

Energy (Oil & Gas)
Europe
Special Report

European Oil Majors - Update

Risk Increases of Oil Price Correction;
Refining Outlook Remains Depressed

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Related Research

- *Depressed Mid - Term Outlook for Global Refining (July 2009)*
- *Oil & Gas 2010 Outlook: Exposure to Deflation Remains High (December 2009)*

Summary

As the second quarter of 2010 approaches, momentum behind economic recovery appears to be slowing in some OECD regions, while growth is stronger in emerging markets like India and China. The impact of any slowing economic recovery in developed markets on oil prices ahead of a decrease in seasonal demand for crude oil and oil products in the northern hemisphere, means European oil companies will need to be even more vigilant in controlling costs in 2010 if they are to preserve profit margins, maintain cash flows, and limit reliance on borrowings.

This is especially true for the downstream sector, which faces a particularly challenging operating environment in the face of continued slow demand growth, large idle capacity, low utilisation rates and persistently high inventories. European integrated companies are also deploying different strategies in relation to downstream capex, as they attempt to make the most of a difficult operating environment.

Developments in the second quarter of 2010 could provide important clues as to how results in the sector will materialise over the course of the year. Economic data in OECD countries remains mixed and could yet revert to lower levels. In the meantime, OPEC countries continue to over-produce, which adds further pressure to high existing commercial inventories – and continues to move market fundamentals away from the current rising oil price dynamics which are in part being supported by increased trading activity in oil futures markets. Fitch Ratings is concerned that the lack of fundamentals driving current oil prices higher could lead to a correction in oil prices at some point over the next few quarters, which would have a negative impact on companies' profit margins and cash flow generation.

Equally concerning, operating conditions remain extremely challenged for the downstream segment of European integrated companies. Fitch anticipates it could take up to three years to rebalance global demand and global overcapacity for refined products to a level significant enough for refining profits to fully revert to the long-term average.

As European oil majors have increased borrowings in 2009 to fund capex and dividends during the downturn in the business cycle, their financial profiles have deteriorated along with the downturn in cash flow generation. Whilst Fitch rates issuers on a "through-the-cycle" basis using the agency's conservative oil price view, companies will need to begin demonstrating in 2010 that business conditions are improving and cash flow generation is sufficient for credit ratios to return to mid-cycle levels. A prolonged downturn in oil prices, or continued difficulties in the refining sector, could delay cash generation needed to implement a deleveraging strategy to a point where there could be a negative impact on their outlooks or credit ratings.

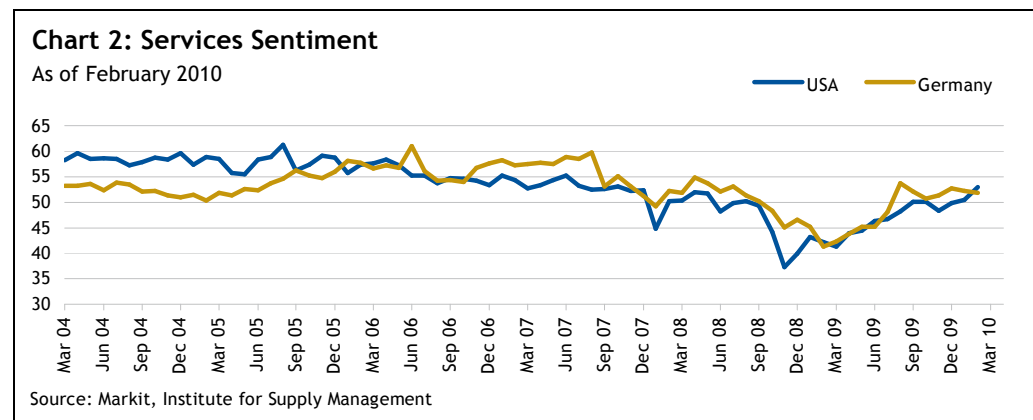
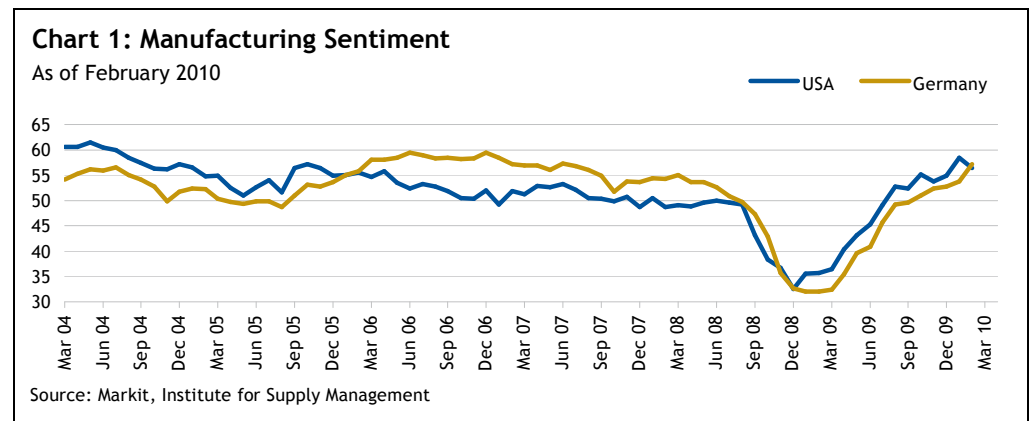
Macroeconomic Picture and Cash Flow Implications

