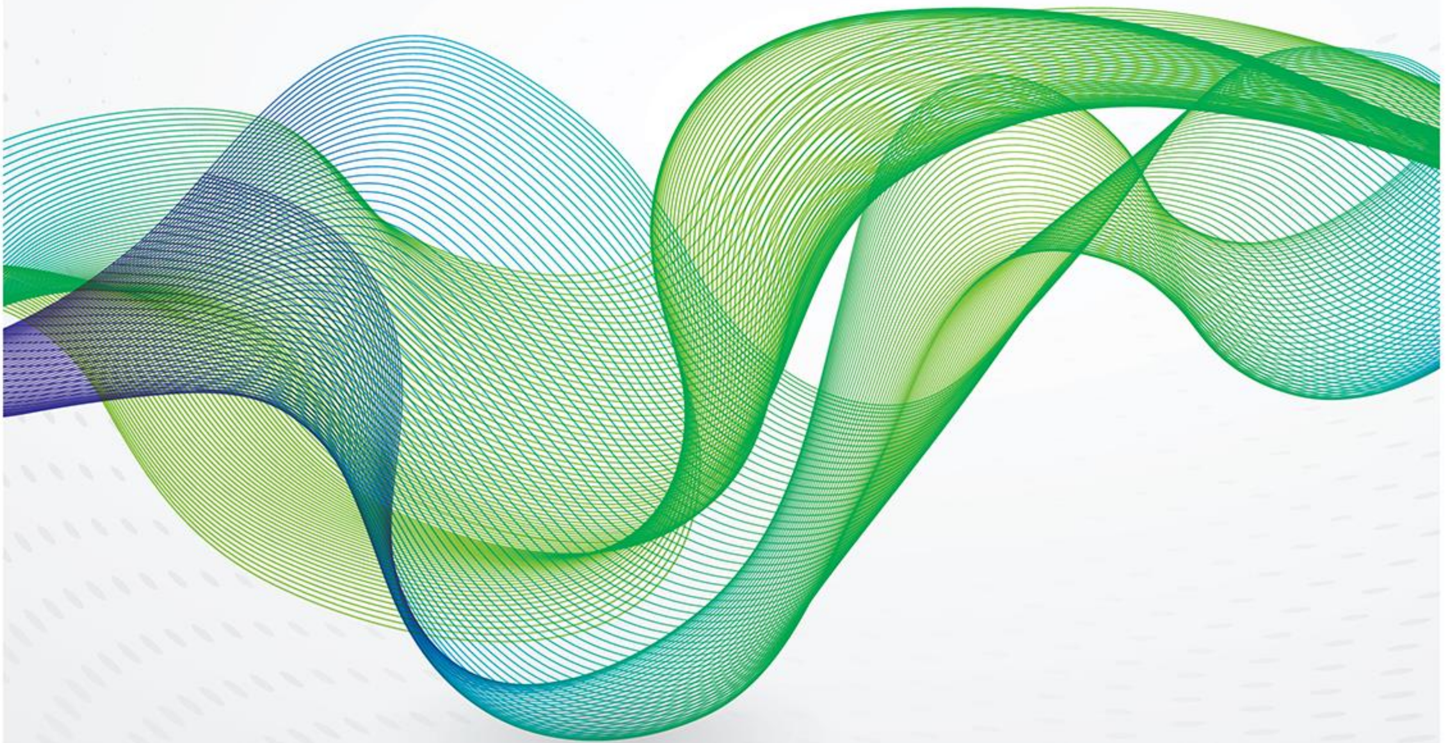
THE OXFORD INSTITUTE FOR ENERGY STUDIES

October 2019

Sanctions, Shipping, and Oil Markets



OXFORD ENERGY COMMENT

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A perfect storm for shipping?

