

# SARAS

## First Quarter 2008 Results

### 2008

### Welcome

**Marco Schiavetti**

**IR Manager, SARAS**

Good afternoon to everyone and welcome to our first quarter 2008 results. Together with me are Dario Scaffardi, General Manager, and Corrado Costanzo, Chief Financial Officer (CFO). We have the usual agenda today. Dario Scaffardi will start with an introduction; Corrado Costanzo will then go through our business segments. We will then go back to Dario for strategy and outlook.

### 2007 Overview

**Dario Scaffardi**

**General Manager, SARAS**

#### **I. Highlights**

Thank you, Marco. Good morning everybody and welcome to our conference call. Today, we are very proud and pleased to present an excellent quarter.

- We have a group comparable EBITDA that is up 25% versus Q4 2007.
- Adjusted net income is up 71% compared to the last quarter of last year, and 14% versus Q1 2007.
- Refining margin is at \$7.6 per barrel, a 9% increase compared to the last quarter of last year.
- I would like to highlight a very strong free cashflow in excess of €100 million, which has brought our net financial position positive by €77 million versus a negative of €27 million at the end of last year.

## **II. Market Overview**

### **1. Diesel and Gasoline Crack Spreads**

The quarter started on a weak note; refining margins were poor. This often happens at the beginning of the year, due to the fact that there is, very often, stock build during December towards the year-end. However, they recovered quite strongly, starting from mid-February, driven mainly by the middle distillate cracks. The current scenario of very high distillate cracks strengthens the competitive advantage that we have, having a complex and diesel-oriented refinery.

We believe, as we have consistently been saying for the last two years, that these market conditions are here to stay for the foreseeable future. The quarter has been very positive for all our divisions, and particularly for refining; we reached our record of 314,000 barrels a day of average production, which is quite notable if you consider that, on the market, there have been rumours of refineries that have cut runs due to poor margins.

The main drivers here are diesel crack. There has been an interrupted upward trend since last summer. This is due to the global demand for diesel, which is very strong, both for transportation and for industry, which accounts really for the majority of the demand; subdued, instead, gasoline, which is weak due to the faltering demand in the Atlantic Basin, particularly in the US, also because of biofuels.

### **2. Refining and Power Margin**

Notwithstanding the fact that the EMC benchmark in the first quarter of 2007 showed an average of \$3 and, this quarter, of \$2, the overall refining mark-up that we add to the benchmark has moved from \$3.7 per barrel to \$5.6. At the end of the presentation, we will go into a detailed discussion to explain how the fuel oil/gas oil differential impacts on SARAS' result.

## **III. Conclusion**

This improvement that we are seeing is driven mainly by this but, in addition, there is the fact that SARAS presents one of the highest levels of diesel production in the market: in excess of 50%; this quarter, I think that it is almost 53%. It highlights SARAS' business strategy, which is based on the fact that we want to fully exploit, both technically and commercially, the flexibility of our units. The fact that the market is a difficult and extremely volatile one creates quite a lot of opportunities if you are quick enough to capture them. Lastly, the quality of our people has translated into a very consistent operational performance, which has permitted the high runs. I would now like to hand over to Corrado, who will go into detail on each of our segments.

## Segment Reviews and Financial Overview

**Corrado Costanzo**  
**CFO, SARAS**

### **I. Segment Reviews**

#### **1. Refining**

##### *a. Record production and above-target margins*

Thank you, Dario. Let us start with refining. We believe that this quarter shows the full potential of our assets and of our refining business model. We have consistently improved both our assets and our operations over the years and months. We were able to reach record runs last quarter of 314,000 barrels per day, and refining margins were significantly above our target premium over the EMC benchmark. We moved from a range of \$4-4.5 to \$5.6 per barrel, which is clearly related to the scenario. The Sarroch refinery is a diesel-oriented refinery and, therefore, the crack spreads for diesel, which were extremely high last quarter, more than offset the disappointing crack spread for gasoline. We will come back to the scenario later in this presentation.

