Shock-proofing

Lesley Bankes-Hughes takes a look at Enerjen's IMO 2020 green fuel note, which allows shipowners to hedge against an anticipated steep spike in diesel prices, and talks to its founders about their innovative approach to helping the industry transition to a cleaner future

There's no smoke without fire, so the saying goes, and the impending introduction of the 0.50% global sulphur regulation is certainly testimony to the veracity of this phrase. 'Smoke' there is in abundance at present, substantially generated by the multiple commentaries, reports and industry events which are lobbing questions over every aspect of IMO 2020: will there be enough compliant fuel and where will it be available?; how are refineries going to respond to an anticipated huge spike in shipping's demand for diesel product?; are scrubbers going to be a long-term compliance solution, will heavy fuel oil still be available and is there any yard capacity left for scrubber installation before the 2020 tipping point?; are shipping companies on track with their compliance strategies or woefully underprepared?. The list goes on.

Beyond the 'smokescreen' of opinion and conjecture is the 'fire', which is the commercial nub of the issue for shipowners and all stakeholders in the marine fuel supply chain: by how much will vessel fuel bills escalate and what will be the price differential between high sulphur and low sulphur product during the transition to 2020 and in the months beyond? Set these concerns alongside the 'usual' pattern of volatility in crude oil prices, and shipping is certainly heading on a difficult and, unquestionably, expensive course over the coming months.

Without doubt 2020 is going to be a disruptor of a magnitude not seen in the maritime sector for many years, and any option that could serve to mitigate the impact of a bruising upswing in bunker prices must surely be worthy of consideration? The founders of Enerjen Capital are certainly hoping that this is the case as they launch the IMO 2020 Note, a long-only hedging vehicle that gives shipowners the possibility to hedge against an expected mega-spike in diesel prices caused by IMO 2020.

Jake Greenberg – CCO, Enerjen Capital

Jake Greenberg, Partner and CCO of Enerjen Capital, sums up how the company's founders looked at the task in hand, seeing it as not only a commercial opportunity for them but a way in which the shipping industry could protect itself against what has the potential to be a financially cataclysmic transition to 2020.

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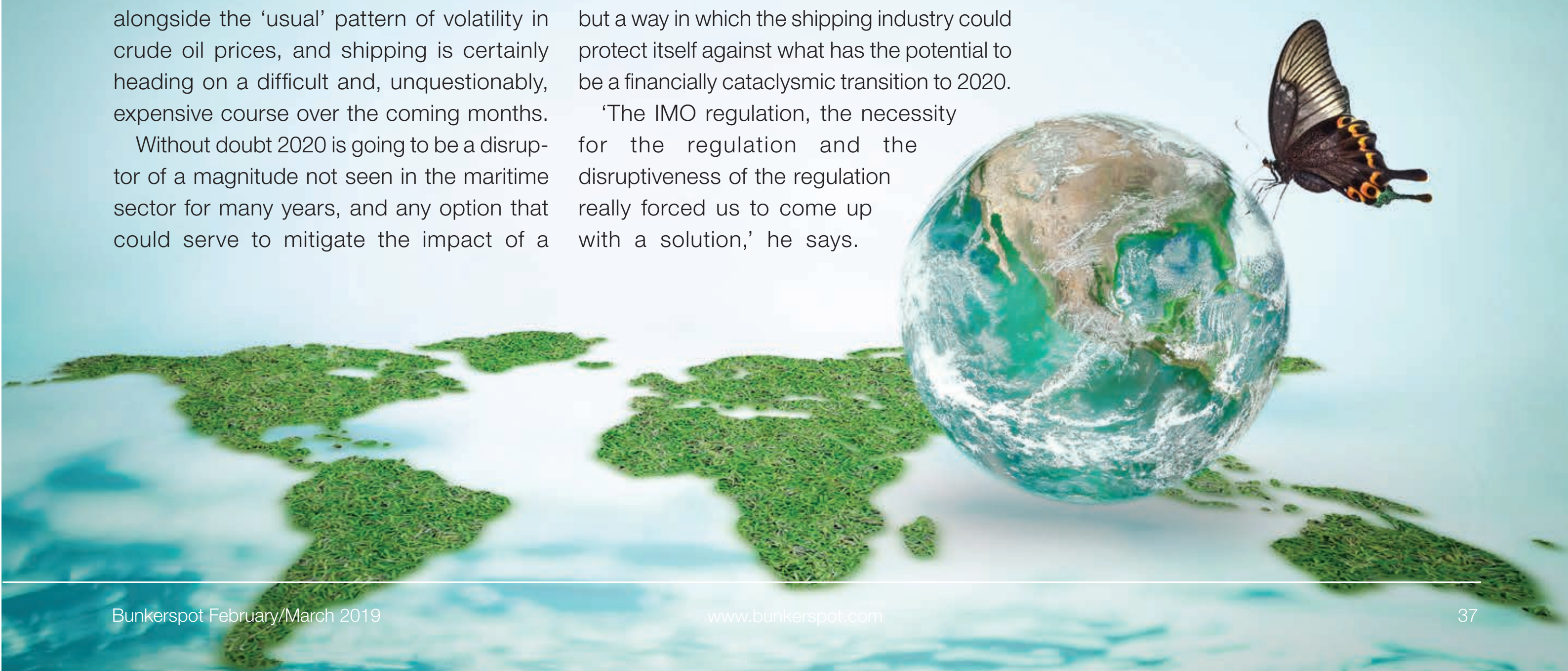
And, perhaps just as importantly, in the context of the financial blow about to be delivered to shipping, one of Enerjen's other co-founders, CIO Gus Majed, believes that there is currently 'a mispricing of risk' in relation to IMO 2020.

