

# **Prospects for the Tanker Market in 2003 and Beyond**

*Intertanko Maritime London Conference  
17<sup>th</sup> September 2003*

*Dr Martin Stopford, Managing Director, Clarkson Research*

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*The tanker industry has had an amazing six years, with three market spikes. The fact that the balance is so tight means that despite the gloomy “fundamentals driven” outlook discussed in this paper, the “spike potential” we have seen so unexpectedly in 2003 will continue to be a feature of this market, at least until 2005. The tightening regulatory programme will distort market driven demolition patterns, perhaps creating a “scrapping holiday” in 2006/7, making it very vulnerable to over investment. Demand is complicated by the ton mile effect, which is tricky to predict. But on balance the market is probably heading for more difficult times.*

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## Tanker market overview

Good morning ladies and gentlemen. I have been asked by the Chairman to open proceedings with few words about the tanker market and where it will be going over the next decade. However many of you here will be more worried about where it's going over the next three months, so I will address that as well!

We are now on the third tanker spike in six years (Figure 1), and this should make us a little nervous about what happens next. I took the trouble to look back in the freight statistics and find that there have been two similar occasions in the last 50 years when there were three tanker freight booms in rapid succession. The first was in the early 1950s, culminating in the infamous Suez boom in 1956. The second was in the late 1960s and early 1970s, culminating in the 1973 boom, which was probably the best of all time, at least in terms of the world scale rates for which tankers were fixed on the spot market.

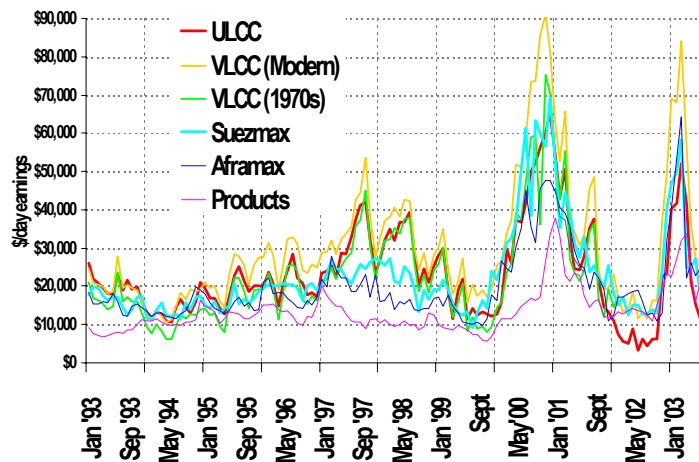


Fig 1

The disquieting aspect of this analysis is that on both occasions the third spike was followed by a long and troublesome recession. Perhaps this is not just a coincidence. Tanker market sentiment being what it is, by the third spike investors had on both

occasions developed a strong sense that the spikes would go on for ever, and thanks to the high earnings, they had the means to invest for the future on a grand scale. So I suppose one of my tasks this morning is to take a look at investment sentiment, to see if we are in danger of repeating the same problem.

### **The tanker market today**

Today the tanker market remains very tight. After 20 years of painfully recovering from the imbalance caused by the 1973 investment bubble, Figure 2 shows that demand has at last caught up with supply, which is, of course, why the market has become so unpredictable. Laid up tonnage statistics reinforce the point. Ten years ago there was still 8.5 million deadweight of tankers laid up, but today it is down to only 1 million deadweight. An exceptionally low level. So at least we are starting from a very strong position.

Just to reinforce matters, this year the market has received an unexpected shot in the arm from a series of "wild cards" which have increased the demand for tankers above the levels predicted by normal supply demand fundamentals. These include the strike in Venezuela, which may have increased tanker demand by around two to three per cent for the first half of the year; congestion in the Bosphorus which restricted supplies from Russia and the Black Sea; the Nigerian tribal wars which restricted exports from West Africa; the shutdown of 14 Japanese nuclear power stations which was partly covered by imported fuel oil; the war in Iraq which led to the Dortyol oil pipeline being closed on 27th March and as a result of bombing it has not reopened; and of course the Prestige effect which is probably still causing some minor disruptions on the supply side. Between them these factors have probably increased demand by 10-20 m dwt and are more than enough to account for the exceptionally high rates this year. However once they fade away it may reveal the weakness of the underlying fundamentals.