Uncertain Economic Recovery in Developed Markets ...

Conflicting economic data in some developed economies – ahead of a decline in seasonal demand growth for oil and oil products in the second quarter of 2010 – could add to the decline in the price of crude oil, and result in greater price uncertainty. Some forward-looking indicators in manufacturing and services suggest lingering doubts of a sustainable economic recovery in developed markets.

For example, while German manufacturers continue to show optimism into 2010 – with the German manufacturing PMI index reaching a 32-month high in February 2010 (*Chart 1*) – such positive opinion stands in contrast with other sentiment indices in construction (reaching a record low in February in the 10-year history of the series) and services (declining to the lowest level in three months – see *Chart 2*).

Key risks to German manufacturing include inflationary pressure gathering in supply chains, as shortages of key inputs could allow suppliers to hike prices. Meanwhile, other developed markets also paint a conflicting picture. For instance, the UK PMI Index remained stable in February at the 15-year high reached in January – thanks to expectations of rising orders and stronger exports due to a weaker pound, while the US PMI retraced in February as production, new orders and exports slowed.



... Could Add to the Seasonal Decrease in Demand for Oil ...

As the winter heating season comes to an end in the northern hemisphere, demand for oil and oil products enters a normal decline in the second quarter of the year before the start of the summer driving season in the United States.

According to OPEC, in the years (2003-2007) before the current economic recession, the global decline in seasonal oil demand from Q1 to Q2 has averaged around 1.8 million barrels per day. In 2010, OPEC expects the decline to be around half of the normal seasonal average, at just 800 thousand barrels per day. This is partially due to the large amount of demand destruction that has already resulted from the global economic recession, leading to smaller absolute changes in the overall OPEC demand picture regardless of the current change in seasonal demand.

Fitch anticipates that a clouded macroeconomic picture could slow the recovery in demand for oil and oil products in 2010. For example, OPEC reported in March that demand for OPEC crude is currently lagging production by approximately 1.5 million

barrels per day, as producers break production quotas to take advantage of high prices. This additional production may lead to increases in OECD commercial inventories, and cause a further rise in already-high excess stock levels.

In fact, the US Department of Energy reported in its February inventory data that OECD crude and distillate stocks displayed a counter-seasonal build-up in January 2010. Fitch is mindful, however, that any spare production capacity built up in the first half of 2010 leaves the industry with added flexibility to deal with rising demand later in the year.

... with an Impact on Oil Prices, Cash Flows and Borrowing

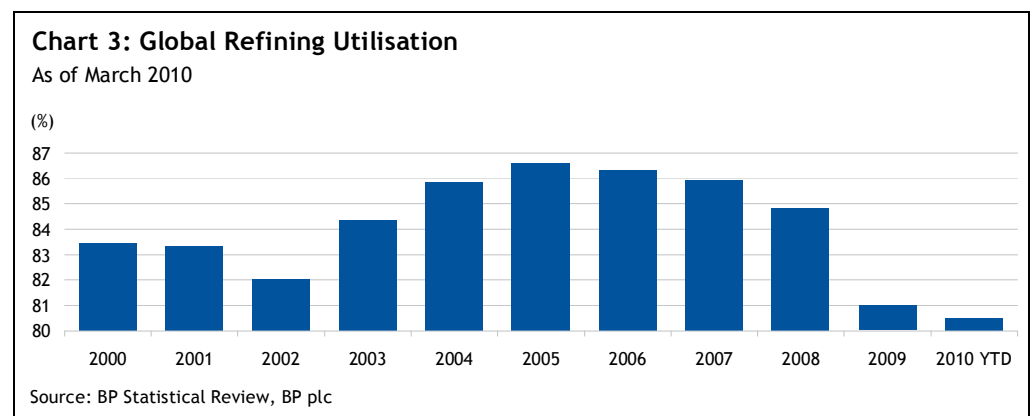
OPEC acknowledges that increased activity in the oil futures market (paper oil market) has supported rising oil prices. OPEC reported in March that money managers are expanding net long positions, and *Bloomberg News* reports that paper long positions outnumber physical barrels of oil available for delivery by more than 3 to 1. Fitch is concerned that the lack of fundamentals driving current oil prices higher could lead to a correction in oil prices at some point over the next few quarters, which would have a negative impact on companies' profit margins and cash flow generation. This is particularly important for European oil companies that have already implemented wide-scale cost-cutting measures across their upstream and downstream operations, and will therefore have less ability to absorb additional cost-cutting measures. It could also imply that companies would have to rely to a greater extent on external borrowings to fund operations, dividends and ongoing capex commitments.

