Market Insights: Maritime Fuels

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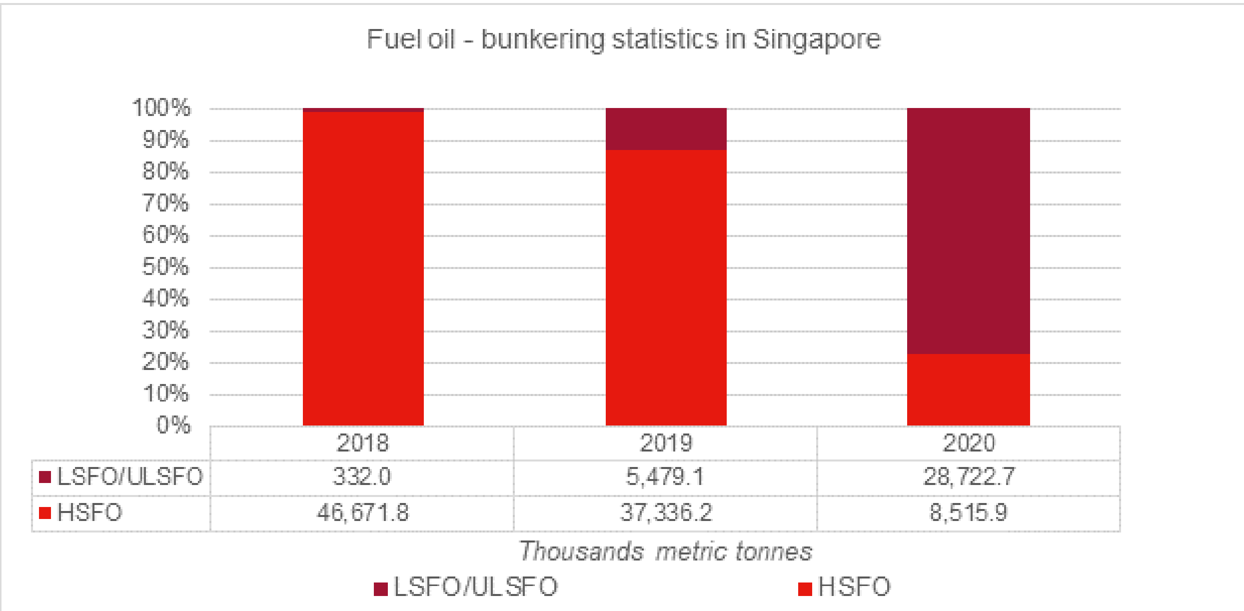
A wise man once said; "No man is an island". In 2020, this maxim could also be applied to EEX' freight markets. As the leading marketplace for freight derivatives, our clients are collectively exposed to numerous risks – and at the forefront, millions of tonnes of fuel oil – inarguably the largest variable cost of seaborne freight. Almost a year after the watershed regulations implemented by IMO, we thought it would be prudent to revisit the maritime fuels market and examine how this new landscape impacts our freight clients.

The international shipping market has left a milestone behind, with sulphur regulations under IMO in place from January 2020. The industry is already bracing itself for new CO2 and GHG emissions targets in 2030 and 2050 respectively and the true decarbonization battle of our industry is on the horizon. In parallel, the race to develop compliant fuels and technologies is taking shape, from methanol, LNG and hydrogen, to molten salt reactors and carbon capture. In an increasingly diverse marketplace of solutions, it seems incontrovertible that the dominant fuel in this decade is highly likely to be varieties of heavy fuel oil with a sulphur content of 0.5% or less. Decarbonizing freight will not happen overnight.

In July 2020, EEX asked our clients to tell us how their bunker risk management has changed in 2020 and more importantly, what *we* as an industry should do for them in the years to come. We received an overwhelming response and are very grateful that so many owners, charterers, traders and brokers were willing to share their thoughts with us.



EEX has previously argued that the maritime fuel market, which according to some estimates, accounts for 40% of the total residual fuels market, deserves new hedging tools that better reflect trading behavior and supply idiosyncrasies in the maritime bunker market. The diminishing returns on installing scrubbers, driven by a narrowing 'hi-lo' spread between HSFO and LSFO also suggests that the market will likely consolidate around a LSFO benchmark, for which the majority of underlying volume is utilized as bunker. Increased activity on physical trading platforms such as the Platts MOC for LSFO also supports the credibility of daily price assessments.

Asked to list their major concerns in the market for fuel derivatives, our clients submitted the following, in order of ranking;

1) Transparency – the ability to assess fair value, in real time, to market prices for their bunker exposure.
2) Liquidity – the assurance that there are available counterparties both at initiation and unwinding of positions.
3) Basis risk – minimizing the differential between cash markets and returns on derivatives positions.

All the above concerns suggest that the maritime fuels market does not cater sufficiently to its maritime users, despite our respondents hedging an average of 65% of their physical requirements. The sentiment is also mirrored in more than 60% of respondents, who specifically expressed a need for derivatives on delivered bunker indices. The differential between cargo prices in cargo markets for fuel oil and that of delivered prices can often be volatile, introducing risks to the matching of cash flows. Additionally, more than two thirds of our survey respondents said that they would prefer hedging in 100 metric tonne increments, or less. Fuel oil cargos are priced for delivery in 20,000 tonne parcels, typically more than two weeks ahead, whereas spot bunker is procured in much smaller increments and in significantly more prompt and narrow fixing windows. It is evident that a reimagined market could help address these issues.

The fragmented picture we see in the physical market is directly reflected in hedging behavior. In what used to be a relatively homogenous market for high sulphur fuel oil, liquidity has split between middle distillates and residual fuel. As for execution of derivatives transactions, the majority of our survey respondents answered that they predominantly utilise the OTC cleared voice-brokered market, engaging in bilateral transactions with counterparties such as banks, or both. With many financial institutions stepping back from typical commodity trade finance and client trading, exchanges and brokers have significant work ahead to fill some of the service gaps that may materialise.

As the prominence of alternative bunker ports increase, so do the complications of using proxies for hedging. This tendency was strongly reinforced by our survey results. Whilst Singapore and Rotterdam remain the mainstay pricing hubs for maritime fuels, our results show that a growing segment of clients would like to see liquidity in derivatives on additional regional prices such as North East Asia, the Middle East Gulf, and even the US Gulf.

2020 has been the year of many things, but for those of us professionally invested in the seaborne trade, few structural events have had such an impact as the near overnight change in fuel demand. Bunker stems in Singapore went from around 90% high-sulphur fuel oil in 2019, to less than 30% so far in 2020. This is not only rapidly changing the production and delivery infrastructure, but also price risk management.

EEX takes its role as stakeholders in the maritime industry very seriously. Over the last years, we have developed a robust portfolio of derivatives instruments that help owners and charterers manage the ever-present price risks in freight markets. Our 2020 credo, "Driving Freight Forward" means that we are constantly looking for underserved market segments, which we can respond to quickly. Building relevant products and services as and when the demand occurs. As custodians of a marketplace that could reach two billion tonnes equivalent of cargo capacity in 2020, it is evident that maritime fuels should be on our radar.