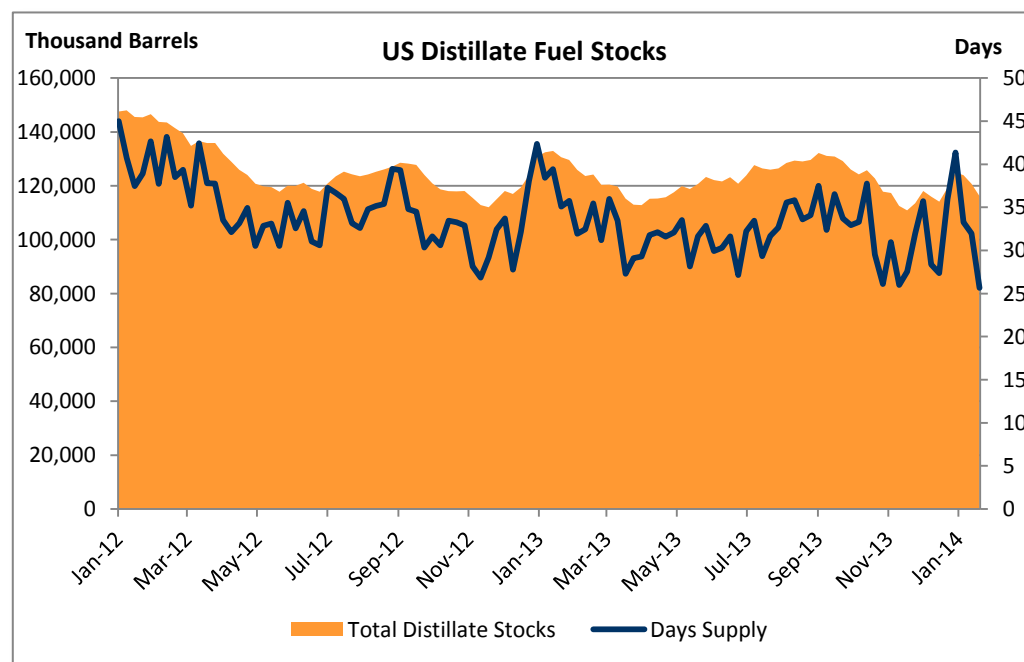




The Super Bowl Shuffle: Heating NYC and the Northeast

With NFL Super Bowl hype in full swing, native New Yorkers are raising their collective eyebrows at the city's ability to deliver what it has promised. When hosting a national event such as this, the question of infrastructure is on the top of everyone's mind. Belying tough exteriors, the recent extreme cold in New York has registered the chilling notion of the delicate heating oil infrastructure in our backyard and elsewhere along the East Coast. A strong demand for heat, combined with regulatory specification changes that impact the type of fuel used, has increased tension in an already fragile system.

A summary of US distillate fuel stocks reveals that current volumes are well-below recent years on a seasonal basis. It should be noted that this product designation includes both diesel fuels and fuel oil for on-road, industrial, power generation and heating applications. Average stock levels are 45% lower this year compared to January 2010 and the ratio of stock to demand ("days supply") has slipped below 25 days; a level customarily seen in summer months.

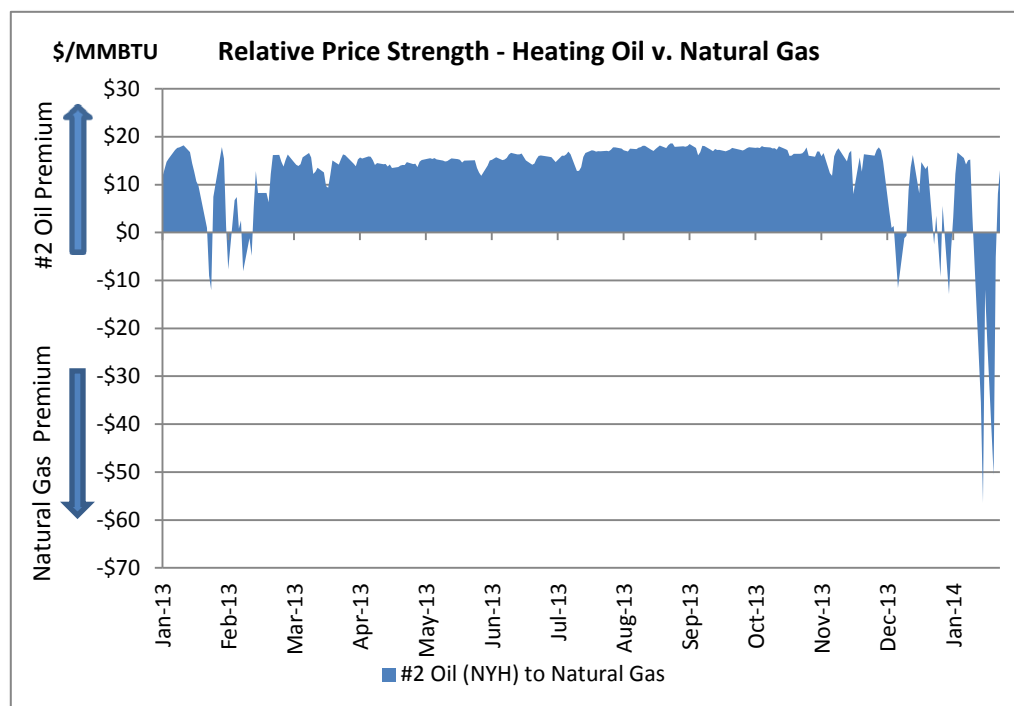


Source: EIA/Poten

The Northeast, not unlike other parts of the world, has been grappling with how to effectively restrict the amount of particulate matter, NOx and SOx emitted from heating fuels in order to improve air quality. While many states continue to use residual fuel oil (#6 oil) for heat and power generation, in 2011 New York City embarked on an initiative to transition residential buildings from #6 oil to natural gas or appropriately-sulfured middle grade #4 oil or #2 oil.

Although this transition is not expected to take place overnight, the introduction of alternative fuels poses new risks to fuel consumers and suppliers looking to guarantee service to residents or hedge costs. In response to impending regulations and fuel oil and natural gas price differentials, many properties like power plants have opted for co-generated boilers and burners in order to economize and meet specifications. When natural gas requirements rise due to factors like surging heating demand, industrial users, power plants and residential properties switch to distillate or residual fuels where possible.

The chart below shows the relative price strength between heating oil (#2 oil basis New York Harbor) and natural gas, basis City Gate. The natural gas market, not unlike liquid petroleum, is also challenged by infrastructure limitations. When natural gas supplies are scarce during times of peak demand, severe price swings can result. Natural gas suppliers must initially cover term contracts; the marginal cost is then passed along to those with 'interruptable service' at market rates.



Source: Bloomberg/Poten

A short-term transition to liquid fuels highlights the marine and inland logistical challenges and associated costs. Densely populated and developed areas, such as New York City and many other places along the Northeastern coastline, have little room for significant marine infrastructure expansion or new tank farm sites. In response, demand surges for all types of coast wise Jones Act barges that can deliver fuel to tough-to-reach customers.

A ripple effect for incremental foreign imports can be expected farther up the supply chain. A surprise draw on domestic stocks is often met with a need for replenishment.

The balance between natural gas and petroleum product pricing is already delicate, and the evolution of state-by-state fuel specification changes will likely complicate matters and impact price. Until market tools are available to sort these inefficiencies over time, a short-term pinch can be expected somewhere in this supply chain - especially in the dead of winter.

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