

Australian Refining Industry

Meeting the Challenges

Slide: BP Kwinana Aerial Shot

Refined petroleum product will continue to be a major global energy source.

Estimated energy demand growth of around 1.7% per annum is expected up to 2030, with 90% or more continuing to be supplied from fossil fuels. Oil is forecast to remain the biggest source of energy and 75% of the increase in oil demand is expected to come from the transport sector.

The performance of a refinery depends on its configuration – the types of products it can produce; and the regional demand characteristics.

But within that global picture, there are marked variations in the pattern of demand from region to region. And while there is also a general move towards cleaner fuels, the process is at different stages in different regions.

Europe the US and Asia have markedly different demand and supply conditions.

In Europe there is the prospect of a modest growth in demand. However beneath the headline figure, we expect continued growth in diesel and jet, and a fall in demand for gasoline - as more diesel cars are used.

By comparison, in the US, there is little evidence of a slow down in gasoline demand growth. It has grown at 1.8% annual growth rate over the last 10 years, and looks set to carry on that way in the next 10.

The US has a gasoline deficit as opposed to Europe's surplus. And its marginal demand is met by imports, predominantly into the east coast.

The deficit will grow and could double to something like 2 million barrels per day by the end of the decade. Simultaneously there is regulatory pressure for cleaner fuels across the US.

Therefore, refining margins in the US will continue to be set by import prices. However the increasing deficit of gasoline will see greater differentials between regional gasoline prices as more product has to arbitrage into the US from further away.

In Asia there is the greatest potential for growth, but also the greatest uncertainty. And much of this stems from the growth in China.

Strong growth in Asia provides attractive market conditions but it could be threatened by a further wave of over-investment and surplus capacity into the next decade

The demand is predominantly for middle distillate, although there is also soaring growth in demand for naphtha as chemical feedstock.

However, Asia currently has relatively low refinery utilisation rates, with an average rate in the low 80's. This results from earlier over-investment.

In geographical terms, most of the growth is coming from China, while the surplus capacity is mainly located in Korea, Japan, Thailand and Singapore. And there are various import tariffs and government policies that also act to constrain the import and export of products across the region.

Hence, while the strong growth in Asia provides attractive market conditions, it could be threatened by a further wave of over-investment and a continued surplus of capacity into the next decade.

Slide: OECD Petrol Prices and Taxes September Quarter

Against this international backdrop, the Australian refining industry continues to meet the challenges of volatile regional environment and fierce import competition.

Stricter fuel quality standards for quality fuels and rapid changes in the Australian retail fuels market add to this complexity.

Over the last five years these challenges have threatened the viability of the domestic refineries and while formidable obstacles remain it appears that the industry may have turned the corner.

Australian refining makes an important contribution to Australia through competitive prices and reliable supply in an environmentally sensitive manner.

A stable and healthy Australian refining industry brings many benefits to the Australian community.

First and foremost, the Australian refining industry is a major contributor to Australian economic performance, supplying almost 90% of Australia's liquid fuels requirements.

The Australian industry consistently supplies petrol at the lowest pre-tax price in the OECD and is a source of competitive advantage for fuel intensive industries such as farming, mining, construction and transport.

Slide: The Australian Refining Industry

Up until a year ago there were 8 Australian refineries whose design capacity was roughly equal to the Australia's demand for liquid fuels. In July last year, Mobil decided to mothball the Port Stanvac refinery in Adelaide.

This confirmed the status of the Australian fuel market as a structural importer, further cementing the price relationship to imports.

Australian refineries must compete on a regional basis. The price which the industry competes with imports is the Import Parity Price (IPP). And what is the IPP? It is the Singapore Product Price plus shipping to Australia.

The economics of Australian refineries are simple. If a refinery's costs are below this IPP price, it makes a profit. If not it makes a loss.

Asian refineries also focus on the production of diesel. Petrol is almost a by product of their production. This meant for a number of years, cheap lower quality petrol has been available in plentiful supplies from Asia

Low Singapore refining margins and the general availability of cheap lower quality fuel from Asia culminated in a record loss for the Australian refining industry in 2001.

The consequence? Low refining margins and low profits for refiners. And when we talk refining margins we mean the difference between the product price and the crude oil price.

Slide: International Refining Margins

You see in this chart how Singapore margins were the lowest in the world and how they fell during the last five years. And, sure they came back last year, but this was partly offset by a falling US\$.

For the Australian downstream industry these low margins culminated in a record loss of almost half a billion dollars in 2001.

The performance of the Australian downstream petroleum sector has improved somewhat since 2001 and the recent profit announcements suggest a further improvement in 2003.

Slide: Industry Profitability (1993-2002)

The structure of the regional refining industry will also be influenced by the community's demands for cleaner fuels. Most countries in the Asia-Pacific region are moving progressively over the next ten years towards the use of cleaner fuels.

Australia commenced the moves towards cleaner fuels with the national fuel quality legislation in 2001.

Cleaner fuels will bring major community benefits but place a financial strain on the Australian refining industry.

The policy goal was to introduce a uniform system of fuel standards which harmonised with relevant European standards. Government studies at the time highlighted large community benefits of almost \$2 billion largely related to improved community health.

But a cleaner urban environment with reduced particulates, air toxics and smog is only part of the cleaner fuels story. Another important part of the story is the ability of cleaner fuels to facilitate the introduction of advanced engine technologies which have the added benefit of improving fuel consumption thereby lowering greenhouse gas emissions from transport.