It should also be highlighted that underpinning the company's focus on developing an IMO 2020 hedging solution is the conviction that the maritime sector must make the transition to cleaner fuels. As CEO Stephen Schueler explains: 'A lot of the time people



don't talk about the "green" element, and how critical it is for the industry – but for 51,000 vessels to change from 3.50% to 0.50% sulphur fuel *is* good for the sector.'

The three founders of Enerjen Capital have gold-plated credentials in terms of their ability to provide innovative hedging and financial engineering solutions and expert insight to shipowners, with their collective C-level experience covering all aspects of the shipping, oil and financial markets.

After senior roles at Procter & Gamble and Microsoft, Schueler moved to Maersk where he was chief commercial officer and also CEO of the Safmarine Shipping Line. Jake Greenberg had a 10-year stint in investment banking, beginning with merger arbitrage at Lehman Bros and most recently as the global head of natural resources at Bank of America Merrill Lynch. The final member of the trio, Gus Majed, was a frontline oil trader for 24 years, starting out on the risk management desk at Shell Trading & Shipping, and eventually moving to Vitol and Hess Energy. He also co-founded Vitol's derivative business along with the global commodity trader's present CEO, Russell Hardy.

Networking and industry connections brought the three together. Schueler and Greenberg met at a lunch organised by Bank of America Merrill Lynch which focussed on IMO 2020 issues.

'Stephen explained that IMO was a once in a generation transformational moment, both from an environmental perspective but also what it would mean for the global supply chain, and he invited me to explore doing something around this theme,' Greenberg recalls. 'I was convinced – he sold me!'

Greenberg, in turn, had links with the legendary oil trader, Andy Hall, who had also been tracking IMO 2020 developments. Keen to explore opportunities but not in a position to take a front-line role in Enerjen, Hall recommended the fuel hedging expert, Gus Majed.

Hall is, however, onboard with the venture as a member of the company's advisory team, along with a raft of other risk management experts and, bringing his in-depth knowledge of the bunker industry to the table, Robin Meech, MD of Marine and Energy Consulting.

With a formidable collective skillset, the Enerjen team drew on their respective market expertise to determine what exactly the shipping industry might need in terms of an effective and straightforward risk management instrument to address what is likely to be a 'cliff-face' hike in diesel prices.

As Majed explains: 'It became quite evident to me that IMO 2020 is a disruptive event; I advise a lot of airlines and other consumers and the one thing they didn't have was access to world-class hedging – and they also tend to be price takers from banks and they will sit with huge hedges, not knowing what to do with them or whether they are the right instruments.'

The upshot of the team's discussions was that 'we formulated Enerjen Capital, which essentially partners with these consumers; we become their in-house advisory hedging and execution business.'

Gus Majed – CIO, Enerjen Capital

– a fuel bill that could be going up by hundreds of millions of dollars next year.'

Maersk's own predictions of how much its fuel spend might rise because of 2020 prove the case perfectly. In its Q3 2018 financial report, the shipping giant suggested that its current annual bunker fuel spend of $4.5 billion could surge by an additional $2 billion in 2020.

Armed with the full picture about a client's own fleet and operating profile, as well as oil production/refining information, Enerjen can structure a tailored and optimal hedging programme. The company essentially acts as a bespoke but outsourced hedging desk, offering advice to shipping companies and airlines who may have previously been relying on banks to provide them with a fixed price hedge, which may not always have been very successful.

In terms of preparing compliance strategies for IMO 2020, shipowners have faced sharp criticism for appearing to drag their heels over putting plans in place, and Enerjen's founders agree that many owners have been slow to act.

