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Arcane Pollution Rule May Cost Saudis and Neighbors Billions

UN's call for low-sulfur fuel could dent sour-crude demand

Saudis to Iraq seen earning $1 to $5 less per barrel of oil

The world's biggest oil-exporting region may lose billions of dollars in annual revenue when an obscure United Nations requirement for ships to burn cleaner fuel takes effect next year.
Saudi Arabia, Iraq and other Middle Eastern suppliers of heavy, high-sulfur crude could take a hit as refiners favor lighter, low-sulfur grades that they can process more easily into less-polluting fuels. The UN maritime agency's new rule kicks in on Jan. 1, and estimates of the possible price impact vary widely.

Revenues could drop by $5 a barrel starting in the second half as refiners and shippers prepare for the change, Citigroup Inc. says. Some traders expect a less dramatic slide, but even Saudi Energy Minister Khalid Al-Falih, whose country ships more oil than any other, sees a $1 reduction for some grades.

Khalid Al-Falih
Photographer: Mohammed Al-Nemer/Bloomberg

A shift in demand away from more viscous and sulfurous -- or "sour" -- crudes would add to financial pressure on the region's producers. OPEC and its allies are voluntarily curbing production for the third year to try to prop up prices in the face of burgeoning U.S. shale output, which is also lighter and easier to refine. While heavy-sour crude currently sells near its smallest discount to lighter grades in a decade, that gap is set to widen on the new rule.

“From the perspective of the heavy-sour crude producers, they have not only lost volumes and market share, but they are also going to get a hit to their price,” said Citigroup commodities analyst Eric Lee.

Middle East Heavies
Saudi, Iranian and Iraqi crudes are thicker and harder to refine than Brent
Source: McKinsey, Total, BP, Exxon, Adnoc
Note: Heavy oils have lower American Petroleum Institute (API) rankings

The ship-fuel requirement adds a layer of complexity to an oil market already jarred by the global production cuts -- since most of the missing barrels are heavy and sour -- as well as lost supplies from Venezuela, Iran and even Canada.

The new rule may widen the spread between sour crudes and those that are “sweet,” or low in sulfur. Refiners that process heavy, sour oil tend to produce a lot of bunker fuel, the mainstay of the shipping industry, along with diesel and jet fuel. Those that process lighter, sweeter barrels produce more gasoline.

Sour, Not Sweet
Middle Eastern crudes have more sulfur than global benchmark Brent
Sources: McKinsey, BP, Total, Exxon, Adnoc

However, forecasting the price impact is difficult because of the many variables at play, from the amount of oil supplied under long-term contracts to the possibilities for refiners to blend different types of crude. Harry Tchilinguirian, head of commodities strategy at BNP Paribas SA, said lighter U.S. oil could be blended with Middle Eastern crude and therefore boost demand for heavy-sour barrels. Heavier grades also yield more marine diesel, which may see higher demand from shippers under the low-sulfur regulation.

“There will not be a delay in this rule,” Edmund Hughes of the UN’s International Maritime Organization said Tuesday at a conference in Fujairah, United Arab Emirates. The IMO will issue guidance by mid-year on its new fuel specifications, said Hughes, who oversees air pollution and energy efficiency for the agency’s marine environment division.

The value of crude exported from the Middle East could slide by $3 to $5, Citigroup’s Lee said in an interview. Analysts at consultant Wood Mackenzie Ltd. and The Oxford Institute for Energy Studies give similar estimates.

These figures suggest that Middle Eastern producers selling about 20 million barrels a day could lose anywhere from $7 billion to $37 in annual revenue, based on Bloomberg calculations. That equates to as much as 8 percent of regional sales, based on an average price of $63 this year.

The price impact on Saudi Arabia, Iraq, Iran, Kuwait, the United Arab Emirates, Qatar and Oman should lessen over the next several years as refiners upgrade their facilities to produce more of the low-sulfur fuel.

Tighter Spreads

OPEC cuts and surging U.S. supply are bringing light and heavy prices closer

Source: Bloomberg

Middle Eastern blends have sold historically at a discount to lighter grades. That spread has narrowed as the Organization of Petroleum Exporting Countries cut heavy-sour output and production of lighter U.S. shale oil swelled. Yet analysts including WoodMac and Citigroup's Lee expect grades similar to Brent to gain in value and regional blends like Dubai crude to get cheaper, with spreads widening to $5 to $10 a barrel.

"For two or three years, there may be a $1 discount of some crudes," Al-Falih, the Saudi energy minister, said on March 7, playing down the impact of the IMO's new rule. "That will quickly be erased by adjustments to the refining sector."

The IMO will begin limiting sulfur content in shipping fuel to 0.5 percent worldwide, down from 3.5 percent in most places. As a result, vessels will need to buy low-sulfur fuel or install scrubbers to remove the pollutant from their emissions.

Bloomberg Strategist Julian Lee explains how all crude is not created equal

A drop in prices may spur less sophisticated refiners to overhaul their plants so they can process the cheaper crudes, said Bob McNally, president of consultant Rapidan Energy Advisors LLC. For now, "producers of heavier, sour grades, especially without complex refining, are not going to be loving this."