### **The economic scenario**

The three Tanker spikes in the last six years coincided with peaks in the rate of industrial growth in the major economic regions. Figure 3 shows the year on year growth rate of industrial production in the Atlantic and the Pacific. In 1997 the Pacific peaked in the first quarter, and the Asia Crisis caused major concerns, though the real pain in shipping was not felt until 1999 which was the most depressed year, at least as far as market sentiment is concerned, that the tanker industry have seen for a decade. The unexpected boom in tanker market rates during 2000 exactly coincided with a boom in the Atlantic and the Pacific economies, and there is no doubt that this was the most significant driver of that exciting year. The reason the boom was so unexpected was that most economic forecasters expected Asia to take two or three years to recover, if at all, so the upswing

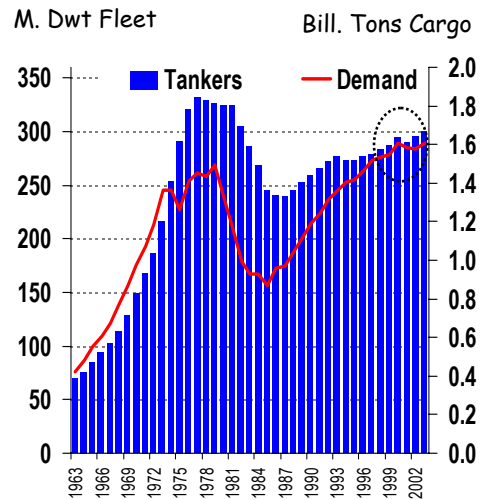


Fig 2

was quite unexpected! A salutary warning about the unpredictability of the modern industrial economies.

In 2003 the underlying driver of tanker freights is, once again the industrial economy. This time it was Asia in the driving seat, and Figure 3 shows that growth this year has been quite exceptional. Of course everyone knows about China, but Japan has also had an exceptional year, as have most of the Tiger economies. In contrast the Atlantic has had a very rough time, at least partly because its industrial producers are reeling under the impact of an avalanche of manufactured goods from Asia, particularly China. This is proving painful and goes a long way towards explaining why most economic reports in Europe are so gloomy. The focus of forecasters is much more on the problems of the German and American economies, and the strength of the industrial boom in Asia, except for China, gets little mention, but from a shipping or interview, it is a key driving force to present.

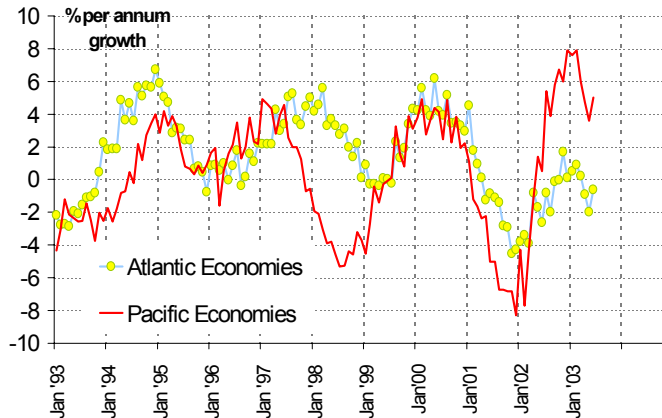


Fig 3

Looking ahead, I find it hard to believe that a boom of this strength can continue. The production and output levels being reported for China are approaching "bubble" levels and it seems unlikely that such a "dash for growth" can be sustained without some sort of correction. My guess is that this will originate in the financial sector, as did the Asia crisis in 1997 and the Russian crisis in the same year. But one can never predict the timing of these things with any accuracy. On more stable ground, Japan has had an exceptional year, and it would be unusual for such a peak to last very long. So my prediction is that we will see the industrial cycle in Asia winding down over the next year, and we will move from a period of very positive growth to one of sluggish growth, or even a major downturn, depending on what triggers the decline.

