Kinks in the supply chain
Money, fuel and logistics – and the rising tide of IMO 2020

Container shipping special report
September 2018
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Foreword

The global container industry is huge — in excess of $4 trillion worth of goods will be shipped using containers in 2018. Almost everything we use on a daily basis is transported by containers at some point in its life.

But at the same time there seems to be a lack of transparency in all-inclusive container freight pricing, which can lead to a lack of trust in negotiations and shows a need for independent pricing.

On top of that, container market participants have massive exposure to bunker prices, which is particularly apparent given recent rises in oil prices, as well as the upcoming International Maritime Organization (IMO) regulations set to cut the global marine fuels sulfur limit to 0.5% in 2020.

Until earlier this year, many container market participants used bunker surcharge assessments published by the Transpacific Stabilization Agreement (TSA), which was a useful formula to calculate bunker charges using Platts bunker prices. After the TSA folded earlier this year we have now launched bunker charge assessments which sit alongside our all-inclusive freight-per-box assessments. These bunker charge numbers show costs per container on a dollar per FEU basis.

Our primary mission at Platts is to ensure transparency and efficiency in commodity markets, and we publish all-inclusive $/FEU freight assessments so everyone can be on the same page. There are many variables involved in calculating bunker surcharges on container routes. You have to consider bunker prices in various ports, speed and consumption of the vessel and so on and Platts assesses all these factors when consulting with the market on the most representative trades on the key routes. And our calculations are directly fed by Platts bunker prices, which will include upcoming 0.5% sulfur fuel assessments, once IMO 2020 is in force.

Industry players have an unparalleled flexibility to track their exposure to bunkers straight up in $/FEU and conclude their contracts against independent, transparent indexes.

The industry has an opportunity to use an efficient pricing tool to aid in freight contract negotiation and hedging against bunker price volatility. Given the amount of known unknowns around debt, prices and credit as we approach 2020 and beyond, it is hoped that these assessments will provide a port in the storm.

— Peter Norfolk, Editorial director, global shipping and freight, S&P Global Platts
Introduction

The container market is in a fractious mood. Crude prices rose by more than 15% in the first half of the year, driving a similar increase in fuel bills, and the suppliers and users of container shipping have fallen out in spectacular fashion over who should foot the bill.

Under normal circumstances in most markets this would be a simple dispute to resolve — transparent contractual terms agreed in advance would set out who was responsible for an unexpected jump in bunker prices. But this year’s fight has come at the end of a decade-long structural shift that has left the pricing mechanisms for container shipping in a more nebulous state.

And the market is bracing itself for an even more complicated situation in 2020. The IMO’s lower global sulfur limit for marine fuels, coming into force that year, will fragment the bunker market with a wider range of fuel options for ship operators to choose from.

In this report S&P Global Platts sets out the current state of the container market, how we got here and what might happen next.

EU liner conference ban

We can trace a large portion of the current muddle in the container market back to a decision by the European Union a decade ago. In October 2008 a European Commission ban on liner shipping conferences came into effect, preventing container liners on routes to and from the EU from acting collectively to set prices and regulate capacity.

Routes elsewhere in the world were unaffected at first, but the removal of the European-related conferences left the remainder much less influential in the global price formation process. The rest of the conferences have steadily been phased out in the ensuing decade, with the last major one — the Transpacific Stabilization Agreement — finally ceasing operations in February this year.

The old system was archaic, opaque and vulnerable to uncompetitive behavior by the shipowners. But it was also unarguable — no one was in any doubt over where the responsibility for changes in bunker prices lay. What has emerged since then is more haphazard.

Container contracts are typically arranged on an annual basis. Bunker costs are charged to the customer using the bunker adjustment factor (BAF), a floating part of the freight charge that is adjusted according to the movements of bunker price indexes like those assessed by Platts and its competitors.

Under the conference system, BAF rates were set by the liners collectively, with no room for argument from the shippers. Since the collapse of those structures, each shipping company now sets its own rates.

In theory, the BAF system should itself account for any moves in the bunker price, with the BAF rate being raised or lowered in tandem with fuel price assessments and the resulting cost being passed on to the shipper. But changes in the structure of how the rates are calculated have complicated matters in recent years.

Change in BAF charge timing

The 2014 crude price collapse delivered a sharp drop in fuel costs for the shipping industry. Brent prices halved over the year as OPEC failed to reach agreement on production curbs in the face of weak demand and rising US supply, and the high sulfur 380 CST bunker price at Rotterdam dropped by 52%.