##### *b. Protection from processing contracts*

There was also some protection from the processing contracts, which amount to about a third of our total production, during January, when margins in cracks for just about every product were disappointing. Last but not least, our ability to process a variety of crudes and to be flexible in terms of switching from crude to crude and exploiting prevailing market conditions also helped. We moved from certain crudes to Caspian crudes, which helped enhance the yield pattern to middle distillates.

##### *c. Product yields*

Let us take a look at the product yields. As usual, I would like to highlight the fact that quarterly figures, in general, are not overly representative. However, middle distillate yields rose to more than 53%, mainly at the expense of lower naphtha and gasoline. There was a slightly higher production of tar and fuel, which derives from the integrated gasification combined cycle (IGCC) slowdown. Overall, however, the choice of crudes helped us increase our profitability while maintaining the same API gravity overall.

##### *d. Costs*

Costs are under control. Our guidance for 2008 is unchanged: roughly €200 million for fixed costs, with obvious variations during quarters because of maintenance schedules, and variable costs also in line with our guidance, bearing in mind that there might be increases due to the rising prices of utilities and oil products in general. However, this effect, in our case, is already embedded in the EMC benchmark.

## 2. Power Generation

### a. Production

Power generation also recorded a satisfactory performance, completely in line with expectations. Production is, in fact, down 8% vis-à-vis the same quarter last year, but this is due to routine maintenance that, last year, was performed entirely during Q2.

### b. EBITDA

Italian GAAP EBITDA is a bit more complicated than IFRS EBITDA, for the obvious reason that IFRS EBITDA equalises every effect and, therefore, is extremely stable. Italian GAAP EBITDA shows more closely the actual performance for the quarter. The CIP 6 power tariff was 6% up. However, the EBITDA was 70% lower because the indexation mechanism of the tar and the fuel component of the tariff are not in line. Tar is still being indexed with the old formula, while the energy authority changed the indexation mechanism for the fuel component. This rose 6% vis-à-vis 30% for tar. There is also a significant time lag embedded in the new energy authority formula of about 10 months before prevailing prices are recognised in the formula.

### c. Costs

Costs for the power generation division are also substantially in line with expectations and guidance.

## 3. Marketing

There was a good performance in this sector too. The comparable EBITDA is up 16% versus the same period last year. I would like to highlight that Q4 2007 was something of an exception. There are also seasonality aspects in this segment, so the comparison should really be drawn vis-à-vis the first quarter of last year. There has been a continuing trend of growing diesel and declining gasoline consumption, both in Italy and Spain and, in this context, overall sales were in line with last quarter and up 10% versus the same quarter of last year. We have, therefore, consolidated our wholesale market share achieved during 2007. However, wholesale margins were slightly lower compared to Q4 last year, but higher than the same period last year.

## 4. Wind

In wind, there is a one-off charge which we did not highlight as an adjustment because we made the charge both to EBITDA and net income, due to the fact that prices for green certificates continue to decline quite sharply, from €120-130 per megawatt hour (MWh) at the beginning of last year to about €80 at the beginning of this year. We therefore had to write off all the green certificates that were awarded during 2007 and which, traditionally, can be sold only the following year. This is somewhat of a disappointment because, in spite of all the lip service paid by the authorities and politicians to renewable energy in this country, the actions being taken at Ministry and energy authority level are quite in contrast. These actions resulted in a very long position for all green certificate-holders. The offer for green certificates far exceeds demand, and this brought down green certificate pricing quite dramatically. The total tariff now for wind is about €65/MWh, which is well below the €80/MWh cap set by the energy authority.

## **II. Financial Overview**

### **1. Key Income Statement Figures**

There is a noticeable difference between EBITDA and net income movements, due to the fact that, first, the corporate income tax rate was lowered from 37% to 32%, effective 1 January this year; and, second, Q1 of last year was influenced negatively by the fair value valuation of petroleum products derivatives which were still in place and coming from the previous years. This effect was negligible during Q1 2008.

### **2. Key Cashflow Figures**

As Dario pointed out, there is very strong cashflow from operations: €162 million. Net of working capital effects, the cashflow increased from €92 million in Q4 last year to €142 million last quarter. In fact, we also closely watched our working capital movements, so the increase in the inventory was balanced by an increase in payables.

