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Imo 2020 – A Potential Joker in the Deck

Effective January 1, 2020, the International Maritime Organization, the U.N. body responsible for setting standards for the international shipping industry, will require an 80% reduction in the sulfur content allowed in the fuels used by marine vessels on the open ocean. Historically, these large ships used in international trade have been fueled by low cost, high sulfur bunker fuels that were, effectively, what was left over after the more valuable distillates (think gasoline, diesel, and jet fuel along with heating oils, to name a few) had been refined out of a barrel of oil. This high sulfur fuel releases sulfur dioxide, nitrogen oxides and other pollutants that damage the environment and cause acid rain when burned. While there have been reductions to sulfur contents in marine fuels before, this is by far the largest reduction the industry has ever seen and has potential repercussions for the world economy as a whole.

As background, demand for high sulfur fuel for shipping was ~3.9 million barrels per day in 2018, the vast majority of which will be affected by this new regulation (U.S. EIA). The industry also consumes about 1 million barrels per day of global diesel and gas oil, both low sulfur distillates the majority of which is consumed by the heavy-duty trucking industry, which is equivalent to ~5% of global demand for those products (McKinsey & Company). Should the shipping industry convert entirely to these low sulfur distillates as a means of satisfying the regulation, they would consume an additional 2-2.5 Million barrels per day. This is on top of the trucking industry which saw its highest demand for these fuels in more than a decade in 2018 at roughly 4.2 Million barrels per day (U.S. EIA). That would represent a ~50% increase in demand. Unfortunately, the refinery industry does not have the capability to produce enough of these low sulfur distillates to meet anywhere near that kind of demand. A new refinery can take 5-7 years to build, and to date we haven't seen the large spike in refinery building that would be expected.

There are, however, several other ways that the industry can compensate:

- Refineries that have the capability can further process and convert high sulfur products to low sulfur fuels that would meet

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the regulations. The refinery industry doesn't currently have enough capacity to process the amount of high sulfur products that will be displaced by the new regulations and the addition of this capability to smaller, simpler refineries is time consuming and costly. Higher margins will likely drive many to make the upgrade to their systems as the industry adapts to the new environment, but it will take time.

- Shippers could use higher cost low sulfur fuel options like marine gasoil, though as mentioned above there is a supply shortage in those products and we lack the capacity to fully meet that need through increased production. This is a likely starting point for many shippers as the industry adapts, and is expected to mean refiners will need to distill an additional 2.2 million barrels per day of crude oil to plug that supply gap. Further, using refining capacity to increase output for marine gasoil would leave less capacity for other distilled products, like diesel.
- Shippers could blend high sulfur content fuels with low sulfur distillates, like diesel and gasoil, to meet the regulated sulfur content. The result would be higher costs for shippers, though not as high as switching to marine gasoil.
- Shippers could install scrubber systems on their ships that would allow them to continue burning the same high sulfur fuels while capturing the harmful byproducts. Unfortunately, these scrubbers are not yet commonly utilized in the industry. While they are far less expensive and less time consuming than building refinery capacity, there is still cost and down time associated with the process. We also have yet to see a spike in scrubber installations.
- Shippers could switch to cleaner propulsion systems powered by liquefied natural gas (LNG). This is only a realistic option for a small subset of existing ships and in-progress ship builds. There is also a lack of infrastructure around LNG that would need to be built out, again costing time and money.

The problem we have in digesting these new regulations and assessing their potential economic impact is that both the refiners and the shipping industry seem to be waiting for the other to move first. Both sides risk taking the first step only to see the other party move in the opposite direction. The general consensus, however, is that shippers seem to be preferring the idea of using the higher cost fuel options over the scrubber or LNG options at this point. While it is impossible to forecast the actual impact of this change, there are a few things industry experts seem to agree on.

First, demand for crude oil is expected to increase in the second half of 2019 into 2020, especially for crude with lower sulfur content like West Texas Intermediate. Though there is excess oil production capacity around the world, some analysts are forecasting the demand growth to outpace that supply growth, leading crude oil to move into a $70-$80 per barrel price range at the end of 2019, and $90-$100 in 2020 as both refiners and shippers adapt. Both are substantially higher than the mid $40 oil we had at the end of 2018, and would put upward pressure on inflation expectations. Second, the price of diesel fuel is expected to rise in the second half of 2019 into 2020, potentially meaningfully. Third, the cost of shipping is expected to rise in the second half of 2019 into 2020 as all types of shippers are hit with higher fuel prices. While the shipping companies and consumers will likely face higher prices, oil producers and refiners will likely see a benefit. Finally, oil futures do not seem to have priced in this future demand growth, which could lead to heightened volatility in crude oil prices in the second half of 2019 into 2020 as the industry and markets adjust to the new landscape.

These all have the potential to negatively impact the global economy in late 2019 into 2020, though the degree to which they come to pass and, therefore, their implications are unknowable at this point as we are in uncharted waters. As such, we will be closely watching how IMO 2020 progresses and adjusting our expectations as necessary.

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