) refining. After all, European demand forecasts in the 1950's (correctly) pointed to a half-century of unchecked growth in fuel consumption, as car ownership went from a luxury to a given.

That period of growth has now ended and the West now has declining fuel consumption as both fuel economy and environmental legislation bite (see last month's report). But in India, we have an economic parallel with 1950's Britain. Car ownership is minimal but growing rapidly. In fact, the next 50 years will see exponential growth in car ownership and with it, fuel demand. So realistically, what kind of CEO is going to invest circa $500m in old kit and in a region of declining consumption (Europe), when they can spend the money where it goes much further both in the short term (build costs) and long-term (market demand). If Europe needs the occasional imported cargo to keep things ticking over, then so be it, because the new refining world will be located in India...and China....and Indonesia...and Brazil and...(etc, etc).