### **3. Capex by Segment**

Capex is broadly underway. There are two things worth highlighting:

- The marketing capex is due to the work in progress for a biodiesel plant in Spain.
- The power generation capex is related to an upgrade of a hydrogen production facility from the IGCC, which will increase its hydrogen production capacity by roughly 35%, beginning in Q3 this year.

## **Outlook and Strategy**

**Dario Scaffardi**

### **I. Outlook**

#### **1. Refining and Power**

Our maintenance schedule for the rest of the year remains the same. We have just had a shift from Q1 to Q2. We had announced that we would have an impact of about €15 million in both quarters; these will be concentrated in the second quarter instead because the majority of the maintenance has been during the month of April. There is no other major maintenance planned, and the usual maintenance is on the IGCC plant.

## 2. Updated Guidance for Refining Margins

### a. *Unprecedented conversion spread levels*

Coming back to what we were talking about at the beginning of the presentation, we are updating our guidance for refining margins to take into account the fact that there has been a constantly rising diesel crack spread and a constantly weakening fuel oil crack spread. The conversion spread – the difference between diesel prices and an average between high and low sulphur fuel oil prices – has reached unprecedented levels. In the quarter, it has been \$430 per tonne compared with about \$300 per tonne in both 2006 and 2007. Today, it has reached \$600 per tonne. Our guidance for 2008 was based on \$300 per tonne. SARAS is a refiner that is much more complex than the average refinery which is used as a model for the EMC benchmark. We have higher yield in the middle distillates and a lower yield in fuel oil. This enables us to take full advantage of the current market conditions. This is probably the main factor but not the only one.

### b. *Wide availability of Caspian crudes*

Other components are the fact that there is a difference in the relative values between other products, but perhaps the most important factor is the wide availability that we have today in the Mediterranean of a range of new crude oils, mainly from the Caspian area, with more crude to come in the near future. The supply of a variety of new crudes, compounded by a very tight energy market, which is extremely volatile, strongly influences the prices of these crude oils; mainly, their differential compared to the reference marker crude, which is Brent-dated for our market.

### c. *SARAS ideally placed to take advantage of new opportunities*

This creates a lot of opportunities that we are able to cash in on if we are able to act quickly enough. SARAS is ideally placed in this respect to take advantage of this scenario:

- First, we have an excellent asset, which we have often described.
- We have a great geographic position, which puts us right in the middle of inflow of a variety of crude oils and an outflow of products to nearby markets.
- We have big logistics.
- We have technical expertise.
- We are able to act quickly.
- We have commercial inventiveness; therefore, we have the benefit of not being linked strongly to any one single grade of crude oil.

We are able to take advantage of what is the best opportunity in the market and to search for the optimal crude. This sometimes creates difficulties but it can also create some tremendous opportunities.

### d. *Sophisticated plant management model*

Our plant is managed according to a very sophisticated model, which is based on actual crude availabilities with their real prices, and the real prices that we are able to achieve on products. It is

continually updated in order that we maximise return, not necessarily single production of products.

*e. Guidance on variation in premium to EMC benchmark*

We have tried to give a range of guidance of how the premium to the EMC benchmark will vary according to the conversion spread which, as I mentioned before, is the difference between diesel and the average of high and low sulphur fuel oil. We are, then, moving from the range that we were guiding on before of \$3.5-4.5 per barrel to a range which, today, is \$5-6 per barrel. If the current scenario remains, we will maintain this guidance. This also means that what we explained in previous quarters in terms of increasing margin due to our investments which, in the last meeting we had, was about \$1.2 per barrel, today upgrades to about \$2 per barrel.

### **3. Short-Term Outlook**

Looking at the outlook, the only important thing that I would like to remind everybody about is that, as of 1 January 2009, the last phase of the European fuel specification will come into full effect. That will mean that sulphur content in diesel and gasoline will move from the current 50 parts per million (ppm) to 10 ppm. This means that market players will start looking for 10 ppm in order to condition their stocks, presumably right after the summer, beginning in September/October. Our units for gasoline desulphurisation will be fully on stream in July, so we will be able to take full advantage of this. We expect further market tightness due to this, similarly to what happened a few years ago when 50 ppm was introduced.