**Tanker demand**

It is always comforting to start a tanker forecast by reviewing the IEA predictions. Their latest forecast, shown in Figure 4, indicates that world oil demand will grow by about 1.1 million barrels per day in 2003, and roughly the same in 2004. Comparing these growth rates with statistics for the previous decade, also shown in the graph, indicates that this is a very positive outlook. It also provides a basis for predicting an increase in seaborne trade of a similar volume, say 1 million barrels per day. Much of this growth is coming from the United States and

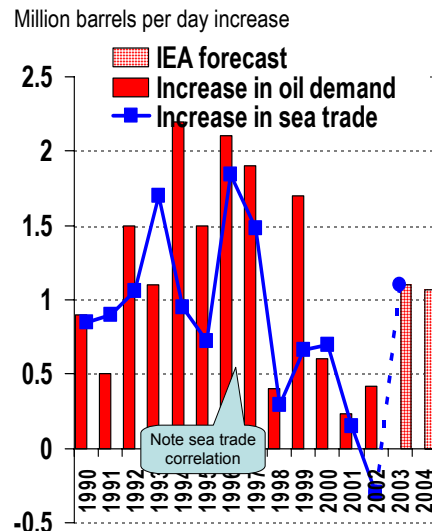


Fig 4

Asia, and I suspect the 2004 forecast will end up being revised down, possibly by as much as half. However that is far from a foregone conclusion. To put these trade forecasts in perspective, an increase in sea trade of 1 million barrels per day would create demand for about 5-14 million deadweight of tankers, depending on where the oil comes from. So that suggests a moderately positive demand outlook, but with more downside risk than upside potential.

Turning to the longer term demand outlook, my estimate, shown in Figure 5 suggests that during the next seven years the requirement for tankers will grow from a current level of around 300 million deadweight to around 340 - 370 million deadweight. This range is based on the assumption that oil demand will grow at about 1 m bpd per annum, but two different sets of assumptions about where the oil will be sourced. The Low forecast assumes robust production and export levels in oil producing areas close to the major consuming centers. In contrast the High scenario assumes that after a decade of heavy "exploitation" short haul growth stalls and most of the additional supplies are sourced from the Middle East. Whichever view you take, the demand growth is not particularly exciting. The high rate scenario suggests an annual growth rate of around 3% pa, and the lowest scenario around 2% pa. Personally I would probably back the Low scenario, but nobody really knows, which is a problem for investors.

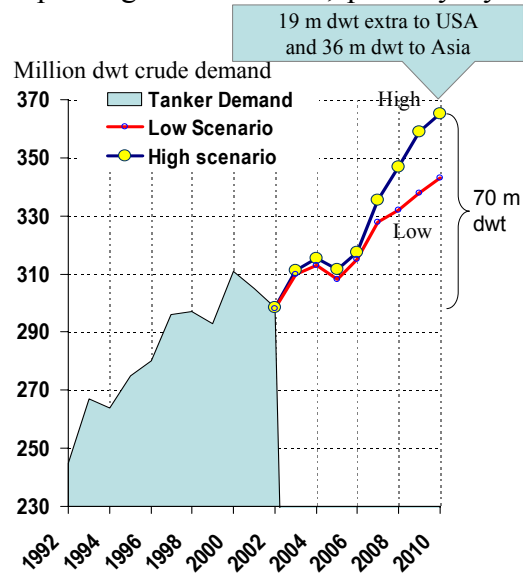


Fig 5

On the short haul front, perhaps the most promising and controversial issue is the future of oil exports by the Former Soviet Union (FSU). The FSU has had a major impact on the tanker market over the last five years. Figure 6 shows that oil exports have increased by two-and-a-half million barrels per day. Over 80% of this oil went to Europe, effectively replacing long-haul imports from the Middle East, so this has been a very negative drag on VLCC demand. It also helps explain why Aframax have done so well during this period, since this is mainly Aframax cargo.

