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UK Downstream Oil Industry Profitability

- **The main driver for higher pump prices in the UK and globally is the price of crude oil and the impact this has on the price of refined products such as petrol, diesel and jet fuel.**
- **Historically, a combination of good supply infrastructure, open markets and strong competition in the UK has kept pre-tax prices of petrol and diesel amongst the lowest in the EU.**
- **On average, UKPIA members with refining/marketing operations have return on capital employed figures in line with the manufacturing sector but below that of the service sector. Their aggregated average return for the period 1999 to 2008 was 11.6%%, compared to 9.5% and 16.4% for the manufacturing and service sectors (*Source: UKPIA/ONS*).**
- **NW Europe refining margins since 2000 have been around $2.00 per barrel of crude oil, adjusted for , but in 2009 dropped below $1 per barrel (*Source: Wood Mackenzie*)**
- **UK refineries will require further substantial investment in the future to meet changing crude oil source and consumer demand patterns, the need for cleaner fuels and tighter environmental standards. A stable fiscal and investment climate will be crucial to attracting this investment to the UK.**

Background

The price of crude oil and the resultant impact on fuel prices is a subject that attracts a lot of debate, particularly against the background of high crude prices that have persisted for the last four years, Brent blend reaching a peak of $147 per barrel in July 2008.

With some integrated oil companies reporting increased earnings as a result of these higher prices, there have been calls in some quarters for a ‘windfall tax’ levy. However, UK oil and gas producers are already highly taxed on their profits, with the tax yield automatically increasing with higher prices.

Oil industry overview

The oil industry is a complex and diverse global business, comprised of a varied mix of national oil companies - often state owned or controlled, integrated international oil companies with upstream and downstream activities; refining companies; oil storage and distribution companies; fuel marketing companies and a range of traders, shippers, suppliers and specialist service providers involved with most stages of the business.

Upstream oil exploration and production in particular is a high risk and complex activity, requiring huge investment in finding and bringing on stream new sources of oil without any guarantee of success. The International Energy Agency has estimated that $3 trillion of investment will be required in the next 25 years to meet projected future oil and gas demand, most of this focused on finding new sources of oil and gas.

Downstream oil refining and marketing

UKPIA’s member companies in the UK reflect in part this diversity, some being subsidiaries of large integrated international oil companies with international exploration, refining and marketing interests, others being specialised refining companies with no fuel marketing interests or some with marketing interests only.

United Kingdom Petroleum Industry Association Ltd, Quality House, Quality Court, Chancery Lane, London WC2A 1HP
T. 0207 269 7600
www.ukpia.com

Downstream profitability in the UK

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Oil refining remains a capital intensive business. Although refining margins for NW Europe refineries have, on average, been positive in recent, higher prices for crude oil and other feedstocks have increased volatility.
For those companies with UK fuel marketing activities, particularly retail forecourts, over the last fifteen years this has become increasingly a high volume low margin business, characterized by strong competition. This is evidenced by the fairly flat trend in the difference between the ex refinery wholesale price of petrol and diesel in the open market and the average pre-tax forecourt pump price (see Chart 2 below) which has ranged between 5-6pence per litre over the last four years.

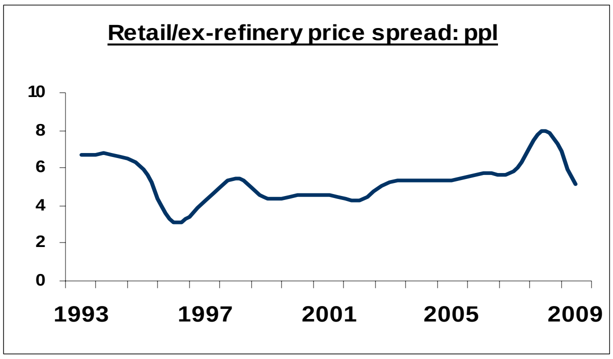

Chart 2: Retail/Ex-refinery price spread 1993-2009
(Source: Wood Mackenzie)

The UK road fuels market has grown very little in volume terms and the low profitability is reflected in the rate of closure of filling stations - an average 600 per year until recently. This background has also prompted some companies to exit the UK market and in addition to filling station closures, two refineries have closed in the last eleven years.

The main driver for higher pump prices in the UK and globally has been the higher price of crude oil and the impact this has had on the price of refined products such as petrol, diesel and jet fuel.

Supplying companies are not profiting at the expense of consumers; the earnings of international integrated companies are mostly derived from oil and gas exploration worldwide, not from UK refining and fuel supply activities A combination of good supply infrastructure, open markets and strong competition in the UK has kept pre-tax retail prices of petrol and diesel amongst the lowest in the EU over the last decade. Duty and tax accounted on average for 67% of the pump price in 2009.

Future challenges

UK refineries will require further substantial investment in the future. UKPIA 's 2006 report *'Meeting our energy needs: The Future of UK Oil Refining'* outlines the growing imbalance in UK refinery output, as well as many current and future major challenges, such as the overall balance and trade-off between product quality and product mix, new specifications, future demand patterns, types of crude oil and meeting environmental objectives.

In addition, a joint industry/Government study, the *'Review of UK Oil Refining Capacity'* by Wood Mackenzie, which examined many of these issues, was published in May 2007.

A stable fiscal and investment climate, to help underpin long-term investment decisions, will be crucial to attracting this investment to the UK.

Conclusions

On average, UKPIA members with refining/marketing operations have return on capital employed figures in line with the manufacturing sector but below that of the service sector. Their aggregated average return for the period 1999 to 2008 was 11.6%%, compared to 9.5% and 16.4% for the manufacturing and service sectors.

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For information on 'Upstream Oil Industry Profitability' visit www.oilandgasuk.co.uk