## **II. Strategy**

### **1. Buyback Plan**

In terms of our strategy, SARAS' General Meeting approved on 29 April a buyback plan to purchase 10% of the outstanding shares in 18 months. This buyback plan will start on 22 May, after paying this year's dividend. The buyback plan will be financed mainly by cashflow, so it will not have any impact on our growth strategy.

### **2. Growth Strategy**

*a. External growth*

As you know, we have been scrutinising the market for possible acquisitions. We have looked closely and analysed, and have made valuations based on our usual stringent economic and financial criteria. Unfortunately, we have found nothing more attractive or better priced than SARAS. We strongly believe that the buyback will create value for shareholders while still allowing SARAS to be flexible in cash allocation.

*b. Organic growth*

Considering the amount of shares involved in the execution period, this programme will not alter our growth plans. We will, of course, continue to keep our eyes on the market in case any opportunities might arise, but we are focusing on organic growth. Today, we will not go into any specific details but we anticipate that, in the period 2009-11, we will have an industrial plan that will be wider in scope, to take full advantage of the expected market conditions. Capex will be

higher than what we have announced in previous plans, but with returns in line with our track record.

c. *Strategy update meeting in June*

We will have an investor day some time towards the second half of June and we will, of course, announce it in due course. Thank you very much for being with us and we are ready for your questions.

## **Questions and Answers**

### **Alexandre Marie, Exane BNP Paribas**

There have been some recent comments that your capex might increase to €800 million from the previous guidance of €600 million. Could you comment on that?

Second, on wind activity, given your comments that green certificate prices are declining, do you remain active in looking for new projects in wind activity?

### **Dario Scaffardi**

These are the numbers that have been announced in the press, taking certain phrases out of context. We have a wider scope of investments that will add more value to our production, since we decided to concentrate on internal growth. We will make some specific announcements and give specific details during our investor day, so I do not want to go any further. There is going to be added capex, but added returns, so it will definitely make it interesting. I think that Corrado is more qualified to answer your wind question.

### **Corrado Costanzo**

Certainly, wind is a mixed bag at this point: a very competitive environment, a very wide and varied number of sector participants bidding for every project, and probably not everyone taking into account the fact that, at least in Italy, the incentive schemes are bound to decline over time. This is making us more prudent in our bids, but that does not mean that we will abandon the sector altogether. It is not, however, an easy sector at this point.

### **Michael Alford, Morgan Stanley**

You did well this quarter to optimise the diesel yield in your product slate. I was just wondering if there is any room to push that further. The second question was also around throughputs: again, a record quarter for runs this quarter. You are giving guidance for runs to Q3 and Q4 following the maintenance in Q2; again, is there the chance to make that throughput higher in the following quarters?



**Dario Scaffardi**

The throughput in Q2 will be slightly lower, due to the maintenance, clearly, but we expect that, in Q3 and Q4, we will be able to maintain 315,000 barrels per day. Our aim is to end the year with well above the 15 million tonnes that we announced last year.

On the diesel yield, the investments that we are making now and the plan that we are going to announce in June are all centred on increasing the diesel yield to our full capability, so that is the centre of our organic growth strategy. We will go into much more detail during our investor day.

**Paolo Citi, Intermonte**

I have just one question regarding the power generation sector and, in particular, the Sarlux IGCC plant. You did not mention in the press release the potential impact of the additional carbon dioxide (CO<sub>2</sub>) costs related to the plant, considering the allocation proposals provided by the new Italian National Action Programme (NAP). Again, on this issue, when can we expect some clarification by the regulator on this front in terms of potential pass-through?

**Corrado Costanzo**

To be very clear, there is no provision in our accounts for CO<sub>2</sub>, since the law provides for full reimbursement – it is Article 7 of CIP 6. There is also a document issued by the energy authority which supports our view. Clearly, over time, we will see how smoothly this mechanism will be enforced, but as far as we know this is the law and we will stick to it.

We do not really have any clear idea, but the regulator already published a document that supported the view that CIP 6 plants are entitled to reimbursement.

**Paolo Citi**

What I find quite strange is that the authority published documentation in November 2006 and we have not seen any additional documents so far.