Up to that point the liners had mostly been arranging their BAF rates on a monthly basis, taking the average bunker price for the preceding month and using it to calculate the rate for the next month. But that year several firms started to shift their customers onto a regime of calculating the rates quarterly — a more advantageous system for the shipping company at a time of rapidly declining prices, as it allows the previous higher BAF rates to be charged for longer.

Fast-forward to this year, and the quarterly calculation is no longer looking so favorable to the liners. Sinking Venezuelan crude output and looming sanctions on Iranian exports have sent Brent prices back to around $75/b, and Rotterdam bunker prices have jumped by almost 50% since the end of 2017.

With BAFs being calculated on a quarterly basis the liners are forced to charge the old lower rates for longer, putting more pressure on their profit margins. Maersk’s profit in its ocean segment sank by 15.1% on the year in the first half of 2018 despite rising revenues, as its bunker costs jumped by 53.6%.

Platts spot container pricing for this year puts the problem for the liners in sharp focus. The box rate from north Asia to the north of Europe was at $1,450/FEU by the end of
July, $50/FEU lower than where it started the year. But the bunker charge for the same route — a bunker fuel cost metric for the container market priced in dollars per FEU, calculated from Platts marine fuel assessments — jumped by 18.6% over the same period, from $251.89/FEU at the start of the year to $298.70/FEU by the end of July.

It’s this failure by the liners to fully account for bunker cost rises in the box rates they charge shippers that has caused this year’s disputes.

**Emergency bunker surcharges**

But the liners had another tool at hand to recoup their costs: the emergency bunker surcharge. In late May CMA CGM, ZIM, the Mediterranean Shipping Company (MSC), Hapag-Lloyd and Maersk all announced to their customers that they would be imposing emergency surcharges, citing the rapid climb in bunker costs in the previous months.

CMA CGM announced a $55/TEU surcharge for dry cargo, ZIM introduced surcharges ranging from $18-65/TEU and Maersk announced a $120/FEU surcharge for dry containers and $180/FEU for refrigerated cargo.

“The situation is no longer sustainable without emergency action,” MSC said in a notice to customers announcing its emergency surcharge May 21. “This last-resort measure is essential to ensure that we navigate these challenging economic conditions in a steady and sustainable way.”

Maersk said it would double its surcharge if the high sulfur 380 CST fuel oil price at Rotterdam rises above $530/mt, but would reduce it to zero if the price dropped below $370/mt.

“The emergency bunker surcharge is a necessary action to ensure a continued sustainable service to our customers, and will only cover the extra costs,” Lars Oestergaard Nielsen, president of Maersk Line in Latin America and the Caribbean, told Platts in June. “We are following the market trends closely, and will adjust the tariffs as soon as the fuel price drops below the beginning level of the year.”

**Backlash from shippers**

The liners’ customers have baulked at the decision.

“The use of emergency surcharges is a none-too-subtle attempt to impose non-negotiable charges on customers,” Chris Welsh, secretary general of the Global Shippers’ Forum, said in May. “It is incumbent on container carriers to provide their customers with full transparency regarding bunker surcharge costs, and to explain why an emergency surcharge is warranted on top of existing bunker surcharge mechanisms.”

Some have pointed out they have signed contracts relatively recently with the liners, and resent the rise in bunker prices being treated as unforeseeable.

“I have sympathy for the carriers’ challenges, but refer to the agreements we and many other beneficial cargo owners have only very recently entered into, both parties with eyes wide open,” Bjorg Vang Jensen, vice president for global logistics at home appliance manufacturers Electrolux, said.

“These agreements include specific clauses around bunker prices, and we expect that the carriers will respect those.”

“There is a risk attached to doing business, which we accept, and which we expect that our suppliers accept too,” he added.

But on a technical level the liners do have the law on their side. The BAF section of a container contract typically contains language leaving room for an emergency change to the BAF charge in the event of a rapid change in the bunker price.

Here is the wording from one example sent to Platts by a liner:

“If during the first quarter of the contract period, the average bunker price fluctuates by 10% or more, we reserve the right to review the BAF portion and amend the freight rate in accordance with our BAF formula.”

That appears to leave little room for maneuver for the liners’ customers when they complain. And it’s telling that shippers...
have thus far not launched mass lawsuits against the liners this year in response to the surcharges; the legality of the situation does not seem to be in serious dispute.

