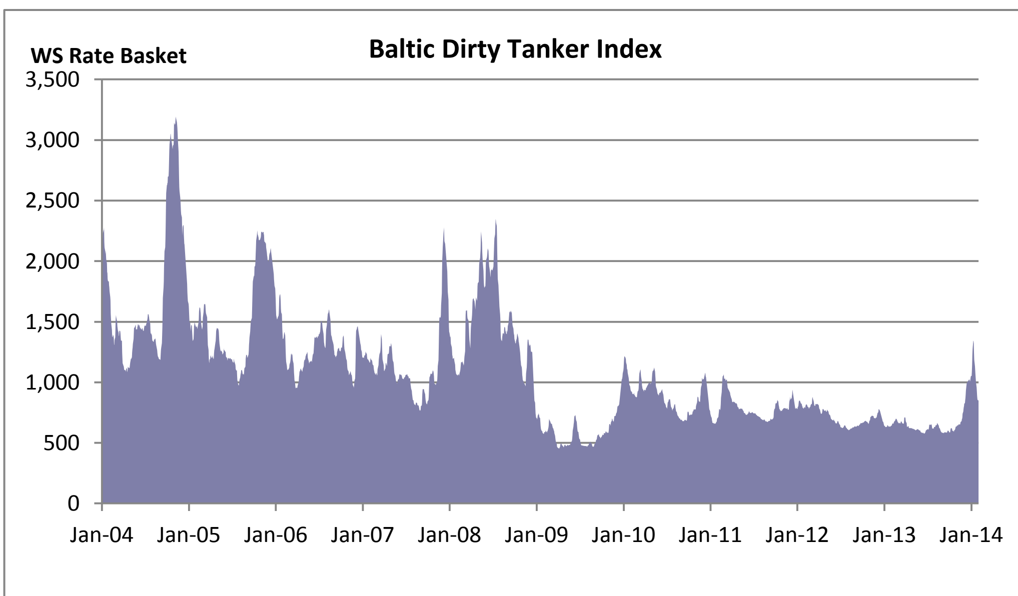
Leaving Some with a BITR Taste

The market landscape for crude oil and refined product trades has an inherent element of shifting sand, presenting an organization like the Baltic Exchange with certain challenges. The Baltic Exchange is a centuries-old institution that, among other services, oversees a collective of member shipbrokers who contribute daily freight rate assessments for the wet and dry bulk shipping markets. The freight rates that are collected by the Baltic Exchange are in turn used by both charterers and shipowners, as well as other market participants, as a reliable metric of freight pricing for internal and external financial calculations. Although the birth and death of trade lanes is a natural market evolution, such developments pose questions of relevancy to the Baltic Exchange's data collection efforts. While the decision to discontinue a certain set of assessments due to perceived obsolescence is objectively simple, it could have broader implications for commercial market participants that have freight contracts dependent on these rates.

The chart below shows the Baltic Dirty Tanker Index for the past decade. This index is currently comprised of 12 benchmark tanker routes, covering all trade routes and vessel sizes. The BDTI serves as an often cited reference of general health of the tanker market freight rate environment.