On 11 October 2019, 'Howe Robinson'[1] VLCC[2] Shipping Report wrote in its commentary: 'The right words are difficult to find to express the current market. Rates are up by over WS100[3] points in the Middle East Gulf (MEG) and West Africa… Sentiment from owners is off the scale.' From 'very firm' rates at WS 90 at the start of October, the report assessed the shipping rate from the Middle East Gulf to Asia (as shown in Figure 1) to be at WS310. In just over a week, the cost of taking a barrel of oil on that route, through the cheapest possible way, rose by $6 per barrel.[4] At times when refinery margins are in single digits, this is a major blow to refinery profitability. Rising freight rates will also impact international trade flows, and there is already evidence of surging US oil exports to Europe, as they normally move in smaller tankers, while the volumes to Asia are falling.[5]

Higher rates at the end of the year have been expected for quite some time,[6] in light of the transition to marine fuels compliant with IMO2020 regulations[7] starting in January 2020. Compliance with these guidelines are set to raise transportation costs by at least $100 per ton. But recent attacks on shipping in the MEG have substantially increased insurance premiums,[8] further adding to the cost of shipping. In short, a perfect storm seems to have hit the shipping industry.

The sudden and sharp spike in freight rates is due to the US administration's decision to sanction two subsidiaries of China COSCO Shipping Energy alongside announcements by global traders including Exxon and Unipec that they are banning the use of vessels linked to oil flows from Venezuela. Combined, these have effectively taken close to 300 of the global tanker fleet offline.[9] In addition, longer sailing times from the US to Asia tie vessels in for longer, while ships are entering dockyards for retrofits ahead of the new maritime rules that come into effect on 1 January 2020. Depending on the length of the disruption, all aspects of the oil industry may be affected: refining margins, oil flows, relative benchmark values and ultimately even supply, demand and prices.

[1] One of the largest private shipbroking companies in the world. End of day report on 11 October 2019.
[2] Very Large Crude Carrier (VLCC) is normally used for long voyages and can load about 2 million barrels or 270 KT of oil.
[3] Worldscale Association publishes annual rates which anticipate the cost of shipping. The rates were calculated so that, after allowing for port costs, bunker costs and canal expenses, the net daily revenue was the same for all voyages. WS100 is simply 100% of the calculated (and published) rate.
[4] Taking Mina Al Ahmadi (Kuwait) to Yokohama (Japan) rate of $21.35 / MT. At WS90 it is $2.58/ bbl and at WS310 it is $8.88/ bbl.
[5] Wall Street Journal, 'Oil Shipping Costs Soar to Highest level in 11 Years', 13 October 2019. US exports hit a record 1.8 million barrels a day for the week ending Oct. 7. The figure is double the 924,000 barrels in the previous week. But shipments to Asia, which are typically done on VLCCs, were reduced almost in half to 508,000 barrels.
[6] See Adi Imsirovic and Ben Pryor (2018), 'IMO 2020 and the Brent–Dubai Spread', OIES Energy Comment, September.
[7] International Maritime Organisation ruling that from 1 January 2020, the limit for sulphur in fuel oil used on board ships operating outside designated emission control areas will be reduced to 0.50%
[8] Lloyd's List, 20 Jun 2019: Middle East crude shipping costs surge on higher freight rates and insurance premiums: 'The additional premium levied on war risk cover is now around 0.25 to 0.4% of the value of a VLCC, according to marine insurers surveyed by Lloyd's List. That adds an additional cost of $171,500 to $274,000 for the voyage based on the price of a five-year-old VLCC.'
[9] Exxon, Unipec ban 250 tankers that have touched Venezuelan oil, Sanctions on COSCO Dalian put 43 oil tankers out of reach: "US sanctions hit global oil fleet as traders shun nearly 300 tankers", *Reuters News*, 11 October 2019, https://www.reuters.com/article/us-iran-nuclear-usa-sanctions/u-s-sanctions-hit-global-oil-fleet-as-traders-shun-nearly-300-tankers-idUSKBN1WQ0JS