Stephen Schueler neatly sums up the shipowner 'mindset'. 'I am a great believer in the four quadrant model: denial, anger, acceptance, commit!'

'Initially believing that IMO 2020 is going to result in a huge diesel spike and that the high sulphur market is going to be over-supplied, a lot of the market rushed in to buy the diesel-high sulphur spread, but actually we have had a huge mash out over the last six months'

Jake Greenberg outlines Enerjen's approach to working out a hedging strategy for clients through a forensic real time information gathering exercise on the oil market – the company has access to satellite data monitoring on oil flows/output which, combined with AI and machine learning technologies, provides a 'cutting edge' picture of what it is happening in terms of global crude production.

'We are helping our shipping industry clients to arrive at conclusions on how much their fuel bills could go up next year,' says Greenberg. 'Based on that you can have a commercial discussion around their business, and this is where Steve can help them, with his experience at Maersk, to think about how they can pass on some of their costs to customers in 2020.

'Then we are left with a number, and sometimes that number is quite big

He suggests that the shipping industry has been in denial about IMO 2020 for a very long time, but he believes that the IMO's meeting last October was pivotal in moving the debate forwards on the upcoming regulation. First, the meeting reconfirmed once and for all that that the implementation date was set in stone, and second, it approved the introduction of the fuel oil carriage ban in March 2020. As Schueler points out, 'The ban changed our estimates on likely cheating from 30% to 15%, because no legitimate bunker company is going to cheat and lie on a fuel manifest and put the wrong fuel on a vessel.'

Another key decision to come out of the IMO meeting was that Member States are going to be able to impose penalties on those owners and operators who flout the regulation, and also collect and keep the fines.

Looking at the compliance options available to owners, Schueler does not see any large-scale demand for marine LNG in the near term, although he does think that LNG will be the fuel of choice for many vessels in the future.

He also suggests the window of opportunity has come and gone for exhaust gas cleaning technology in terms of installations ahead of 1 January 2020 – and for some shipping firms the cost of scrubbers will be prohibitive.

'If you are a shipping company with 59 vessels, it is going to cost you on average $3 million, based on the size of your vessel, to put on a scrubber.

'If you are a real shipping firm, then you are going to be barely profitable right now, so opting for scrubbers could potentially make or break companies.'

Enerjen estimates that around 4,000 vessels will be equipped with scrubbers by 2020 and, says Schueler, 'Right now we think that the global capacity is that 1,800 vessels can be done a year; if you look at 51,000 commercially registered vessels, that is a small number.'

The other compliance option open to the shipping industry is, of course, low sulphur fuel, and Enerjen is firmly of the opinion that demand for low sulphur product will put the price of diesel under heavy pressure.

Gus Majed offers some very interesting insights on near and longer-term crude oil and refining trends, and suggests that shipping may not actually be looking at the bigger picture as it tries to assess where fuel prices – high and low sulphur – are now and where they may be heading in the run-up to 2020 and beyond.

The new sulphur regulation will require a switch of 3.8 million barrels a day of high sulphur fuel oil to compliant low sulphur bunkers. Aside from the issue of scrubber uptake, Majed highlights that 'how much of [demand] is going to switch to low sulphur fuel oil and how much will move into marine gasoil depends on the blending margins, the availability of 0.10% sulphur fuel, and, particularly, the availability of low sulphur crude oil.'

Around 17% of the world's crude oil is ultra low sulphur which can be used to produce low sulphur fuel oil, but in terms of looking at global refining capacity the key issue in relation to 2020 is how much high Nelson Index upgrading capacity will be coming on stream that can process very heavy sour crude into low sulphur distillate.

Majed also points out that the market's expectation that high sulphur fuel prices are heading for an imminent fall might be wide of the mark.

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Stephen Schueler – CEO, Enerjen Capital

> 'What we do is sit down with companies as partners, recommending the right hedges, and the price of the hedges is where the market is trading at – with no margin. That's the way it has to be done, and it's a totally different and innovative way to do it'

the high sulphur market is going to be over-supplied, a lot of the market rushed in to buy the diesel-high sulphur spread, but actually we have had a huge mash out over the last six months,' he says.

'So if you look at the economics of fitting scrubbers, it is becoming manifestly worse – and it will actually get a lot worse before it gets better – because fundamentally the high sulphur market is quite strong.

'But then it really does fall off a cliff next year.'

Notwithstanding the misperception amongst some in the oil trading sector that IMO 2020 wouldn't go-ahead on 1 January 2020 or at least might be stalled, perhaps through a President Trump 'intervention', Majed points to some warning signs over low sulphur fuel avails in 2020. Output of this product from China's complex refineries has only been expected to come in late 2020 and now some of this low sulphur stream has been delayed. There are also concerns over low sulphur crude oil avails given the political instability in two of its major sources – Nigeria and Libya – and the current financial state of affairs for producers in the other major supplier, the United States.

