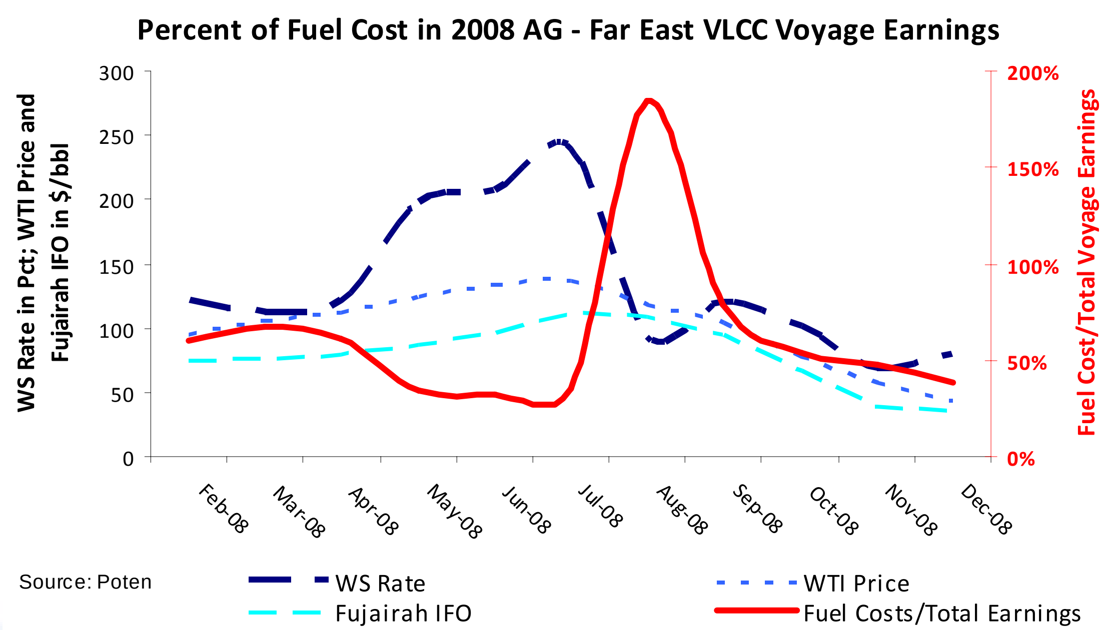
Tightening the Screws

While the European Union's (EU) announced phased embargo on imports of Iranian oil may be stale news to some, views on the eventual ramifications of this move continue to swirl in the oil market. The EU's timetable to wean its members off Iranian oil extends to the beginning of July. Over this span, the hope is that trade patterns will adjust to find sufficient replacement barrels so as to mitigate any oil supply or price shock. An estimated 20 percent of Iran's roughly 3.2 million barrels/day crude oil and condensate exports is taken by EU. Replacement of this flow amounts to less than half Libya's outage that 2011 market's successfully endured. How oil price will likely adapt to this dislocation of Iranian oil, especially if protracted, is still under debate.

Of course, events surrounding the full implementation of the EU's embargo of Iranian oil may not unfold in an organized and logical manner. Rumblings of an early and disruptive EU preemptive embargo on the part of Iran have recently seeped into the media. Additionally, mostly inscrutable actions by speculative, non-commercial paper players could again fan the flames of rising oil prices. Realistically, though, it is almost impossible to predict how or if the events to come by July will have any impact on oil's price. Nevertheless, it may be prudent for tanker owners to consider the possible impact to their operations should spur a rise.

While history does not always exactly repeat itself, reviewing the past can still is still instructive. To glean an insight from days-gone-by, the chart below explores a particularly turbulent year in the life of tanker owners – 2008.



Still fresh in most minds is the unprecedented run-up of VLCC Worldscale (WS) rates and oil prices in the first half of the year followed by their equally unprecedented collapse. In early 2008, the rapid advance of VLCC WS rates for the AG – Far East voyage easily outpaced the total voyage fuel costs, which were being pulled up by crude oil's price rise. Once the WS rate bubble burst, however, fuel costs quickly devoured tanker earnings since bunker prices did not decline as fast as WS rates.

Adjustments in oil trade through the smooth transition to full EU sanctions will pivot on where its members seek substitutes for Iran's heavy and high sulfur crude oil. Finding enough replacement volumes of Libya's light and low sulfur oil proved expensive for the EU. Fortunately, ample quantities of Iran's type of oil lie nearby. Several other AG countries have oil with qualities approaching that of Iran's. These countries also have sufficient reserve production capabilities to compensate for diverted Iranian volumes. Hence the price strain of sourcing these substitutes may not match that experienced from the Libyan replacements. Shifting supply patterns to EU markets will naturally impact tanker markets.

A question that lingers is whether or not Iranian oil no longer taken by the EU will instead be taken by other countries. For those countries not bothered by the prospect of Iran' alleged program to acquire nuclear weapons, continued consumption of Iran's oil – perhaps even at distressed prices – may even increase. As these seemingly unfazed countries are mainly located in Far East, tanker utilization may actually improve.

What lesson does history offer tanker owners with regard to riding occasional updrafts and downdrafts in oil's price? Back in early 2008, oil supply was deemed adequate by commercial market participants. Although physical oil was readily available, speculative actions by non-commercial paper players may have been behind oil's price run up in the first half of 2008. WS rates responded upwards to this rise, in part, to pay for higher bunker costs. Clearly, though, other factors may have also contributed to pushing WS rates up. If the full screws of the EU's sanctions also spawn market sentiments that increase oil's price – even if only short-lived – history may be telling tanker owners to enjoy riding any resulting bunker price driven earnings increase, because the earnings on the peak's slippery downside may not be as great.

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