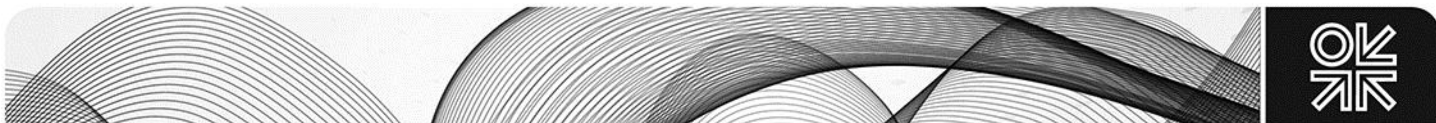
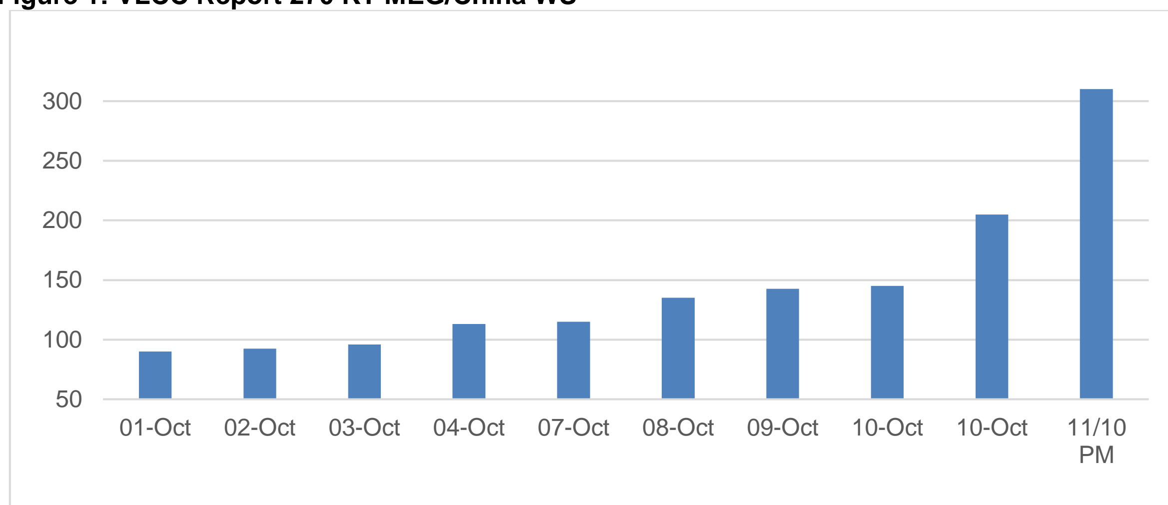


Figure 1: VLCC Report 270 KT MEG/China WS



Source: HOWEROB VLCC Report

A series of unfortunate events

On Wednesday 25 September, the US Treasury Department announced that it was blacklisting two affiliates of COSCO Shipping Energy—COSCO Shipping Tanker (Dalian) and COSCO Shipping Tanker (Dalian) Seaman & Ship Management Co—alongside four other shipping companies: Kunlun Holding Co., Kunlun Shipping Co, Pegasus 88 and China Concord Petroleum Co for trading with Iran.[10] While the US Treasury noted that the sanctions did not apply to the parent company COSCO Shipping Energy or to other COSCO subsidiaries, given COSCO's complex ownership structures, and as the Treasury statement did not clarify which vessels are under these companies' control, market participants have shunned all COSCO vessels. The decision has impacted long-haul oil shipping as 26 COSCO Dalian-owned VLCCs represent 3.3% of the global VLCC fleet of 792 ships.[11]

The impact has not been limited to oil,[12] as a US-listed company Teekay LNG announced that its 50-50 Yamal LNG joint venture may be affected because its partner, China LNG Shipping, is partly owned by COSCO Dalian. The joint venture reportedly controls six Arc7 ice-class vessels[13] chartered by the Yamal project, four of which are in operation.[14] CNOOC is also now reportedly seeking to replace COSCO ships it had previously chartered, pushing up LNG freight rates ahead of peak winter demand.[15]

COSCO Shipping Energy halted trading in Hong Kong on Thursday 26 September but resumed trading on 30 September stating that the company 'is comprehensively organizing its various businesses, assessing the relevant impact, and conducting various response work'.[16] But COSCO

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[10] See US Department of Treasury, Iran-related Designations; Issuance of Iran-related Frequently Asked Question, 25 September 2019 https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20190925.aspx