As Majed flags up, 'If the oil price is going to be maintained at $60-$64 a barrel, then all you have to do is to look at last quarter earnings to see that a lot of these shale producers are actually not profitable.

'So you can put yourself in a false state of security by thinking that oil prices are actually $20-$30 down, when actually there is an underlying beast in the market, just waiting.'

And this brings the discussion round to the issue of pricing risk, and how Enerjen can assist shipowners in the assessment and mitigation of such exposure. Majed sets the scene by looking at the business structures of transportation companies, such as shipping or aviation operations. He points out that many of these companies can be seen as having two businesses.

'They have a specialist business, which is what they do – such as shipping – and where they are experts and which makes 10%-30% a year, but leveraging that balance sheet they may actually have a short oil hedge fund business because they are such heavy consumers of this product.'

He suggests that a low or flat price environment masks these companies' underlying risks. Added to this, they have also been major off takers of an oil by-product for many years, but now they are going to have to take their fuel from the middle of the barrel – a highly competitive segment with already strong and entrenched demand from the airlines and mining companies.

With a price differential between high and low sulphur bunker fuel already at $200-$300, Majed also points out that a move in the price of crude back up to $80-$90 a barrel could potentially translate into a $500 a tonne price move from what bunker buyers are paying at the moment.

He points to the perfect storm currently building in the distillate market, with a slight slowdown in China's refinery capacity, the rise of shale and the resulting decimation of the gasoline and naphtha markets, and currently 'appalling' refining margins.

'We have got a situation where we are not building enough distillate for 2020 and refinery runs are actually being throttled back,' he cautions.

Given this rather doomsday prediction,

he believes that shipowners will begin to acknowledge the imperative of looking at innovative solutions in terms of hedging and locking in their operating margins.

Enerjen will use hedging proceeds from partners to purchase a hedge basket through out 2019, so that the hedge is fully placed by the end of Q3 2019, which is when shipping companies will need to buy marine diesel oil to ensure compliance across their fleet by 1 January 2020. This fixed term hedging instrument will only be in place throughout 2020, with the initial principle and profit to be distributed to participants at the end of Q1 2021.

Jake Greenberg explains the rationale behind the structure: 'We tried to put together a hedging vehicle where shipping companies would no longer be subject to margin calls, and it is also possible to put the hedges in place without shipping companies having to sign an ISDA agreement, which is very onerous.'

Furthermore, shipping companies will also be able to access this hedging facility regardless of their credit ratings.

Greenberg emphasises that: 'The key message that we have for the shipping world is that we are offering something that has never been offered before, which is really an outsourced hedging desk…which offers world-class expertise in understanding the oil market and how the execution works.'

Majed takes up this thread: 'What we do is sit down with companies as partners, recommending the right hedges, and the price of the hedges is where the market is trading at – with no margin.

'That's the way it has to be done, and it's a totally different and innovative way to do it.

Participation in this hedging programme will close at the end of February, to give sufficient time for the Enerjen team to execute and layer the hedges in a systematic way from the end of March to the end of Q3 this year.

Greenberg describes market reaction to the Note as 'overwhelming'.

'We have seen big companies coming directly to our website, and some of these are highly sophisticated commodities trading companies and oil producers; it has been very surprising that some of these really very sophisticated groups don't yet know what they are going to do [about IMO 2020) and we are only months away from the deadline.'

Enerjen's founders see the IMO 2020 Note as just the first foray into the green energy space. The ICAO is introducing a sustainable aviation fuels regulation next year, and the company is considering whether a hedging solution could be structured for this.

'We are also really excited about the transition to LNG,' says Greenberg. 'How do we help companies who want to buy LNG-powered vessels be able to hedge their risk around LNG pricing? It's a necessary transition, and really there is no market yet in these types of products in LNG.

The company is also mulling the options for setting up hedging exchange-traded funds (ETFs) and hedging products around carbon credits, as well as growing its position as an outsourced hedging advisory and executive desk for large transportation companies or any industrial users of diesel fuel or other energy sources.

However, drawing the focus back to IMO 2020, Stephen Scheuler is keen to reiterate where Enerjen 'sits' in the world of commercial shipping. 'We have always been on the same side as the shipowner,' he says, 'providing a service and really helping the industry to navigate the challenges to a greener future.'

- For more information go to: **www.enerjencapital.com**

Lesley Bankes-Hughes
Publishing Director/Editor

Tel: +44 1295 814 455
Email: lesley@petrospot.com