FEATURES|OIL|SHIPPING

The challenge to meet unpredictable demand from IMO 2020

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With shippers switching to low-sulphur fuels when the rule takes effect next year, the oil industry faces a period of volatility as buyers choose a new favourite fuel

The International Maritime Organisation's new regulation to require all ocean-going vessels to burn fuel with a maximum sulphur content of 0.5% comes into effect on 1 January 2020. Known as IMO 2020, its arrival will be the biggest change in the global shipping sector since the switch from coal to oil bunkering. With the new rule only months away and about to impact every consumer of products transported by ship – which is essentially everyone – no consensus exists in either the maritime or oil industry on which fuel shippers will choose to comply.

Refining

For oil refineries, IMO 2020 is potentially both a huge opportunity and a source of disruption, because it will drive such a significant shift in demand from high-sulphur to low-sulphur fuels. The unanswered question on everyone's minds is how refineries will meet the sudden surge in demand for compliant fuels, particularly when shippers have a few options to choose from.

We spoke to industry leaders across the oil value chain about where they expect to see the most substantial immediate and long-term effects. While everyone we interviewed had a different opinion about which fuel would end up on top, most expect the end of the year and the beginning of next to be a volatile period for the oil markets. Mikael Bonalumi, Founder and CEO of Auriga Commodities, a trading and advisory company based in Geneva, adds: "Technically this creates a number of challenges in the production, storage and usage of the new fuel. Some of the bigger companies, such as Exxon and Maersk, will simply exclude any middleman to avoid compromising the crucial issues of product quality, particularly sulphur and stability. I believe it will be increasingly difficult for smaller players to be present."

As the regulation is written, shippers are able to transition to either low-sulphur fuel oil or marine gasoil, meaning the market will potentially need to boost supplies in both types until buyers show a preference. Kenneth Tveter, Portfolio Manager at IMO Direct Exposure Fund, a derivatives fund with a focus on IMO 2020 that is part of Svelland Capital, says: “The lack of a defined ISO standard and uncertainty around the compatibility and stability of blends are pushing most shippers toward marine gasoil, or high-sulphur fuel oil with a scrubber.”

Whatever emerges as the most in-demand alternative, refineries that have the technology to produce and meet the burgeoning demand are going to steal a march on rivals. The pressure will then be on others to upgrade or face closure. Cosmo Kedros, Senior Trading Specialist at Vortexa, sees middle distillate demand rising sharply and points out that the IMO regulation will drive “a staggering 6mn t/month of new diesel demand from January 2020”.

One senior executive in the refining sector says: “The market will become extremely volatile for at least end-2019 and 2020. Refineries with process and logistic flexibility should do much better than refineries focusing only on one type of heavies production, whether that is bitumen, high-sulphur fuel oil or ultra-low sulphur fuel oil. Fundamentally, it is still pretty hard to predict what will happen, even if consultant views are all aligned in thinking this should be good for refining margins worldwide.”

Trading

It is difficult to make predictions about the impact of IMO 2020 on trading simply because of the way in which it touches on so many different parts of the value chain.

Mark Jacob, Head of Market Analysis and Quantitative Trading at OMV Supply & Trading, says: “Oil traders have focused on three key issues ahead of next year: What effect will producing the new 0.5% fuel have on the rest of the barrel? What price will allow high-sulphur fuel oil to clear post-2020? And, how will these changes affect relative crude values?”

Roland Rechtsteiner, Partner at consulting firm Oliver Wyman says: “With the level of uncertainty in the market and the associated volatility, there should be ample opportunities for the traders. The key optionality will rest on the spreads between high-sulphur and low-sulphur fuel oil, the differentials of new grades and their varying specifications, which could also link to new blending destinations.”

The impact on high-sulphur oil is simpler to predict – only a small percentage of merchant ships have so far installed scrubbers that can remove sulphur oxides from exhaust gases to comply with the legislation, so high-sulphur oil prices are set to collapse. Despite trading significantly above coal pricing for now and adjusting for scrubbers, non-compliance, new upgrading capacity and refinery adjustments, some experts are expecting prices to drop to around coal parity.

