PKN Orlen - MOL Cooperation

On November 20, 2003 Polski Koncern Naftowy Orlen, S.A. ("Orlen") and Magyar Olaj- és Gázipari Rt. ("MOL") signed a memorandum of understanding to enter into exclusive negotiations to explore some kind of combination of the two firms. The specific nature of the combination was left as part of the exploratory process. According to an article in the Polish daily newspaper, *Rzeczpospolita,* on May 4, 2004 ("Letter Expires, Plan Remains"), the MOU has expired as of April 30. A joint press release by Orlen and MOL states that discussions will continue.

Information received by Pan EurAsian indicates that the likelihood of success of these discussions is not high. However, we also believe that the potential results of a combination of the two firms is tantalizing enough to keep them both at it for a while longer. The objective is to establish a dominant regional entity before any of the western Europan super-majors comes in and takes over.

The two firms are very similar in size, although the constituency of the two firms is somewhat

	PKN Orlen	MOL
	Results for 2003	
Crude Processed (million tons per year)[1]	12.5	10.5
Retail Petrol Stations	2,438	764
Reserves		
Oil (million barrels)	0	81
Gas (million barrels oil equivalent)	0	188
Total Revenues (million US$)	6,357.3	6,702.3
Net Profits (million US$)	271.1	369.0

Notes:

1. Tonnage for Orlen based on 2002

Source: Annual reports and websites of MOL and Orlen

different.

Overall, the revenues are quite comparable, but the composition of those revenues is quite different. Orlen is exclusively an oil and chemicals refining and marketing business. It has no oil or gas reserves to back it up. It does have extensive retail distribution of gasoline: 1,944 stations in Poland and 494 stations in Germany.

MOL produces both oil and natural gas for its own account. Natural gas sales account for 28.6% of its total revenues. MOL also owns 70% of Slovneft (Slovakia) and 25% of INA (Croatia), the results of which are integrated into the results shown above for MOL.

MOL also has a joint venture, yet to produce significant results, with Yukos in Russia to develop the Zapadno-Malobalyk oil field in Western Siberia. MOL's share of the production is expected to reach about 1 million metric tons per year, effectively doubling MOL's own production of crude oil. MOL continues to explore other opportunities to integrate back into crude oil production to enhance security of supply.

Orlen, on the other hand, has no stake in crude oil production. During 2003 Orlen stated an intention to seek participation in oil production, most likely production with direct access to the Druzhba pipeline system (the Russian "Friendship" pipeline system) through which Orlen presently receives most of its crude oil supplies. Orlen seems to enjoy some cost advantage versus MOL in acquiring Urals, or Russian Export, Blend.

Orlen recently has become the apparent, successful bidder in the auction for Unipetrol (Czech Republic). Unipetrol's figures are not included in the numbers cited above. Due to the price to be paid for Unipetrol and the condition of Unipetrol, the international rating agency Fitch recently announced that it had placed Orlen on its "watch list" with negative implications. We believe that the concept of the acquisition was valid strategically, even if it strains the finances in the short term.

A number of barriers exist to the combination of Orlen and MOL. The main barriers appear to be:

- Both companies are " national champions;"
- Both have significant " undigested" acquisitions;
- Both are still subject to considerable government influence.

Since both companies are national champions, a combination of the two would require that one, or both, would lose that status. It seems unlikely for the moment that either company is eager to let the other company become the dominant entity. A Royal Dutch - Shell Transportation and Trading model is not likely to work under these circumstances, although with time they might work that out. In addition to the factor of being national champions, both companies have strong managements with strong management egos. This is not unusual in dominant companies. Eventually, with the right will to succeed, the management ego issues are usually resolved. But, it is complicated by the factor of being national champions.

As for undigested acquisitions, both need a lot of work to absorb what has been recently acquired. In the case of MOL, the Slovneft and INA acquisitions require considerable focus. In the case of Orlen, the absorption of the refineries in southern Poland and the acquisition of 494 petrol stations in Germany also require focus. Pan EurAsian also believes that Orlen needs to sort out better its crude oil supply arrangements before it can tie up with MOL. The recent acquisition of Unipetrol only complicates matters further for Orlen.

Finally, there is the issue of government influence. In the case of both, government influence continues to have a high social/economic flavor. Neither government would like to lose this social engineering tool. However, the influence of the government in the matters of pricing of products is diminishing. Membership in the EU of both countries (from May 1st) should enhance the independence of both companies.

Will there ultimately be some kind of combination or cooperation between the two companies? Although there are a lot of barriers, we hesitate to say "no." The idea is not dead yet. The potential benefits seem to outweigh the barriers, but overcoming those barriers will not be easy, or quick.

We hope that this brief, introductory analysis will help those who wish to follow from afar the discussions between the two companies.