What’s under debate is more the attitude taken by the liners, and the risk that surcharges imposed on an apparently largely arbitrary basis will make an already complex market even less transparent.

“It is likely such an approach will be seen very negatively by the shippers, serving not only to undermine necessary efforts to get compensated for fuel increases, but also make it even more difficult for the carriers to implement cost-based surcharges in the future,” consultant Lars Jensen wrote in May.

“It is very clear that carriers need to be able to adjust their prices to reflect changes in fuel prices,” he added. “What is needed is a re-introduction of a truly enforceable bunker surcharge mechanism which fairly represents fuel price change outside the control of the carriers, but with these ‘emergency’ actions we seem to be headed more in the direction of illogical short-term fixes and away from a more sustainable long-term solution.”

The market is largely clear that the container liners need to be able to pass on the cost to their customers when bunker prices rise sharply, as they have done this year. But the shippers need the process to be as transparent and predictable as possible, and the suspicion is widespread that this year’s emergency bunker surcharges have been an attempt to recover money lost elsewhere as overcapacity continues to plague the market.

Debate on this issue continues, and for now seems relatively even-sided between the shippers and the liners. In a poll of Platts Bunkerworld readers in June, 55% said the container lines were justified in their use of emergency bunker surcharges this year — and 45% voted the opposite.

Complications from IMO 2020
And after this year’s fights, the market is now anticipating further complications just over a year from now as the IMO’s global marine fuels sulfur limit drops from 3.5% to 0.5% at the start of 2020. The shipping industry will mostly no longer be able to rely on the cheap high sulfur fuel oil that has been its staple for the past century.

There is no single universal means for shipowners and operators to comply with the new rules. A wide range of options are on the table: marine gasoil, one of several planned new 0.5% sulfur fuel blends, alternative fuels like LNG and methanol, and the installation of scrubber systems to clean the emissions on board and continue using fuel oil.

Some may also opt to ignore the new rules altogether in some parts of the world in the hope of not being caught.

The advantages and disadvantages of each option are widely documented in Platts coverage and elsewhere. The most important consequence of this regulatory change for the container market is that bunker demand will be fragmented across the various options.

In contractual discussions, shippers and their customers will no longer just factor in the high sulfur 380 CST fuel oil price as their bunker cost. In discussions for 2020 and beyond, both sides of the deal will need to consider which of a wide range of fuels their ship may be burning.

Maersk has so far said it will not use scrubbers, and intends mostly to rely on the new 0.5% sulfur fuel blends and marine gasoil. CMA CGM made a high-profile announcement last year that it was ordering nine LNG fueled vessels, but has released little detail about its plans for the rest of its fleet.

MSC has retrofitted part of its fleet with scrubbers.

But none of these options will necessarily apply all the time. A vessel with a scrubber equipped may still be forced to burn a 0.5% sulfur blend, if calling at a port where high-sulfur fuel oil supply is more limited after 2020.

Similarly, ships usually buying 0.5% sulfur blends may be forced to bunker gasoil or another product on occasion; their preferred blend may not be universally available, and the ones on offer may sometimes be incompatible with what they have in their fuel tanks.

What’s clear is that a one-size-fits-all BAF charge — already something of an anachronism — will become completely divorced from the reality of the bunker market in 2020 and beyond. The costs of all the various fuel options will not move in tandem, as supply and demand disparities in the immediate term after 2020 are likely to leave prices highly volatile in relation to one another.

Under these circumstances, the uncertainty around how the supply chain pays for fluctuations in fuel costs will become more intense, and arguments more frequent. The stressed market in 2020 is likely to bring casualties, and a container industry already struggling with overcapacity will be sorely tempted to turn again to the murky system of emergency surcharges to extract more money from its customers.

Until the container industry settles on a more transparent mechanism for how it charges for its services, and how bunker price rises are accounted for, the controversy over who foots the bill can only become more rancorous.