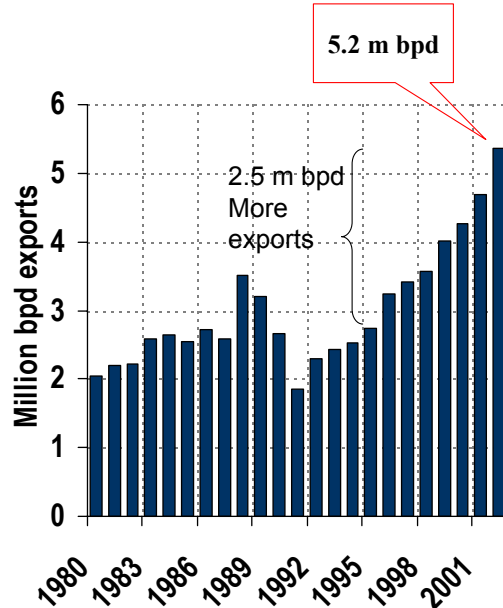


Fig 6

Looking ahead the future of short haul oil is very difficult to judge. Russian oil is located deep inland and must be shipped to market by pipeline. There are questions about the robustness of the existing pipeline system and

its ability to support significantly higher export volumes over the next two or three years, so in the short term I suspect the growth may be much slower than previously. The pact with Saudi Arabia in September 2003 involves \$25 billion inward investment, so that could help in the medium term. Plans for increasing exports from Kazakhstan are also experiencing setbacks, with the announcement in September 2003 that the start up of the big new Caspian oil field will be delayed from 2005 to 2007. This was expected to add at least 1 million barrels per day of export supplies by 2005, so that is another blow for short haul supplies. There are also doubts about whether the Bakhu to Ceyhan pipeline could be completed in 2005 as planned. Add the problems which still exist in Venezuela and Nigeria and the predictions that the North Sea output may start to decline over the next five years and the short haul scenario looks far from certain.

## Tanker supply

### Regulatory changes

Turning to the supply side of the market, the tanker industry is now moving into a phase when the phase-out of ships by the European Union (EU), and the International Maritime Organisation (IMO) will play a major part in controlling the supply of tankers. This is a complex and challenging task. As far as the IMO is concerned there are three issues on the table. *Firstly* the phase out of category 1, 2, and 3 single hull tankers; *secondly* the requirement for compliance with the Condition Assessment Scheme (CAS) in 2005; and *thirdly* the phase out all single hull Tankers from the carriage of Heavy Grade oils (800kg/cbm). This is a complex topic, which I cannot cover in the brief space allowed to me here, but I will at least makes some short comments. The EU has already enacted these regulations on a unilateral basis and in March wrote to IMO urging them to implement the same regulations internationally. This would involve changing Regulation 13G of MARPOL Annex 1.

The IMO Marine Environment Protection Committee (MEPC) met in July 2003 to discuss the changes to Regulation 13 G of MARPOL proposed by the EU. However they were unable to agree on all the issues, and the debate will continue at the MEPC meeting on 4th December 2003. As far as the Phase Out programme is concerned, the current proposal is summarized in Figure 7. Category 1 single hull tankers (i.e. those without MARPOL compliant SBT) will be phased out on their anniversary date in 2005 and Category 2 and Category 3 Tankers on their anniversary date in 2010. Tankers with "environmental friendly" features such as double bottoms and double sides are treated more leniently. There is general agreement that the phase out of Category 1 ships in 2005 is acceptable. After all the ships are mostly over

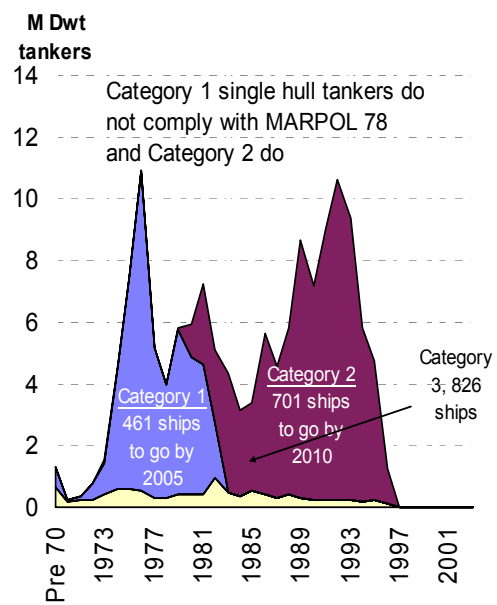
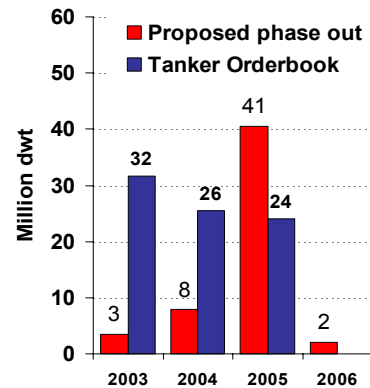