[11] "COSCO Dalian's ships shut off tracers after US sanctions announced", *Reuters News*, 9 October 2019, https://www.reuters.com/article/us-iran-nuclear-usa-cosco/cosco-dalians-ships-shut-off-tracers-after-u-s-sanctions-announced-idUSKBN1WO0RA

[12] See 'Shipping Costs Are Soaring as LNG Vessels Drop Out of Service', Bloomberg, 11 October 2019, https://www.bloomberg.com/news/articles/2019-10-11/lng-shipping-costs-soar-as-cosco-sanctions-add-to-lack-of-ships

[13] Arc 7 ice class vessels have been custom designed and built for the Yamal LNG project to support year round navigation.

[14] "Teekay's Yamal LNG JV falls under US sanctions", Argus, 8 October 2019

[15] Jessica Jaganathan, "China's CNOOC looks to replace COSCO-linked LNG tankers after US sanctions –sources", *Reuters*, 11 October 2019, https://www.reuters.com/article/iran-nuclear-china-lng/chinas-cnooc-looks-to-replace-cosco-linked-lng-tankers-after-u-s-sanctions-sources-idUSL3N26W0V5

[16] http://energy.coscoshipping.com/module/download/down.jsp?i_ID=119352&colID=7296

has yet to spell out its response. From the shipping industry's perspective, the onus is now on COSCO to state clearly which vessels are controlled by which entity and until COSCO does so, charterers will be wary of all COSCO vessels. Estimates of COSCO Shipping Energy and COSCO Dalian vessels vary widely, with media reports citing a COSCO Shipping Energy disclosure document stating that COSCO Dalian owns 43 oil tankers, including 26 VLCCs. Argus, however, reports that 'at least six of COSCO's 44 VLCCs are owned by entities likely under US Sanctions'.[17] So, barring a clear statement from COSCO (or the US Treasury), charterers will likely remain cautious.

Yet for COSCO Shipping Energy, there may be a concern that even if it does clarify the ownership structures for specific vessels, or if it takes steps to transfer ownership from sanctioned subsidiaries to COSCO Shipping Energy, this would still not be enough to assuage fears about reputational risk or about future designations.

Unappealing arbitrage

Adding fuel to the proverbial fire have been announcements by Exxon Mobil, Equinor, Unipec and Trafigura that they are avoiding tankers which have carried Venezuelan oil in the past year. This could involve as many as 250 crude and product tankers.[18] Most other companies are likely to follow suit or at least exercise outmost caution.

Refiners and traders, in light of the rising costs of imported oil, will look to buy regional grades, ideally with dedicated vessels. Arbitrage movements will become unattractive. Unless committed, US exports from Houston will be postponed as much as physically possible. Those who are committed to lift the barrels will have to incur additional costs. Recent vessels 'on subjects'[19] from the US Gulf have achieved their highest levels in a decade.[20] If the high charter rates persist, US flows to Europe may well continue at higher rates at the expense of exports to Asia since shorter routes can be economical on smaller vessels. The additional volumes may put pressure on Brent, while Asian importers may have to bid Dubai higher to attract imports. In the long run, higher shipping costs act as a tax on both producers and consumers and affect demand. If prolonged, high shipping costs are bearish for oil prices as they dampen demand.

The impact on LNG markets is harder to assess as the freight market is less liquid. But LNG freight rates are also soaring currently[21] and depending on the number of affected vessels, the impact could be even greater as LNG is harder to store and a large proportion of vessels are still dedicated to particular projects.

