23 August 2019

IMO2020: Calm before the storm?

Hans van Cleef
Sr. Energy Economist
Tel: +31 20 343 4679
hans.van.cleef@nl.abnamro.com

- **IMO2020 does not trigger lots of action…yet**
- **Three alternatives available to comply with new regulation**
- **Price effects hardly seen so far**

IMO2020 requires cleaner fuel oil

In October 2016 the International Maritime Organization (IMO) announced that the global regulation for the emission of sulphur in fuel oil will be more strict starting from 1 January 2020. The current standard is 3.5% m/m (mass by mass) of sulphur (high sulphur fuel oil = HSFO) and this will be lowered to a maximum of 0.5% (low sulphur fuel oil = LSFO). The global consumption of fuel oil for large ships is currently roughly 3 million barrels per day (mb/d). And although this is only +/-3% of global oil consumption, a change in demand or supply of these oil products could lead to significant price swings.

The three alternatives

To meet the stronger regulation, all sea ships, container ships, and other large oil consumers at sea should be ready before implementation. Although the first signals finally start to become visible, it seems that large scale actions to lower the consumption of HSFO still have not started. That said, there will most likely be a short period of time in which compliance will not be that strict. This creates some room for ship owners to adjust. Nevertheless, the overall expectation is that it is just a matter of time before inspections will be ramped up during the first half of 2020.

The three most likely options to comply with the new rules are:

- Installing a new motor or revising the existing motor of the ship to one which is suitable for the usage of LSFO or Marine gasoil (MGO)
- Installing a motor which runs on LNG
- Installing a scrubber*

**A scrubber is a system that filters the sulfur dioxide from the exhaust gases with the help of atomizing seawater. There are various types of scrubbers (open, closed and hybrid systems).*

LNG is seen as a relatively clean alternative for the use of fuel oil, but requires a large investment. A large part of the existing fleet is not yet up for a replacement of the motor, which makes LNG often a long-term solution for many ship owners. In the near term, either a revision of the motor to make it suitable for LSFO or the installation of a scrubber seem more plausible solutions. The choice between these options is mainly determined by the remaining life span of the ship, the payback period, fuel consumption, the size of the ship owner and the region in which the ship is sailing. The risk with a scrubber is that at a later date the IMO may still introduce stricter rules for the use of HSFO while the investment may not have been fully earned back yet.

The market hardly reacts, with just five months before implementation

Although the measure was already announced in 2016, the market remains very reluctant to act. In fact, with just four months to go before the new regulation comes into force, there is still little action seen. And although more ships are entering the docks for maintenance and to have technical adjustments made to their motors, transport rates are not reflecting shortages of available capacity. Also, fuel prices remain relatively stable ahead of the IMO2020 implementation.

Risk of oversupply HSFO and shortage of LSFO

As the demand for HSFO will decrease, there is a risk of overproduction which could lead to an increased price pressure. At the same time, there could be seen a shortage in HSFO for some regions if refineries switch to the LSFO too fast while there remains a demand for HSFO from ships with a scrubber. For LSFO, there is a risk of shortages if, for example, 1) too little is produced, or 2) too much is already purchased by large ship owners for security of supply reasons. The market expectation is that the price of LSFO will eventually rise. The price movements so far do not yet reflect the possible changes that are lying ahead. The question is whether:

1) the market underestimates this transition towards the new IMO2020 regulation,
2) many parties have already hedged themselves for the changes, and/or
3) we can expect strong price movements in the last months of the year.

Larger ship owners are better equipped to hedge

Yet, some changes start to become visible. More and more contracts for the trade in LSFO are becoming available and the first hedges for the purchase or sale of both LSFO and HSFO for 2020 are seen. We also see refineries that are preparing for shifts in demand for the different types of fuel oil. The expectation is that the large shipping companies can hedge themselves relatively easily against the changing circumstances. They can determine their routes well in advance, and thereby buy already their fuel requirements in the right region. For the smaller market parties - that work more on an ad hoc basis and do not know well in advance which routes they will sail -, buying the right type of fuel oil in the right location may be a larger problem. Making the right choice for a fuel type is therefore a lot more difficult for those smaller ship owners and involves more (price) risks.

Conclusion

The question remains whether the lack of IMO2020 implementation can be described as ‘calm before the storm’, or whether the stricter regulations for marine fuel oil turn out to be a storm in a teacup. Since the first option – an underestimation by the market – from a financial risk is not desirable, it remains interesting to see that the market is in such a wait-and-see mode. We will continue to monitor the transition closely and will provide regular updates regarding the IMO2020 regulation and its impact in the coming months.