FEATURE: Shift to sour crude, higher demand prompt bullish turn in Europe LSFO market

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* European LSFO market sees rare demand surge
* NWE-Med arbitrage open for first time this year

The European low sulfur market bounced back at the beginning of autumn in contrast with the persistent bearishness seen for most of the summer, on the back of increased demand for electricity generation in the Mediterranean combined with lower availability of low sulfur materials as refineries switched to cheaper sour crudes, which were yielding fuel oil with higher sulfur content.

This shift came as a surprise to many in the industry who, following lackluster demand during the typical peak of summer and extremely slim bunker fuel consumption, had expected the market to remain depressed.

The physical hi-lo differential, which represents the difference between FOB Northwest European 1% sulfur fuel oil cargoes and FOB Rotterdam 3.5% sulfur fuel oil barges, showed that cargoes had switched to a premium against barges at the beginning of October, reaching a peak of $9.75/mt on October 14 when 1% cargoes were assessed at $225.25/mt.

This is in contrast to much of the year which has seen a historically weak hi-lo in the wake of the implementation of legislation from the International Convention of Prevention of Pollution from Ships -- more commonly referred to as MARPOL -- which states fuel oil used on ships operating within the Northwest European Emission Control Area should not exceed 0.1% from January 1, 2015.

Equally, in the Mediterranean, delivered low sulfur cargoes -- with the Mediterranean market typically receiving extra material from Northwest Europe -- moved to a premium against the sum of FOB NWE cargoes plus freight costs to the region, reaching a premium of above $7/mt on October 20, being assessed at $240.50/mt, representing a wide open arbitrage and reflecting the region's strength.

Meanwhile, in the paper market hi-lo swaps spreads strengthened, with November moving to $4.75/mt Thursday from the lows of minus $1.50/mt earlier in September, reflecting the strength of the physical.

The November hi-lo swap spread reached its widest mark in four months of $5.25/mt on October 14, Platts data shows. The November hi-lo swap spread was assessed at $4.25/mt Wednesday.

Market sources said this was happening on the back of increased utility demand in the Mediterranean, which was mostly being covered by volumes coming from Northwest Europe.

"Low sulfur demand for bunkering is residual," a trader said, adding that demand was mostly for utility grade low sulfur and "the only place to find that [type of material] is Rotterdam."

Another source said output of low sulfur fuel oil from Mediterranean refineries had remained stable, but since volumes had been sold in the high sulfur pool in recent months on the back of unfavorable economics for low sulfur due to the new and more restrictive environmental limits, there were fewer volumes available to meet the current increase in demand.

Platts has noted a number of Mediterranean refiners and traders selling low sulfur fuel oil into the high sulfur pool, trading the two grades at parity. This came at a time when limited demand in the usual peak period led to a significant drop in value for LSFO across Europe. Shortly afterward, changes to refinery optimization saw this trend reverse.

Meanwhile, there was demand for utility grade fuel oil in Spain, Cyprus and Malta.

In addition, Turkey's Tupras issued two buy tenders for a total of 60,000 mt of LSFO, to be delivered CFR the Izmit or/and the Izmit Refinery for delivery November 2-7 and November 13-18. Greece's Hellenic Petroleum issued a further 30,000 mt LSFO buy tender for delivery DES at Thessaloniki November 5-10.

This extra demand has come at a time when refiners in the region have also begun to produce less LSFO, on the back of crude optimization.

REFINERIES SEE SHIFT TO CHEAP BASRAH CRUDE, LESS LSFO PRODUCTION

Furthermore, a shift in the type of crude that refineries have been running has led to higher production of high sulfur fuel at the expense of lower sulfur grades.

Throughout much of the third quarter, inexpensive sour crude from the Persian Gulf has pushed into the Mediterranean and NWE refining pool, making sour crude more cost effective for refiners over the lighter, sweet barrels that are more likely to produce low sulfur fuel.

In particular, a drop in Asian demand as the Chinese economy stuttered in mid-2015 helped to propel both Iraq's Basrah Light and the new Basrah Heavy crude into the European refining pool throughout much of the third quarter, bolstering sour crude supply in the region. Additionally, flows of Kurdish crude out of Ceyhan pushed higher throughout the third quarter, adding to the glut of heavier, more sour barrels in the Mediterranean.

While Platts does not assess delivered prices of Basrah Light in the Mediterranean, the influx of sour crude into the region weighed heavily on the differentials for Urals, basis CIF Augusta, relative to Dated Brent.

Between July 1 and July 7, the differential between the Aframax Urals market and the Aframax Azeri Light market, both basis CIF Augusta, climbed nearly $1.85/b, according to Platts data, before peaking at $3.91/b on October 7, its highest level since late January.

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