Yet the market seems to believe that the situation will not remain tight for long. As the chart below shows, VLCC rates on the busy Middle East to China (so called 'TD3c') route are expected to normalise by the beginning of the next year. From the current peaks of about $30/MT, forward traded rates halve by February 2020 and then stabilise at just over $10/MT from March 2020 onwards.[22]

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[17] "Cosco-owned vessels back on spot VLCC market", Argus, 10 October 2019

[18] Marianna Parraga, Roslan Khasawneh, "US sanctions hit global oil fleet as traders shun nearly 300 tankers", *Reuters*, 11 October 2019

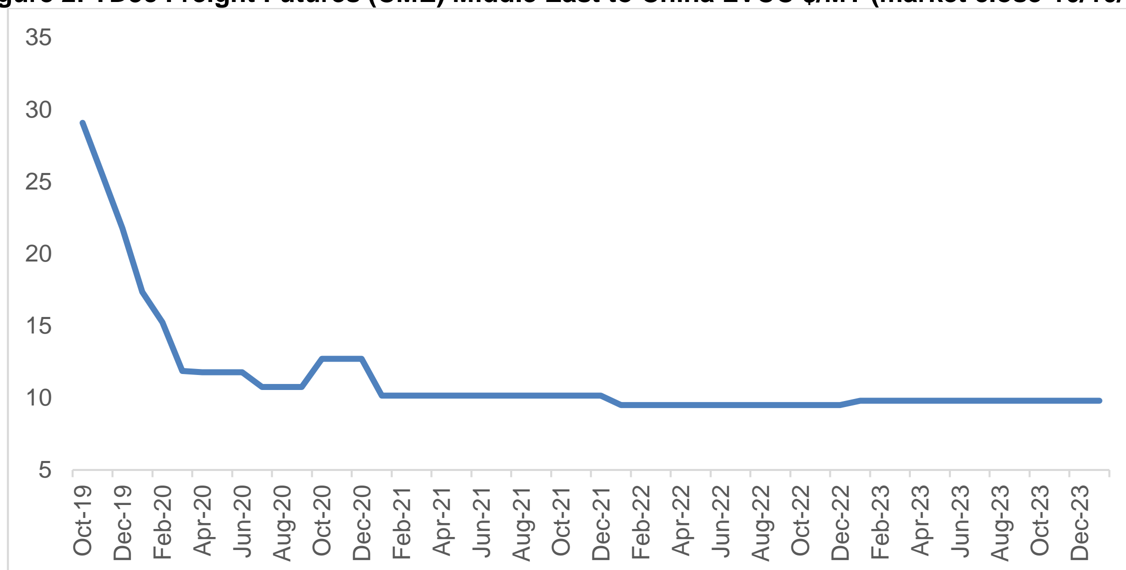
[19] Terms and conditions of chartering have been agreed except for a few details. The charter is only fixed 'subject to' the outstanding terms yet to be agreed.

[20] "Occidental tentatively books oil supertanker for record $13.25 million to Asia", *Reuters News*, 8 October 2019, https://www.reuters.com/article/us-occidental-crude-shipping/occidental-tentatively-books-oil-supertanker-for-record-13-25-million-to-asia-idUSKBN1WM205

[21] Shipping Costs Are Soaring as LNG Vessels Drop Out of Service, Bloomberg, October 11, 2019

[22] Liquidity in this contract is thin and the forward curve should be interpreted with utmost caution. However, it is the best forward indicator available for VLCC rates.

Figure 2: TD3c Freight Futures (CME) Middle East to China LVCC $/MT (market close 10/10/19)



Source: CME Exchange

The obvious way to resolve the situation would be to relax sanctions. The shipping industry might be hoping that the US government will delist COSCO. In the past, US Treasury has removed sanctions once the sanctioned party had taken what Treasury deemed to be adequate measures to change behaviour. Yet in light of reports of ship-to-ship transfers taking place offshore Malaysia, the burden of proof likely lies heavily with COSCO and the bar will be extremely high. Reports that China has asked the US to end sanctions on COSCO as part of a trade agreement may also be giving the market a false sense of comfort. Even if the administration were to agree (which would require COSCO to show it is changing its alleged behaviour and/or to clarify vessel ownership) a limited deal will take weeks or months to iron out as negotiators are likely timing a deal for a potential meeting between Presidents Trump and Xi the mid-November APEC meeting. Even then, it remains unclear whether Treasury can go through its delisting procedures quickly. In the near term, however, the US Treasury is likely to issue further guidance regarding the scope of sanctions allowing vessels in transit, for example, to discharge cargoes. Finally, COSCO could undergo some restructuring that would change the complex structures of JV ownership in order to comply with sanctions. Yet in the interim, COSCO Dalian seems to be opting for opacity, reportedly shutting off ship tracking transponders.[23]

For now, then, geopolitics are adding to the anticipated IMO 2020-linked increase in freight rates. Going forward, the Chinese government, ship-owners and refiners' response to sanctions will remain a determining factor in vessel movements and supplies, and therefore prices.