IMO 2020’s effects are also likely to extend to the crude market, as demand for the crudes needed to produce compliant 0.5% fuel oil could outrun supply. George Dannecker, who was Global Head of Crude at Chevron and CCO at Gibson Energy, thinks that the market would do well to consider the shrinking global supply of heavy crudes and points to “a steady decrease in the availability of Latin and South American crude oil due to operational constraints, political restrictions and government instability in the region”. With the traditional global flows of crude disrupted and limited heavy crude supply alternatives, traders will enjoy a great opportunity to capitalise on market uncertainty and dislocation.

All the big trading firms therefore see IMO 2020 as a key event that has the potential to generate huge value. It is impossible to know how long the shock waves from the new rules will reverberate through the global system. Goran Trapp, Founding Partner at Energex Partners, says: “The issue of the tenor of these temporary shortages and its geographical spread is the big unknown. Many analysts are now thinking that this is really is a question of two to three years before we are getting to a more steady-state situation.”

Trapp adds: “Our call is that the global system will adapt quicker than most analysts expect but that there will not be a smooth path to the new steady state.”

Bonalumi says: “People will wait until the last moment to do anything. For now, traders will continue to speculatively trade on fuel oil cracks.”

What is certain is that the opportunity to capitalise on the widespread imbalance from January is one that all trading firms are positioning to seize as best they can.

Shipping

The shipping industry has known about the prospect of IMO 2020 for many years, but no single approach to adaptation has so far emerged. What is clear is that shippers will employ some combination of a switch to low-sulphur fuels and the use of scrubbers to deliver onboard desulphurisation.

In the short-term it looks like scrubbers will win out over the alternative switch to lighter fuels, which requires engine upgrades. Tor Svelland, Founder of Svelland Global Trading Fund, which trades and invests across commodity futures, freight futures and equities, says: “We expect the scrubber-fitted vessels to be the clear winner in 2020 and 2021, while vessels that use compliant fuel and diesel will struggle to have full access to bunkers."

There will also be an impact on the global fleet size, with scrapping across all vessel classes likely to increase as older vessels become uncompetitive, and many owners unwilling to invest in bringing vessels up to date.

Longer term, the problem is that scrubbers themselves are likely to become outdated, not least because they rely on capturing and then disposing of the sulphur that scrubbers remove from the oil onboard. Rechtsteiner says: "I believe the scrubber still remains a vulnerable option – not only in the case of further regulatory enforcement, which nobody can really predict, but also in scenarios in which more effective and innovative solutions come into play."

Shipping companies could end up paying more than necessary for compliant fuel if they sign supply contracts directly with oil majors and blenders ahead of the deadline, said Gus Majed, Chief Investment Officer of Enerjen Capital, a London-based firm partnering with shipowners to hedge and procure physical IMO marine fuels.

"Traditionally, shipowners have had a certain degree of pricing power in a transparent high-sulphur global bunker marketplace. What has happened with the introduction of the new IMO 0.5% marine fuel blend is they've been panicked into a situation where they're giving that pricing power away," he explained.

"The oil majors and the blenders are trying to take over this pricing power, and some of the shipowners are being lulled into a false sense of security where they've actually added more financial risk to their books," says Majed. "By fixing forward physical barrels on gasoil-related basis, when a significant portion of the IMO marine fuel molecules are priced in and blended up on a fuel-oil related basis, they are inadvertently increasing their company's financial basis-risk."

Marine fuels

The marine fuels industry is preparing for IMO 2020 in parallel with the transition activity taking place across the physical supply chain, and despite uncertainties around implementation and standardisation, the new compliant-fuel quality and pricing is expected to become more transparent towards the end of 2019. With so many small bunkering companies operating on tight margins, however, and banks scaling back on offering lines of credit, there could be a squeeze on smaller participants during transition.

Cem Saral, CEO of Cockett Marine Oil, says: "Going forward, we expect that IMO 2020 transition will fuel further consolidation among the industry players, favouring financially sound, well-managed entities offering global solutions as increased attention to sound corporate governance and compliance becomes more visible.”