S&P Global Ratings container industry outlook

S&P Global Ratings believes that the overall supply and demand conditions have shifted in favor of container liners, with trade volume growth likely outpacing containership fleet growth in 2018 and 2019, but we remain cautious on the freight rates’ outlook. Average freight rates on major trade lanes recovered to more sustainable levels for ocean carriers last year, thanks to decent trade volumes, supply-side measures (such as vessel scrapping and lay-up), and streamlining of networks after yet another wave of industry consolidation. However, significant deliveries of ultra-large containerships schedule in 2018 and beyond (these were ordered a few years ago by shipowners looking for economies of scale to be reaped from utilizing such ships) are putting (and will continue to put) pressure on freight rates, in particular on the main Asia—Europe and Asia—US lanes (a home for mega-containerships), despite the likely favorable supply-and-demand industry balance in general. According to Clarkson Research, the current order book for post-Panamax containerships—which have a capacity of more than 15,000 twenty-foot equivalent unit and which will be delivered within the next two to three years—account for a significant 60% of the global post-Panamax fleet.

While our base case assumes no major glitches on the demand side, underpinned by our firm 2018-19 GDP growth forecast for all major contributors to global trade volumes, especially China, but also the eurozone and the US, we bear in mind the persistent supply burden and freight rates that will ultimately depend upon how prudent the leading container liners are in their capacity management decisions. Taking into account historically poor supply discipline, we see a risk that ship lay-ups and loop withdrawals will be insufficient and new ship orders will accelerate. We are alerted to this year’s orders of 20 mega box ships by industry leaders MSC and CMA CGM. And, given the container liners’ traditional battle for market shares, new orders from other players may follow. In addition, the demolition of older tonnage remains a critical supply-side measure to help correct excess capacity and stabilize rates at commercially viable levels. However, we are mindful that the pace of scrapping has slowed in recent quarters.

During the next 12-18 months — after the most recent acquisitions have been integrated, shipping networks and customer platforms aligned, and cost synergies realized — we expect to see whether consolidation in the container shipping industry, with capacity management decisions now in hands of fewer players, translates into more sustained profits. In particular, we will monitor how successful the container liners are in passing through the bunker fuel price increases to customers via higher freight rates. If the recovery of cost inflation works, this could be a sign of stronger pricing power of liners, which we would normally expect in a more concentrated industry.

The liner industry has been through a few rounds of consolidation over the past several years, as an answer to erratic rate movements and recurring operating losses, including the most recent acquisitions of Hamburg Süd by Maersk Line, United Arab Shipping Company by Hapag-Lloyd, and Neptune Orient Lines by CMA CGM. The consolidation led to a structural change of container liners’ competitive landscape so that the share of the top five players escalated to around 65% this year from 30% around 15 years ago. About half of the top 20 players were either absorbed by mergers or defaulted (Hanjin Shipping), and the gap between the larger and smaller players, as measured by their total carrying capacity, has markedly widened. What’s more, it appears that size in this industry matters, as reflected in the above-industry average EBIT margins reported by the largest liners, such as Maersk Line and CMA CGM, over recent quarters.

A more concentrated industry is normally more rational and efficient, but a risk of destabilization remains, with a background of historically aggressive capacity management by the largest players. Our base case assumes that, notwithstanding the consolidation efforts, the container liner industry will remain volatile because of its asset-intensive, operating leverage-heavy, and network-based nature. But cyclical swings could be less pronounced and of shorter duration, and mid-cycle freight rates could trend above the operating cost breakeven.

— Izabela Listowska, Director—Ratings Analytical in Corporate Ratings

Special report: Container shipping  |  Kinks in the supply chain: Money, fuel and logistics – and the rising tide of IMO 2020
Marine credit analysis

CREDIT NEEDS TO COME OUT OF SHIPPERS’ BLIND SPOT

Credit has become the taboo topic of the bunker industry since the announcement by the International Maritime Organization that a 0.5% global marine sulfur cap will be introduced from January 1, 2020.

After running on easy credit from the banks, as purchases are typically paid for several weeks after delivery, credit lines will need to be increased significantly once the majority of shipowners have to stump up extra cash for pricier, cleaner fuels. But that could test this relationship-driven bunker business to the limit as financing options dwindle. Bunker buying is typically conducted on an open credit basis, and buyers with limited credit lines will struggle to open letters of credit and will need a trading house with risk appetite to shoulder the financial risk. This will be a real push for smaller outfits which could be squeezed out of the market and may see the industry undergo a wave of consolidations.