Whilst Fitch does not currently (March 2010) anticipate borrowings by the European majors to increase by more in 2010 than was the case in 2009, the agency will continue to monitor the situation for evidence that internal cash flow generation will be sufficient to reduce leverage to a level more in line with the normal business cycle.

The weak global economic picture could also be particularly damaging to the longer-term prospects of the European oil companies' downstream operations.

Downstream Refining Sector

In July 2009, Fitch published its medium-term outlook for the global refining sector (hyperlink located on the front page of this report), in which the agency stated that prospects for the sector are likely to remain challenging. This view remains largely unchanged as the sector continues to suffer from low utilisation rates (see *Chart 3*), high inventories, weak distillate demand, depressed refining margins and weak free cash flow (FCF).



Cost-Containment and Capex Drive Strategy

Fitch anticipates downstream operations will be an important focus for integrated European operators throughout 2010 and into 2011, as the global refining environment remains depressed. Specifically, the agency feels that integrated European operators will continue to drive down costs by closing obsolete facilities or attempting to sell idle capacity, possibly to upstream emerging market producers in countries like Russia that are looking to enhance or expand their global downstream footprint.

Examples of companies redeploying downstream assets include Royal Dutch/Shell Group's (Shell, 'AA+' /Stable) announced plans in February to sell 15% of its global refining capacity, and Total SA's (Total, 'AA' /Stable) announcement of specific refining shutdowns over late-2009/early 2010. These announcements reflect the need for the European oil industry to battle both a drop in demand for oil products and 15-year low refining margins. Similar activity is occurring with the US majors – Chevron Corporation (Chevron, 'AA' /Stable) announced its intention in March to exit US East Coast retail markets and further review its global downstream portfolio; while Valero Energy Corporation (Valero, 'BBB' /Negative), and Sunoco, Inc. (Sunoco, 'BBB' /Negative) have also announced specific refining shutdowns over late-2009/early 2010 following decisions to idle operations (see *Table 1*).

Table 1: Announced and Possible Refining Shutdowns

	1,000 bpd	Announcement date
Royal Dutch Shell (Montreal)	130	January 2010
Chevron (Pembroke)	210	March 2010
Valero (Delaware City)	210	Q4 2009
Sunoco (Eagle Point)	150	Q4 2009
Total SA (Dunkirk)	137	January 2010

Source: Company reports, Fitch estimates

Fitch estimates the companies listed in *Table 1* could permanently close approximately 800,000-900,000 barrels per day of excess refining capacity. Total reported in February that 1.0 million barrels per day of refining closures have been announced in OECD countries since the start of 2009. Fitch estimates that around 3.0 million barrels per day of global overcapacity would need to be permanently reduced at current levels of demand in order to structurally improve refining profits to historical long-term average levels, which Fitch anticipates could still take several years.

Capex

European integrated oil companies are employing varied downstream capex strategies in 2010, which range from overtly conserving cash on the one hand to reconfiguring operations to improve margins on the other. For example, Total has announced that it is sharply reducing capex in refining in 2010 by 42.3%, to USD1.6bn from USD2.6bn in 2009, and will average around an annual USD1.8bn from 2011 to 2015. This downstream capex reduction is larger than amounts announced by Chevron of 22.6% (to USD2.4bn from USD3.1bn over the same period).

By contrast, BP plc (BP, 'AA+' /Stable) stated in its 2010 strategy update that it intends to hold downstream net investment largely stable at around USD2.7bn in 2010. This level is slightly above depreciation and is part of the company's overall strategy to reconfigure its refining at Whiting in the United States to process less expensive heavy crude. BP expects commissioning of new units to begin in 2012, and should derive greater refining margins by producing lighter products from heavier feedstock. BP says it has a strategy to target break-even margins in an environment similar to 2009, when the company's global indicator margin averaged USD4.0/barrel (bbl) versus USD6.0/bbl in 2008 and around USD10/bbl in 2007.

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