Weekly Tanker Opinion

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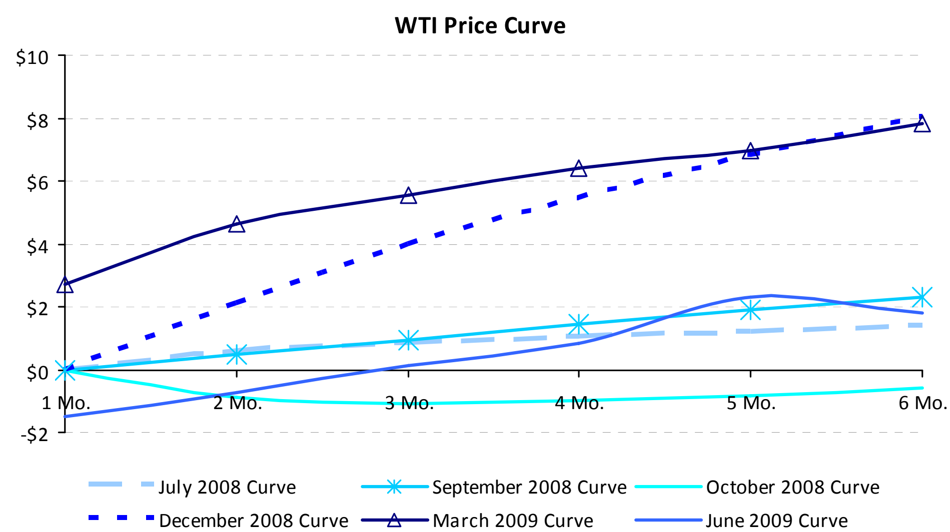
Hope Floats

Crude oil has never proven to be a dull commodity especially for those entangled in its web of commerce. Be it the volatile environment in which to buy and sell it or move it, or perhaps even its glamour as being the 'black gold,' its fluctuation sometimes takes the market for a wild ride. In the past six months, it's danced the contango, offering traders and charterers of ships the chance to scoop up the liquid commodity at a low spot price and make cash from higher future prices. In tankers, this has led to the waterborne storage of roughly 80-90 million barrels of oil primarily aboard VLCCs. However, as the spot price of oil continues to rise, this contango opportunity may be fading fast.

Earlier this week, even at the price of $70 per barrel, West Texas Intermediate (WTI) was trading futures at higher levels, giving incentive to fix ships for storage. But by the end of this same week, oil broached $72 per barrel and futures did not follow upward. So the contango structure seems snuffed for now. But it could be argued that this is just a brief pause for the unique market play. However, even if this is the case, how many times can the contango fade in and out and how much oil can truly be stockpiled worldwide? Market fundamentals would suggest that this uptick in spot crude prices is a reflection of illogical market psychology rather than being rooted in current supply and demand fundamentals.

In the chart below, quarterly WTI price curves beginning from nearly year ago (July 08), representing the price difference between the spot price and the future prices are shown.

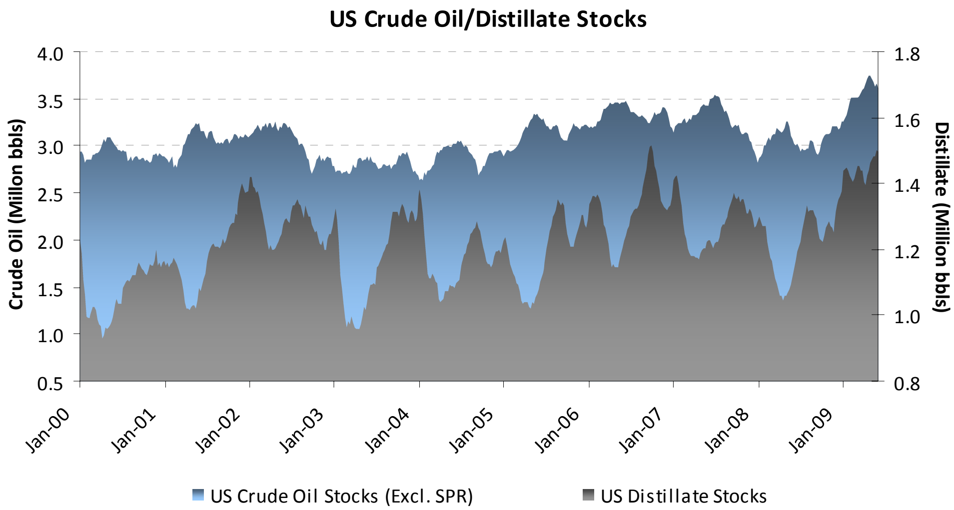


Aside from October 2008, contango lingered in the market for almost a year. It became the "strategy de jour" when oil prices began to ramp up last year, forcing consumer demand down. If price curve does not return from its current contango recess, it would stand to reason that the VLCCs used for storage would reenter the fleet; however weak demand for crude oil suggests there is little demand for the cargo onboard those ships.

Distillate Dilemma

In addition to various tanker sectors being employed for crude oil storage, Aframaxes and Panamaxes, also known as LR2s and LR1s, respectively in the clean petroleum product market have started to store finished commodities.

Rumors have been circulating that upward of 60 LR2s and somewhat fewer LR1s have been chartered with short-term storage options for primarily distillate cargoes – most commonly diesel. In the chart below are US crude oil and distillate stock levels, which suggest that the market is currently amply supplied. Apart from September 2006, US distillate stocks are at their highest levels in ten years or well over 1.5 million barrels.



Last summer, the opposite occurred when gasoline prices were unaffordable and diesel demand was driven up, forcing diesel stocks to be bled out. However, the opposite is true currently as margins on gasoline are more favorable than on those for distillate. The incentive of refiners to run for gasoline is creating a surplus of diesel in the market.

The vast demand imbalance now equates to floating storage off the coast of Northwest Europe, the Mediterranean, West Africa and Singapore waiting to be soaked up just like its crude counterpart. This volume of unused product represents a wall of vessel supply, roughly a third of the LR2 fleet waiting to be thrown back into a market starving for business. Additionally, the shelf life of a refined product presents an eventual time limit on these storage deals whereas crude oil storage is governed by when the money can be made and not by degradation consumption.

Cloudy Horizon

Tankers face two very scary animals lurking in the background waiting to pounce on the market when the timing is right. On the crude side, the looming increase of spot barrel prices questions their relevance as a storage vehicle. On the clean product side, a lack of diesel demand can be linked to the falloff of industrial use, but could quickly reverse with any positive economic signs.

No matter how eloquently it is expressed, these shifting demand drivers pose a potential threat to a strengthening in freight rates. The oncoming new supply of vessels in these two sectors has been quietly sequestered because of the fixtures for storage. VLCC owners will eventually be forced to look for other ways to employ their vessels if the contango craze winds down. However, this contango could reemerge soon: it appears that fundamentally, the demand for spot crude oil is not strong enough to justify an increase to $72 per barrel.