He adds: “Companies operating within the marine fuels space will need to continue to look to improve their talent pool proactively, to adapt to the needs of the post IMO 2020 marine fuels landscape and constantly adjust key operating principles to remain relevant to the future market place.”

Bonalumi adds: “Credit risk and risk management are already key considerations in the bunker market. Adding fuel quality issues to this, I cannot imagine that financing will be easier or cheaper.”

Storage and terminals

The storage industry is generally very positive about IMO 2020 and sees significant upside for assets located in major bunkering hubs as, in addition to the existing high sulphur fuel oil and marine gasoil grades, the market will see a range of new compliant fuels leading to increased demand for tank storage. As these new low-sulphur fuels consist of various blends, which may well not be compatible with each other, there will be increased requirement for segregation for both finished products and blending components.

Jared Pearl, Chief Commercial Officer at VTTI, says many storage terminals operating in key bunkering hubs have been making preparations, whether adding new lines to the jetties, adding new pumps and tank connections to improve blending capabilities, as VTTI is doing in Fujairah, or increasing tankage capacity to feed the new crude processing facility in its Malaysia location aimed at 0.5% fuel oil production.

Pearl says: “We already started to see good uptake globally from oil majors last year and then from trading companies this spring, as players ensure they are well positioned with flexible fuel storage and logistics that will allow them to participate and react to how the fuels market evolves.”

In addition, low sulphur material has already been building stocks ahead of January 2020.

Robert Buky, Managing Director of RB Energy Consultants, adds: “The most obvious new demand for terminals will be blending. The impact on prices is already significant and could magnify as January 2020 approaches, and these price dislocations could create huge incentives for blending and arbitrage, and this in turn could see increased demand for logistics. There will be huge opportunities for those with strong logistics positions, particularly in bunkering hubs such as ARA, Fujairah and Singapore.”

Retail

Kedros believes the impact of the new regulation is being vastly underestimated in a broader context. He says: “IMO 2020 has far-reaching consequences well beyond the shipping world. Given its global impact, it still seems very underreported by the mainstream press – particularly in terms of its inflationary nature. The jump in bunker costs for ship owners will be passed onto charterers and ultimately the unsuspecting consumer.”

Jacob adds: “Post-2020, the shipping industry will be exposed to fuel price competition in an unprecedented way, as producing sufficient quantities of 0.5% fuel will draw oil away from clean products/road fuels.”

Shippers’ increased operating costs will inevitably be passed on to consumers, and the price hikes could be considerable. A recent study indicates that compliance is estimated to increase the cost of port-to-port movement by 10-20% in the consumer goods sector, and even more in the case of shipping from the US to east Asia.

Fuel retailers will have to pass higher costs on to consumers, adding to the expected rise in diesel pump prices in northwest Europe, where the use of diesel is widespread. EdgePetrol Founder Gideon Carroll says: “With UK fuel duty being 57.95 pence per litre, higher fuel supply costs will put even more pressure on retailers’ slim margins.”

Recruitment

What is clear is that the ramifications of IMO 2020 will be widespread and the entire industry is likely to be impacted, at least in the short term. Trapp says: “There will be some short-term challenges as the triangulation of efforts by the refinery industry, bunker suppliers and shipping companies needs to be bedded down. While the global supply system is very good at creating equilibrium in the long term, the challenges of solving significant dis-equilibrium in the short term can always create both primary, secondary and tertiary effects that take the market by surprise.”

From a recruitment perspective, companies across the value chain have been busy preparing for IMO 2020 through upskilling and reorganisation for around 12 months, with activity accelerating over the last six months in anticipation of significant and widespread market disruption. Refiners and vertically integrated companies have been reorganising themselves to keep as much optionality as possible, in many instances combining fuel oil and middle distillate teams and seeking skilled originators and fuel blenders. We have also been noticing cross-pollination between trading houses and bunkering companies, with the big merchant houses hiring bunker traders and bunkering firms taking on middle distillates talent.
These changes reflect a need for companies to stay agile because of the uncertainty

around how the IMO-compliant fuels market will organise itself and how the various product specifications will trade both in the short and longer term.

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