

# Closure of the clyde oil refinery

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Closure of the Clyde oil refinery Executive Summary The announcement of the closure of the Clyde refinery has attracted attention from all quarter including the government. According to the management the profit margin had fallen considerably and competition from large-scale refineries of Asia had influenced them to try out a different business model. The move has received consent from the Gillard government. (Edwards, 2011) It is important therefore to analyze the reason of the company to relocate their operation. The paper tries to analyze the reason behind the dwindling profit and the rising cost based on economic theories. One finds that the refinery was operating at level beyond the optimum. As a result the profit fell. In the long run the firm would have been pushed to relocate or get wiped out through competition. Therefore the closure of Clyde is a result of natural economic laws of average cost minimization and a firm operating in a competitive market.

Introduction On April 12, 2011 Shell informed their Australian employees at the Clyde oil refinery, their strategic decision to shut down the refinery. It had spread wide discussion among the policymakers and the employee unions. The Clyde oil refinery, which is almost 100 years old, had provided employment to about 310 employees directly. There are also 200 more contractors who find their employment through this refinery. The company announced their plans to convert the refinery into an importing terminal and cut down the employee strength to 30 to 50 staffs only. The decision has been a result of the growth of large refineries in Asia and China. (Murphy, 2011) According to the management of Shell the refinery is not competitive enough and they have decided to import the fuel from abroad to cater to their customers. To run this facility the management has estimated

an investment of \$70- 80 million till 2013. (Holt, 2011) In modern times a refinery of the size of Clyde producing 75, 000 barrels per day employs around 30 to 50 employees. On the contrary the large refineries of Asia operate at a more optimum capacity. (Main, 2011) Analysis of the Decision In the short run the fixed cost of a firm is fixed. In the present scenario it implies that Shell cannot construct a new refinery. Under this situation the firms will try to maximize their profit from the refinery they have got. But as demand increases, in the short run the firm will have to exceed the optimum production capacity. They will have to employ more employees and maximize the production capacity of the refinery. In the process they cannot optimize their cost. The short run average cost curve, which is U-shaped, has the minimum cost at the trough of the curve. However as production is increased, the refinery has to move beyond the lowest point. As the production increases, average cost increases simultaneously. Therefore in the short run the firm has to make a trade-off between minimum cost and maximum production. However there are other firms operating in the market that have optimized their costs. Under these circumstances, Shell had to import from abroad to take advantage of the economies of scale present there. In the long run they shift to a plant that optimizes their cost better under the present situation. In this way in the long run, through investment they vary their capital cost to establish a new plant and minimize their costs. (Mankiw, 2008, pp. 280-281; Stonier, 1984, pp. 137-140) The better economies of scale may enable the company to have supernormal profit in the short run (Samuelson, 1980). However in the long run, the supernormal profit will be wiped out by the entry of other firms. The relocation of

operation by Shell will prompt their competitors to follow their example in a competitive market. In this way in the long run all the firms will operate from large refineries. (Karl, 2007, pp- 201) Also, Shell operates in an oligopolistic market structure governed by a few sellers where decisions of one firm will affect or influence that of the others and therefore it is likely that Shell's rivals might also close down unless they learn quickly from their mistakes. Apart from the above impact, the closure will imply a rise in the vulnerability of finished petroleum goods to the extent crude oil was being utilized by the refinery. As the crude oil volumes are coming down refineries are expected to close down and in this case the inefficient ones will be victimized first just like it happened with Clyde oil refinery. It could not have competed with the larger and more efficiently built Asian refineries. These refineries like the Clyde oil were built in anticipation of increase in demand and oil production. The government might now require halting work on other fuel consuming operations. Conclusion Experts have commented that the refinery was profitable. Higher profit had prompted the company to close the refinery (Tabakoff, 2011). The refinery would indeed make profit in the short run though it is operating beyond scale. But as the production increases further the profit margin will slowly fall. Ultimately in the long run the company would either have to relocate their operation or get wiped out. (McEachem, 2008, pp- 195) The Vice President of the company has assessed that it would enable them to secure the future in the long run. Clyde the second smallest refinery in the country operates on an economy of scale that is not optimal. (Main, 2011) Bibliography 1. Edwards, M. (April 13, 2011), Criticism as Shell considers closing down refinery, ABC, available at: <http://www.abc.net>.

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