Fig 7

25 years old. However the phase-out of Category 2 and 3 ships in 2010 is much more controversial. It would phase out some ships in 2010 at only 15 or 16 years of age. So the case is being argued for measures to "soften" and phase-out for the younger of vessels in Category 1.

The proposal that all Tankers must have CAS certification in the 2005 has been greeted with concern by industry organisations who say that from a resources point of view this is impossible to implement. The CAS scheme is a lengthy, detailed and bureaucratic survey which takes anything from eight months to 12 months to complete. If this burden is placed on top of the normal survey programme carried by the classifications societies in 2005, it is argued that it would over-stretch resources. It has therefore been proposed that some effort should be made to co-ordinate CAS with the normal survey for these ships, of which there are more than 700.



Finally the proposal to ban Category 2 and Category 3 tankers from carrying heavy Grade Oil from 2005, and in tankers of 600-5000 deadweight in 2008 raises a more issue. In the bigger ships, the orderbook is more than sufficient to ensure an adequate supply of the double hull vessels to replace the single hull ships phased out, with the notable exception of Panamax Tankers. However in the smaller ship trades, so little is known about the business that until more research has been carried out this regulation is very much an "act of faith" by the regulators.

**Short term implications of IMO regulations**

In the short term, the orderbook is more than adequate to cover the phase-out of Category 1 ships by 2005 (see Figure 8). As far as the Category 2 and 3 phase-out is concerned, that is a long way ahead, and the only point I would make in this brief overview is that the market has already heavily discounted modern single hull ships in the expectation that they will be phased out early, and that in their declining years they will be cold shouldered by regulators and charterers alike. Currently the discounts are quite significant, with a 10 year old VLCC selling for \$24 million compared with \$44 million for a double hull vessel of the same age. At these prices some investors are taking a close look at the single hull market.

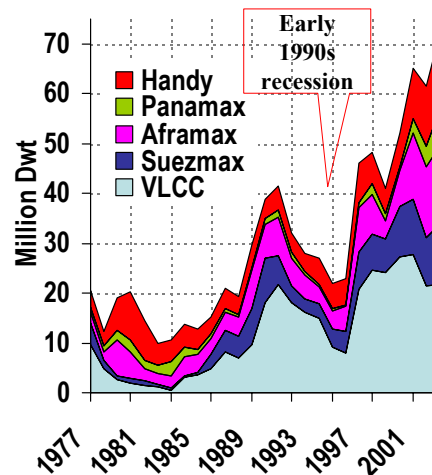


Fig 8

**The tanker orderbook**

The biggest risk facing the tanker industry today is the size of the orderbook. It has now reached 71.8 million deadweight, and in 2003 exactly twice as many tankers will be