Compliance with Chinese characteristics

Chinese compliance with US sanctions, in the context of an escalating trade war (notwithstanding recent reports of a limited trade deal), seems surprising. Indeed, Beijing's official diplomatic position remains that it will not abide by unilateral US sanctions and will therefore maintain its relations with Iran. But both Beijing and the state owned traders recognise that a US designation, related to trade with Iran or Venezuela, would be devastating for their global activities. So while flows of Iranian crude

[23] Shu Zhang, Roslan Khasawneh, "COSCO Dalian's ships shut off tracers after US sanctions announced", *Reuters*, 9 October 2019, https://www.reuters.com/article/us-iran-nuclear-usa-cosco/cosco-dalians-ships-shut-off-tracers-after-u-s-sanctions-announced-idUSKBN1WO0RA

to China continue through the now sanctioned Zhuhai Zhenrong, volumes continue to fall.[24] In Q1 19, Iranian crude arrivals averaged close to 0.5 mb/d but in August, they reached 0.2 mb/d. Similarly, imports of Venezuelan crude have fallen from 0.4 mb/d in Q1 19 to 0.3 mb/d in August. In short, Beijing is toeing a fine line: on the one hand, it does not want to 'kowtow' to US sanctions and will therefore maintain some commercial activities in Iran and Venezuela, but on the other, it will want to avoid financially crippling sanctions on its majors. It is possible, however, that the designated COSCO Dalian will transport Iranian or Venezuelan crude, much like Zhuhai Zhenrong will maintain its commercial linkages with Iran.

In order to insulate themselves from future sanctions, COSCO and other Chinese shippers will likely start shifting their marine insurance to Chinese companies[25] while rising concerns that the US will start sanctioning capital and currency flows to China could strengthen Beijing's resolve to promote the de-dollarisation of commodity flows.

Glimpses of de-globalisation?

The US administrations' decision to sanctions two subsidiaries of China's largest shipping company have put a massive strain on international oil markets. Just as the industry braced itself for the impact of IMO 2020 regulations, it got hit by higher insurance premiums due to the tensions in the Middle East and a shortage of vessels, particularly long-haul VLCCs, due to US sanctions. Shipping costs have soared. If this situation persists, due to its high dependency on oil imports, China will be hit hard by rising freight rates, as it also will have to bid higher prices in the spot markets, making oil imports ultimately more expensive. At a time of slowing economic growth, this will further weigh on the economy. To be sure, China receives oil as collateral for loan repayment, and its traders have built up fleets (jointly owned with COSCO Shipping Energy) which could insulate them slightly from higher freight rates. Refiners can also draw down on domestic stocks in an attempt to ride out higher prices, but as the independent refiners will want to exhaust their import licences to qualify for their 2020 allocation, and refiners will raise runs ahead of peak demand during the Lunar New Year (in early January 2020), they will need to return to the market.

It is now abundantly clear that China's biggest oil supply vulnerability is US. In spite of the limited trade truce, Beijing and its traders will increasingly seek to nationalise their commodity supply chains, insurance providers and financial flows. These latest developments may therefore be offering commodity markets a glimpse of what de-globalisation could look like.

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[24] Michal Meidan, "Why China will keep importing Iranian crude, but volumes will remain limited", *Oxford Energy Comment*, August 2019, https://www.oxfordenergy.org/publications/why-china-will-keep-importing-iranian-crude-but-volumes-will-remain-limited/?v=79cba1185463

[25] Michal Meidan, "China's Energy Security at 70", *Oxford Energy Comment*, October 2019, https://www.oxfordenergy.org/wpcms/wp-content/uploads/2019/10/Chinas-energy-security-at-70.pdf?v=79cba1185463

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