The financial struggle of international physical supplier Aegean Marine Petroleum provides a timely reminder of what may come. Aegean, one of the world’s largest bunker suppliers, said it may have to write off $200 million of accounts receivable earlier this year and was downgraded by Platts marine division Ocean Intelligence as a result. What followed was a $1 billion financing agreement with energy trading group Mercuria which gave the trader a large stake in its future and is seen as an opportunity for the New-York listed company to revitalize its fortunes. Ultimately we could see a stronger industry with a more stable cash flow upon the implementation of the sulfur cap as the increased costs create its own set of winners and losers amid the increased consolidation and reduced competition in the industry.

Take for instance a voyage for an 18,000 TEU vessel from North Asia to the UK at 17 knots, which would consume roughly 124 mt/day of bunker fuel, at a bunker cost of around $400/FEU. With fuel costs set to soar in 2020, Platts Analytics estimates a spread between 0.5% and 3.5% bunker fuel of $425.00/mt and marine gasoil will likely be around $450/mt above high sulfur fuel oil initially in 2020, before easing over time. That will double the price of fuel and thus the number of existing bunker players are expected to thin as operating costs skyrocket.

Ocean Intelligence’s Jason Silber says that these higher costs will wreak some havoc as the price of bunkers accounts for around 60–70% of operating expenses and raises the question as to where the extra financing will come from. Certainly some of the bigger operators in the industry are playing down the issue and it would appear that it’s the smaller operators that may suffer the most, even if some will have greater flexibility and others may benefit where they dominate supply in small ports.

Bunker buyers are typically offered credit lines up to a certain limit and sellers are unlikely to increase these limits purely because fuel prices have increased. Nonetheless this year some bunker suppliers have been jolted by the high freight rates and the Aegean scare and have reduced credit lines to between 14 and 21 days to minimize risk. These events could well be a harbinger of what is in store after the 2020 fallout.

SHIPOWNERS MAROONED BY RISING BUNKER PRICES

Tanker owners have experienced similar problems to the container liners with this year’s jump in bunker costs.

The owners have struggled for much of 2018 as rising bunker fuel prices squeeze daily earnings, with shipowners often barely covering operating expenses on a number of key routes. And there appears little let-up on the horizon.

Bunker fuel prices have soared in 2018 as the 1.8 million b/d production cuts from OPEC, Russia and its allies to rebalance the market pushed up the price of crude oil, which translated into higher fuel prices.

Economies of scale are now the priority as bunker buyers find alternative means to reach the most economic port, by slow steaming for instance, in order to minimize bunker costs at a time when earnings per day are slack.

The message seems to be that shipowners are just buying enough to safely reach the next port.

Worldscale flat rates for 2018 voyages, which came into effect on January 1, showed an average increase of around 15% from 2017. The rates were calculated using average fuel prices from October 1, 2016 to September 30, 2017, when prices for IFO 380 CST as well as low sulfur fuel rose considerably.

However, while flat rates rose, Worldscale multipliers dropped across the board for all crude vessel classes to reflect the higher flat rates on offer, with most vessel classes oversupplied with tonnage.

No subsequent bunker price increases which occurred after September 2017 were incorporated into 2018 Worldscale flat rates.

Shipowners have had to swallow the higher bunker costs with flat rates failing to capture the increase and the weak market meaning they are unable to pass on the costs to charterers.
Other sectors have coped better with higher bunker costs, with VLCCs benefitting from stronger demand in the Persian Gulf. Even so, real earnings may be a lot lower as most, if not all, ships will have a mortgage against them which has to be serviced along with other costs such as insurance, so it remains a challenging operating environment.

The VLCC orderbook-to-fleet ratio is rising, up one third from last year — from 90 to 120 vessels, approaching 17% of the total fleet. If the orderbook-to-fleet ratio hits 25% then destruction looms — similar to the 10 bad years that the dry-bulk Capesize market found itself in due to overbuilding, according to another shipowner.

While bunker prices have been on an upward trajectory for much of the year, clean product tanker rates have stagnated. “The natural thing here would be for [multiplier] rates to compensate for how low the flats are but this is not the case. So naturally shipowners are struggling and will not be able to sustain this situation for much longer,” one shipowner said.

As IMO 2020 approaches shipowners in oversupplied tonnage markets are looking forward to the prospect of increased scrapping rates, in order to remove the least efficient vessels from the fleet. This will reduce the fleet and decrease the competition for cargoes, whereas competition among a large fleet for few cargoes has been a prevalent feature of the last 12 months.

— Peter Farrell, Editor Freight Markets and Eleni Pittalis, Associate Editor, EMEA Fuel Oil

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