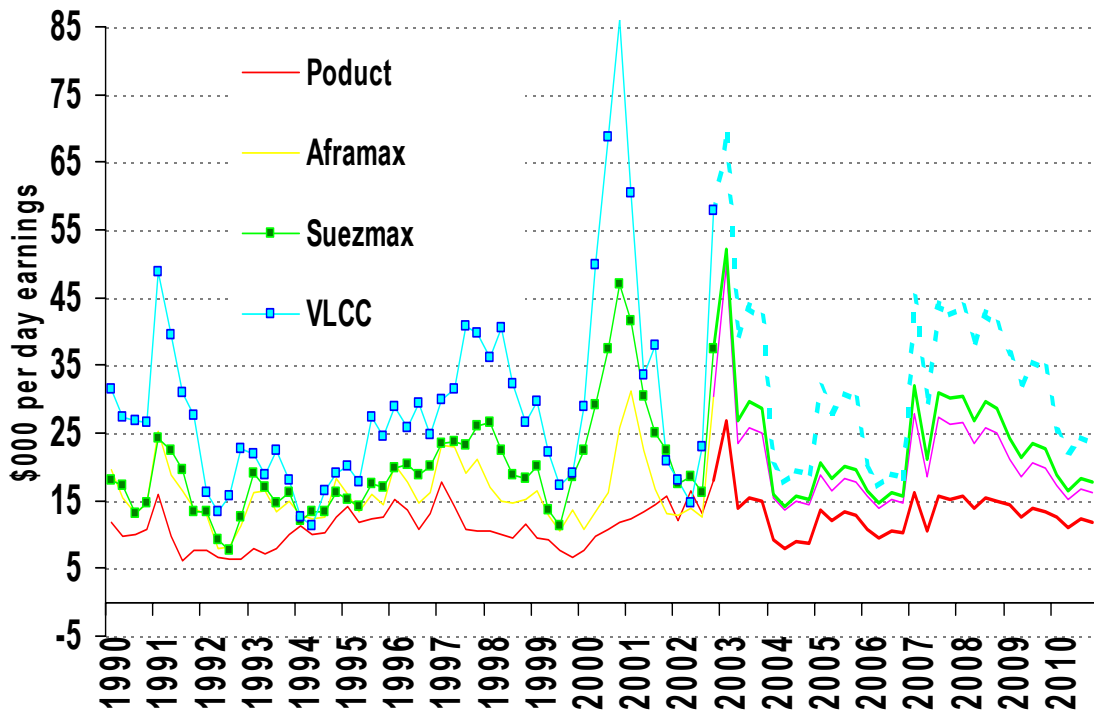
Fig 9

delivered as in 2001. So in the short term the tanker market in is very vulnerable to any weakening of Asian growth which, as I indicated earlier in this paper, is a significant possibility.

### **Scrapping Holiday in 2006/7?**

In the longer term there is another issue to consider and that is the distribution of the “demand” for new tankers. If we assume that all Category 2 & 3 tankers are scrapped by 2010 (ie the IMO regulation introduced as proposed by the EU) then the annual average requirements for new orders over the next five years is 20-25 million deadweight, depending on which demand scenario you use. This is not in itself a real cause for concern, but the timing of orders and demolition is.

After three very profitable freight rate spikes, and in a low interest rate environment, there is a real risk that the tanker industry will invest heavily in the next couple of years. Indeed I believe this is quite probable. That means heavy deliveries in 2006/7. However after the massive clear out of Category 1 tankers in 2005, there will be little to scrap in these years. Almost all ships over 23 years will have been phased out, and we know from recent experience that owners rarely scrap tankers under 25 years if they have a choice. So we may see a “scrapping holiday” for a couple of years, leaving the market with no way to respond to low rates, making it very vulnerable to over investment.



### **Freight Rates Outlook**

Which leads me to the freight forecast. In the short term, the world economy is still reasonably buoyant and the tanker market is very tight, so there is plenty of "spike potential". However over the next 12 months I would expect the balance to progressively

Fig 9

move from shortage to surplus, and by 2004 the market will be moving into recession again. There is a significant concern that with the weight of orders, plus additional ordering in the meantime, the scene could be set for a difficult spell. In the period through 2005 the Category 1 scrapping should keep the market close to balance, but my main concern is what happens when the “scrapping holiday” starts in 2006. This could help kill off the next upswing as illustrated in my forecast scenario in Figure 9.

Over the last six years the market has got used to downturns which only last six months, but the combination of fundamentals we have at present seem to me much closer to the circumstances in the early 1990s when a spell of in different rates dragged on for a depressingly long time.

So, that’s it. As Thomas Carlyle said, Economics is the miserable profession, and we like nothing better than to dish out a bit of doom. So there it is. Make the most of what’s left of the Halcyon Days!

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Thursday, September 11, 2003  
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