Falling fuel prices: shrinking distances, weeds and other quirks

Contributed by

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The tanker market, as noted here and elsewhere, is rocking and rolling. Depending which commentator that one reads- the present drop in oil prices (which has led to more loadings, and to shifting trade patterns- both good for shipping) is battle of titanic proportions between the major oil producers, and the new supplies in the form of shale oil. Most impressive is the bravado of Continental Resources, one of the biggest (maybe the biggest) producer of Bakken oil. In the past week, its CEO, Mr Harold Hamm, sailed against the hedging trend, by very publicly removing his company's "sell" hedges meant to protect against oil price decreases. In this season of Q3 earnings releases, many other domestic oil producers were trumpeting the fact that they had put on more downside protection (ie selling financial instruments that would gain value if oil prices fell). Oil price forecasters, in their infinite wisdom, have seemed to follow the spot prices all the way down, readjusting their views 2015 to coincide with the present lows. It's really anybody's guess whether Mr. Hamm will be vindicated (meaning that oil prices would climb back up towards $100/barrel, and perhaps even higher), or not. The impacts of falling energy prices have reverberated around the whole shipping business- including the cost side.

For shipowners, falling fuel prices can be a good thing. As noted by Teekay Tankers in its recent market report: "Reduced bunker prices are positive for tanker earnings by lowering voyage operating costs." The tanker trades are full of many quirks, one of which is the system for ascertaining freight rates on more than 300,000 voyages- priced in $/tonne of cargo (rather than $/day- the currency of time charters). The system, embodied in a big fat book (though these days, there is a website, as well) is so secretive, that I can't use its name (they might do something to me that would halt the flow of articles- kind of like an embargo, or sanctions, but worse). At the beginning of each year, the big fat book is sent around to members, and the web database updated, to reflect a new set of base rates for notional voyages- on a ship that will correspond to an actual ship on an actual voyage, only by a very slim coincidence. That's also good news for ship owners who take spot business, because when rates are quoted on voyage basis ($/ton), the obfuscation growing like a weed all over the calculations almost guarantees that owners will come out ahead in freight rate negotiations. More on weeds in a minute.

Spoiler alert- on many subjects, my Wall Street analyst friends are quick to remind me, "Barry, that's not a justifiable investment thesis." But here comes an observation regarding fuel pricing and chartering. Most likely, the margins of those owners, or vessel operators, who book their crude or products cargoes on a $/ton basis, will widen as the fall in costs more than offsets a drop in agreed freights. For drybulk, there's more transparency to the calculations, but the assertion may still apply. On the liner side, just a guess- the bunker factors will lag on the way down, surprise surprise…

Speaking of weeds- let's get into them. Prices for typical intermediate fuels, sometimes called "bunker fuel". have fallen to prices around $430/tonne - $450/tonne in major fuel hubs; for diesel fuel- typical prices are around $900/tonne. These are down from levels of maybe $600/tonne and $1,100/ tonne that had prevailed up until the end of Summer. So, it was with some bemusement that I read a report noting that the 2015 rates for tankers would be scaled based on bunker fuels at a $600+ /tonne price (due to the computation which "looks back" over fuel prices from October 2013 to end Sept 2014) in determining a fuel price to be used in all of the calculations. To further complicated matters, the fuel pricing calculations also consider the costs of mandated low sulfur fuels in two major regions traversed by crude and product carrying tankers- known as Emission Control Areas, or ECAs. Quite sensibly, the calculation boffins have added in "differentials" to reflect vessel operation in the ECAs, which comes out a little over $48.00 per mile in European operations, and something like $65.00 per mile in North American operations; thus, charterers need to pay an additional amount where the voyage occurs in the ECAs- where restrictions on sulfur content are soon moving down to 0.1% (from their present 1.0% reflected in the differentials). However, in practice, the parties will likely negotiate the notional mileages downward. Yes, shrinking distances.

Confused yet? In the face of increased fuel prices and the need to burn lower sulfur fuels, the sellers have announced some workarounds, at a sensitive time in the marine fuel markets. So far, there have been announcements that big fuel providers might offer "blends" that would enable compliance with new ECA sulfur limitations, while allowing shipowners to avoid the expensive proposition of switching from (non compliant) bunker fuel to (compliant) diesel fuels. Early reports have indicated that these new types of fuels may be facing technical difficulties. As a reminder- any type of confusion, or lack of available fuel, will cause inefficiencies- this is a good thing for rates and hires. Not that I would wish for a stock-out by fuel providers, in the face of intransigent regulators who do not allow non-compliance due to non-availability….well, maybe for a day or two… And, the more complicated and non-intuitive that all the calculations get- that's more business from folks who ask for help in reverse engineering. Though most fixtures are private and confidential, I will try to find some verifiable fuel clauses that I can share with readers.

Timing is everything. As an aside, the sensitivities in the marketplace have now been extended way beyond non-availability (possibly) of low sulfur fuels. The entire fuels business is undergoing a shake-out in the wake of financial difficulties at OW Bunkering, a major player that had done an IPO earlier this year; readers should closely watch the trade press for news on this.