**Corrado Costanzo**

It is difficult to predict any further moves by the authority but, again, we do not see why the regulators should seek to not comply with the law, even after they concluded in a public document that CIP 6 plants were entitled to this reimbursement.

**Gordon Gray, JPMorgan**

I wonder if you could tell me when you last did an upward adjustment to the crude price assumption in the Sarlux linearization process and where your current assumption is.

**Corrado Costanzo**

We had to rerun the linearization model for Sarlux at the end of last year. It is a yearly requirement from our auditors. We have used \$80 per barrel, which was, we believed, a reasonable assumption

at the time. Clearly, the market scenario now looks very different, but this is what we used: \$80 per barrel.

**Lydia Rainforth, Lehman Brothers**

The first question is on the \$5-6 per barrel premium to the benchmark guidance that you mentioned. Is that just based on the current conversion spread or does it also include the flexibility in the crude slate that you mentioned? I am just thinking that, at the moment, for the first quarter, it was \$5.6 per barrel. How much of that premium came from the flexibility in the crude slate that you mentioned?

Second, on the fuel efficiency side, is that an area that you think you can improve in terms of improving the fuel efficiency of the refinery?

**Dario Scaffardi**

It is difficult to distinguish between the two factors because, clearly, one influences the other. The differential between diesel and fuel oil, in turn, influences the differential between the variety of crude oil, so which belongs to which is a bit difficult. The guidance of \$5-6 that we are giving is mainly based on the commercial spread. On the optimisation, there is something that we are not really able to factor in beforehand because it is optimisation, so it is something that we take advantage of as it comes. We prefer not to make any commitments on that beforehand.

Regarding fuel oil efficiency, clearly this is one of the main focuses that we have on the operational performance of our asset. Fuel efficiency has always been important, clearly, with crude at \$125 per barrel, and today it is even more so. We will give some detail on the actions that we have planned for the forthcoming years during our investor day. It is, however, very important for our people.

**Sergio Molisani, Unicredit**

Is it possible to have more flavour on the opportunities you have explored in the Mediterranean basis with regard to the Caspian crude?

Second, on capex, without going into details on the potential upgrade of the capex plan, can you give us an idea of whether this new investment would be directed towards major treatment of these crudes coming from the Caspian?

Third, on gearing, can you give us an idea of the time horizon you have in mind before taking a decision between acquisition or financial gearing through a dividend?

**Dario Scaffardi**

Regarding opportunity crudes, those that we see are all the new crudes coming out of the Caspian region, mainly, so and particularly Azerbaijan and Kazakhstan. There are new pipelines that have been increased in size, so there is a large availability of crudes which tend to be very light and sweet. There are also quite a number of new crudes coming from West Africa, which are different in nature. These crudes tend to be sweet, but heavy in gravity. What we try to do is optimise between these two types of crude in order to exploit them fully. It is also a matter of, since there is

a certain abundance of these crudes, sometimes they come at a price that is extremely attractive compared to the standard alternatives.

Regarding the capex plan, it does not foresee any major new project that is going to come on stream over the next two or three years, but an improvement and upgrading of existing projects and plants in order to fully exploit, for instance, energy recovery. Lydia asked the question, which is one that makes a lot of sense today, so the sort of investment that is able to capture heat from our plants has a much higher return than what it had just a few years ago, so we are taking a closer look at that.

The influence on our investments based on the type of crudes which are available address in a slightly different manner what we already had planned before. A couple of years ago, our plans were for a heavying up of the average API of crudes, based on the assumption that a majority of the analysts had at that moment in the market. Having changed this view today, this does not mean that the investments that we already planned are not worthwhile; they still are, but we are going to change them in order to have a little more flexibility, so that we can run crudes very different in nature –lighter rather than heavier crudes, extracting the full value of diesel from them.

Regarding the gearing, as I mentioned before, in terms of acquisitions, we are keeping our eyes open. We look closely at the market. At the moment, acquisitions seem slightly less likely because we do not really see any interesting and available targets. However, markets change very quickly. At the moment, an acquisition seems a little less likely, but perhaps Corrado can add something on the gearing.

