

# Oil Market Report: September 2017

If you talk “oil” to any player in the shipping industry, the topic that will almost immediately come up is the fuel specification changes to be introduced in 2020. Shipping is international, so rules for the industry are set by the International Maritime Organisation (IMO) - a body that for many years has been leading the way in the reduction of sulphur in fuel. Back in the 1980’s, shipping fuel (known as Fuel Oil) was permitted to have a 5% sulphur level. This was reduced to 3.5% globally in the 1990’s, but with only 1% Sulphur permitted in European Waters (as part of a combined agreement between the IMO and the EU). But for 2020, sulphur content is set to go down even further, with a new mandatory level of 0.5% Sulphur Fuel Oil across the world.

This creates a problem of fairly sizeable proportions for the world’s oil refineries, who produce the Fuel Oil that propels the ships of the world. Back in the day, Fuel Oil was actually a money spinner for refineries when heavy industry, power stations and shipping all took the fuel, thus generating robust demand. But fast forward to the modern day and shipping is the only real market for Fuel Oil and because refineries produce more of the stuff than they can easily sell, prices are normally rock bottom and almost always, lower than the actual raw material cost of crude oil.

Despite the losses, refiners are still stuck with producing Fuel Oil, because it is a bi-product of other more valuable products. So if they want to sell the nice, clean stuff (Gasoline, Jet Fuel, Diesel) for higher prices, then they also have to sell their filthy Fuel Oil at much lower prices. Which means that a product that is already seen as a necessary evil, is about to become even more problematic once the 2020 spec changes kick-in. Few (if any) refineries have sufficient desulphurisation capacity to meet the new legislation and although there were initial hopes that the shipping industry itself would address the issue (via engine scrubbers - a process which literally scrubs the sulphur from the fuel), this now seems highly unlikely. Firstly, engine scrubbing technology is extremely expensive. But in addition, the maritime industry has its own problems of overcapacity (too many ships) so that the commercial environment is not favourable to such a large investment programme. In fact, latest projections only have circa 4,000 ships - less than 4% of the global commercial shipping pool - with scrubbing technology by the 2020 deadline.

All of which pushes the problem back to the refiners, who have nothing more than a Hobson’s choice to make. They can invest serious money in increasing their desulphurisation capacity, but who wants to do that for a grade of fuel that already loses money? Alternatively, refineries could mix lower sulphur products such as Diesel, into Fuel Oil, to generate the correct composite level of sulphur. But again, which refinery wants to eat into profits, by taking valuable volume (Diesel) and downgrading it to near junk status and selling it as Fuel Oil?

Until very recently then, it really did seem that these were the only options available for refiners and they were beginning to face up to the bitter fact that manufacturing 0.5% Sulphur Fuel Oil was going to mean significant costs (or losses). But then a certain German car manufacturer was found to be lying about diesel emissions and global sales of diesel cars started to fall off a cliff (UK diesel registrations this July alone were down by 63%). Now as we know, oil production is completely interrelated and as we also know, refineries around the world have invested massively in diesel capacity. But with the sale of diesel cars drastically reducing, refineries could very soon be finding themselves in surplus diesel territory. Mmmm...let’s think...what better way to get rid of excess Diesel than by cutting it into Fuel Oil to help meet new marine fuel specifications? As a minimum, such a move will give refiners a bit of breathing space, so that they can assess the long-term impact of dwindling diesel demand. It’s even possible that such a move could start pushing diesel prices back up, as the supply of neat Diesel is strangled at the expense of blended Diesel for Fuel Oil.

This would be a completely unexpected and quite incredible outcome for the refiners, many of whom last year were in the depths of a 0.5% sulphur induced depression. Now they will be increasingly confident of dodging this particular bullet, and some may even be rubbing their hands in keen expectation of things to come! One imagines that last Christmas, Refining Executives sent rotten eggs to Car Executives as “a thank you” for their efforts in knackered up the Diesel Market. Perhaps this year, they will be sending flowers...