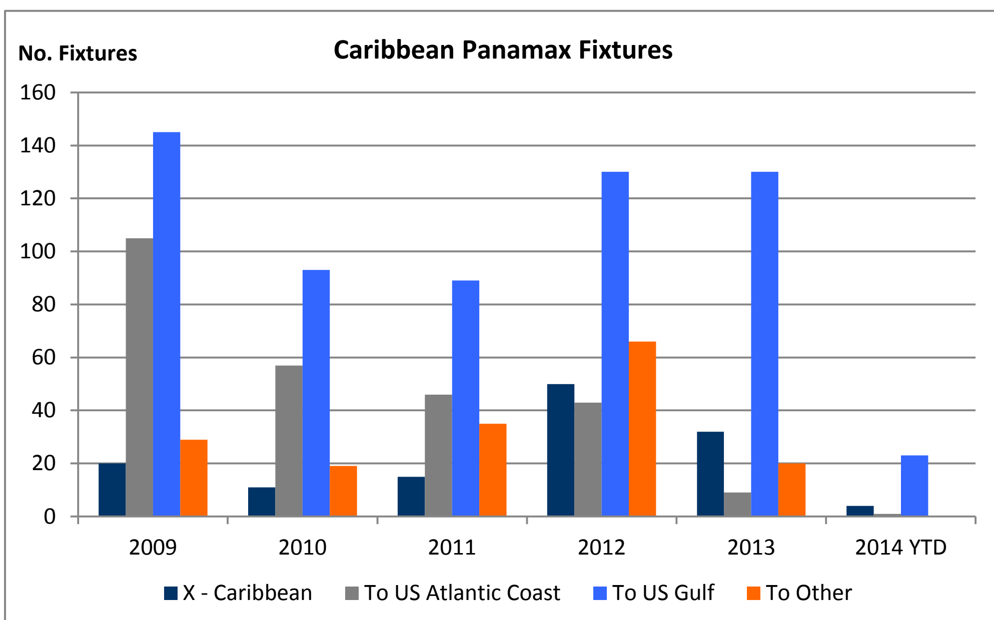
Source: Baltic Exchange/Bloomberg

The Baltic Exchange International Tanker Routes (BITR) are quoted on individual trades for specific cargo sizes for clean and dirty cargoes. For example, the tanker trade with the largest volume worldwide is often referred to as “TD3” or “Tanker Dirty” route number “3” – the voyage basis is from Ras Tanura, Saudi Arabia to Chiba, Japan for 265,000 metric tons of cargo.

An announcement issued on February 5' 2014, indicated that the Baltic Exchange was suspending their assessments of the routes “TC3_38” and “TD10D”, Aruba – New York for 38,000 metric tons of clean products and Aruba – New York for 50,000 metric tons of fuel oil, respectively. The removal of TD10D would leave the market without a Baltic Exchange instrument for quoting Panamax freight rates.

In early 2012, Valero shut down their 235,000 bpd Aruba refinery, effectively rendering the voyage basis irrelevant. Historically, the Aruba refinery yielded significant volumes of fuel oil that were exported and often utilized as feedstock in Valero’s Paulsboro, N.J. refinery or for power generation on the US East Coast. The Aruba refinery eventually became structurally disadvantaged compared to US Gulf Coast refineries due to a higher operational cost base; it, like other Caribbean refineries, did not have access to cheap natural gas for power supply.

The chart below shows reported spot fixture activity for Panamaxes loading in the Caribbean by discharge location. Using reported spot market activity as a proxy for total market activity, trade volumes from the Caribbean to the US Atlantic Coast have become insignificant. Although still a relatively small market, fixture activity has increased for the Caribbean to US Gulf trade.



Source: Baltic Exchange/Bloomberg

It stands to reason that the Baltic Exchange should continue to assess at least one dirty Panamax trade route. Contracts of Affreightment, or COAs, whereby shipowners and oil companies pre-arrange transportation volumes over a specified period of time, often incorporate some kind of discount to prevailing spot market rates. In exchange for a guaranteed volume of business from an oil company, a shipowner or pool will typically offer a discount to market rates. The Baltic Exchange rate assessments are often referenced in contract language accordingly. The same logic applies for time charters that involve profit sharing elements; shipowners and charterers agree how the profit share will be determined based on independent freight rate assessments.

In the case of TD10D, the Baltic Exchange might consider changing the voyage basis in order to prevent commerical disruption. Load ports for crude export in countries such as Venezuela, Colombia or Trinidad are viable options and the destination should, undoubtedly, be in the US Gulf.

The question of what to do with the Aruba to New York (TC3) benchmark for clean products is more black and white. The sizeable increase in refined products exports from the US Gulf to the Caribbean and Latin American countries has displaced imports from the Caribbean. With strong refining economics in the US Gulf, it is difficult to see any reversal in this trend anytime soon.

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