### **Corrado Costanzo**

The re-gearing will take place progressively. The authorisation from the AGM simply says up to 18 months and up to 10% without any further specific requirements. We will keep the market posted and report on a regular basis. By the way, Q2 is not a very good month for cashflow because we are going to have to pay dividends and taxes, but the operational cashflow is still strong. I would like to highlight one more time that, according to Italian law, dividends are not payable to stock in treasury, regardless of whether you cancel those shares or not.

### **Anish Kapadia, UBS**

First, how are coping with the higher crude price from a working capital perspective; i.e., the detrimental impact it is having on working capital and what measures you are going to take to deal with that at the moment?

Second, just looking at the middle distillate market at the moment, we are seeing great crack spreads. Are you seeing any demand impact on the marketing side of the things from these very high prices, what is your outlook for the middle distillate crack, and do you think that they could spike even further from this level in the third and fourth quarter?

### **Dario Scaffardi**

Starting from the last part, I think we are already at very high levels. Although high levels will probably be beneficial to SARAS' business, I do not think that they would be beneficial to the overall economy, so I do hope that we have reached a cap on the market, because higher levels would probably start to have an impact on consumption and, overall, a negative impact on the

economy. I do not think we could really go that much higher than this, but making predictions about the oil market is the riskiest thing that one could do, so I would prefer to avoid any strong commitments in this respect. What are your views about this?

**Anish Kapadia**

Who knows at the moment? I think that there is a risk that they could come down, but they could go back up again in the third quarter – that is the worry.

**Corrado Costanzo**

Working capital is clearly an area which needs very close monitoring in this environment. However, first of all, bear in mind that about one third of our throughput is linked to third party processing, so there is hardly any working capital there. For the remaining two thirds, certainly we did place an emphasis on controlling inventory levels, and we believe that we have been fairly successful. Also we monitor very closely payment and collection terms and conditions. However, primarily, it is inventory level control.

However, bear in mind too that we report in euros, and our inventories, for reporting purposes, are converted into euros. The euro did play a role in minimising the impact of working capital. Clearly, we would welcome a different situation, but on this specific point the fall of the dollar vis-à-vis the euro also helped. If you, by chance, were a bit surprised by the tiny difference between our LIFO and FIFO-reported EBITDA, this is largely due to the fact that we took, on a FIFO basis – the official EBITDA under IFRS rules – a big hit on our inventory, which grew in dollar terms but took a hit of tens of millions in euro terms. If you report in a different currency – i.e. in dollars – you would not have this problem; if you report in euros, you do. Otherwise, our inventories are very close to the minimum operational level. We still believe that FIFO movements in our inventory, whether they are linked to oil prices or the euro/dollar exchange rate, are nominal because they would be hard to convert into cash.

**Anish Kapadia**

What would you see as the working capital move in the second quarter if the oil price stayed at \$125 until the end of the quarter? I just want to get an idea of what impact that would have, and also including the tax effect that you talked about.

**Corrado Costanzo**

As I have said, we believe that we have things under control. The change should not be major, also because our inventories were already valued at the end of the quarter. Therefore, most of the impact is already embedded in Q1 figures.

**Will Forbes, Credit Suisse**

First, do you still expect your capex programme to be in line with 2007? Obviously, there is a slightly higher run rate for capex this quarter and next quarter because of maintenance in biofuels; I just wanted to check that that is still the given guidance.

The second question is on biofuels. When do you expect the biofuels to be up and running fully, and what kind of EBITDA guidance could you give us on that?

**Dario Scaffardi**

Capex for 2007 is broadly in line with the guidance that we have already given.

Regarding the biofuel plant, that should start operations some time in September/October. It is too early, really, to project an EBITDA at the moment. The whole market of biofuels is changing in unprecedented ways. We had a negative period during the very last part of the year and the beginning of this year, mainly due to incentives which are being paid on the American market on biofuels coming from the US, which have competed with European biofuels. We expect the situation to already have eased and to cease, probably, by the end of the year, so we will need to have a clearer situation to really update our models and project what sort of EBITDA levels we can have.

## **Closing Comments**

**Marco Schiavetti**

Thank you very much for being with us today. Our next appointment will be our investor day in the second part of June in London. We will keep you posted in due course. Thank you very much.