The move to cleaner fuels has presented the industry with a major capital investment challenge. The first round of fuels standards to 2006 is expected to cost the refining industry close to 1 billion dollars and increased operating costs of about 1 cent per litre. While still uncertain, preliminary estimates suggest that the cost of the post-2006 fuel standards will be of a similar magnitude.

Slide: Costs of Cleaner Fuels

I am proud of the way the industry, in spite of poor financial viability, has been prepared to tackle the issue of fuel standards. The success of the Government's clean fuels agenda has been built on the cooperation of Australian refineries, close coordination with Australian vehicle manufacturers and the willingness of all parties to be flexible.

Government can improve the effectiveness of the cleaner fuels policy by formalising the initiatives in the proposed energy statement and introducing regulations for the announced cleaner fuels incentives as soon as possible.

The cleaner fuels challenge is ongoing, with the refining industry currently working with Government and other industries on the post 2006 standards. These standards will move the Australian fuels and motor vehicle industries to closely align with European standards.

The Government has committed to support investment to produce post-2006 cleaner fuels with the announcement in last year's budget of incentives to accelerate supply of these cleaner fuels.

The broad initiatives of cleaner fuels standards, motor vehicle design standards and cleaner fuels incentives together can be seen as a basis for a better coordinated motor transport policy for the future.

To improve certainty, refining industry believes it is important that these initiatives be formalised in a comprehensive policy in the Government's forthcoming energy policy

statement. Also the Government can implement regulations which support these policy initiatives as soon as possible.

One issue that is consistently raised in relation to cleaner fuels is supply availability and the price increases.

During the last round of fuel standards there were scare stories that more stringent fuel standards would mean a substantial increase in fuel prices. Now that we have some experience in implementing fuel standards, the concerns about availability and price have been shown to be exaggerated.

When the WA fuel specs were introduced in 2000, there were claims of likely price rises of 6-7 cpl. In fact they were nowhere near this. The current price differential is around 2 cpl.

The key point that alarmist commentators miss is the dynamic and flexible nature of the fuel supply system. Such handsome margins, if they do appear, act as a strong signal to the market to supply fuel to that spec.

Clean fuels cost more to produce but the alarmist arguments of major price increases for clean fuels have been shown to be exaggerated

Nonetheless, it is important that we ensure that the requirement for a particular quality of fuels is closely linked to the demand for that fuel. There is little to be gained from producing quality fuels if the vehicles do not deliver the expected benefits.

Slide: Caltex Kurnell Aerial Shot

The debates about the price impacts of fuel standards also raise important issues about supply reliability.

The first is crude oil self sufficiency.

I know that this issue is important to the members of APPEA who are engaged in exploration for new sources of crude oil. While access to secure supplies of feedstock is important, our refineries have the capability to handle a range of crude oil imports. In fact, almost 65% of the crude oil used in the Australian refineries is imported.

The Australian downstream petroleum industry has an excellent record over several decades of ensuring supply reliability.

The second aspect of supply security is supply reliability.

The Australian downstream petroleum industry has an excellent record of ensuring reliable supplies of transport fuels to the Australian market. Where there have been supply disruptions these have generally been of a localised nature and resolved in a short space of time.

AIP recognises there is concern about supply reliability especially in the face of the changing structure of the industry and fuel standards. It is true that it is becoming increasingly difficult to purchase fuel of Australian quality on the spot market in Singapore. However, fuel of the appropriate quality is readily obtained on the term market.

Governments can assist in supply security by ensuring that there is a positive policy framework which supports investment in the industry. This is critical for Australian refineries because in general we compete for investment dollars with other alternative locations.

The Sites and Franchise Acts actively discriminate against refiners because the regulations only apply to fuel marketers who have refining operations in Australia. There have been numerous Government reports that have recommended the repeal of these Acts, including very recent comments from the ACCC, highlighting these Acts as anachronistic, inequitable and inefficient.

Until these Acts are repealed, lingering doubts will remain about the investment climate for Australian refiners.

The Australian refining industry has met some formidable challenges and is hopeful of a sustainable future in Australia.

Conclusions

Slide: Australian Refining: Meeting the Challenges (following dot points)

Let me conclude by reviewing what is being achieved and what is sought by the Australian refining industry.

- The downstream petroleum industry continues to sell petrol at the lowest pre-tax price in the OECD which says that the industry is efficient and competitive, and demonstrates we provide a considerable benefit to consumers
- While refinery and industry profits have improved, it is against a backdrop of 5 or more tough years. This underscores our claims about competition in Australia and the Asian region.
- It delivers product reliably over a large and thinly populated continent efficiently and safely with minimal environmental impact.
- It will continue to deliver needed improvements in fuel standards, with positive impacts on air quality and health. Consumers will also benefit from new vehicle technologies which will deliver fuel economy gains.

In return the industry requires very little from Government other than a commitment to policy stability and certainty, and the removal of regulation which actively discriminates against its efficient operation.

- The continued implementation of new fuel standards on a sound scientific basis where there are demonstrated positive environmental and health benefits.
- The confirmation of a positive investment climate for Australian refining including the introduction of the necessary regulations, such as clean fuel incentives.
- The repeal of the Sites and Franchise Acts.

In getting on with our business, the industry has met formidable challenges and is now hopeful of a sustainable future in Australia.