Whatever Floats Your Boat

It seems that summer has made bears of us all. And with the outlook for the fourth quarter looking less promising, owners and analysts alike have been searching for signs of life in a seemingly comatose tanker market. The single hull phase out has marched on with little observable effect, and the influx of newbuilding tonnage is stoking fears of overcapacity. In recent weeks there has been speculation that floating storage deals will come to the rescue of the VLCC market in these troubled times. However even as crude oil markets have seen contango persist, asserting storage as the savior of freight rates may be more of a Hail Mary than a sure bet.

The economy of scale offered by VLCCs has made them the working horse of crude oil storage plays. Particularly in the first quarter of 2009, the chartering of VLCCs for storage created additional tanker demand, offering employment for ships and absorbing tonnage from the market.

One cannot mention floating storage without a brief song and dance about petroleum markets. The dance here of course is the contango, which occurs when the spot price of a commodity is lower than the future price. When this structure is in place opportunity knocks to buy now and deliver later and rake in a profit. The rub lies in the availability and cost of storage. Amply supplied crude markets may open opportunity to profit from contango, but they also have resulted in little free space in onshore storage tanks. The low freight rates of 2009 and 2010 have
made it possible for ships to stand in for onshore tankage. The attractiveness of the floating storage play, however, depends on the depth of the crude oil contango in comparison to rates for short term tanker charters.

Brent crude has been the standard stock of floating storage deals for crude oil, as unlike West Texas Intermediate, which is delivered in landlocked Oklahoma, physical delivery of Brent crude oil takes place in North Sea ports, minimizing costs incurred by piping the stream to marine terminals for storage and transportation. The chart below shows historical spreads between the spot and six month forward price per barrel of Brent crude oil in comparison to the cost of storing each barrel for six months on a VLCC, assuming a charter rate of $30,000 per day. It is important to note that this oversimplifies the economics of these deals and does not take into account carrying costs, such as bunker fuel, cargo insurance, and the cost of financing the cargo itself.

These additional costs are significant factors in the profitability of storage plays and further narrow the window of opportunity for traders seeking to hold cargo at sea. While the past year and a half has seen the crude oil market in constant contango, demand for floating storage deals are unlikely to emerge unless the spread between spot and future crude oil prices opens wide enough to cover these operational costs.

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