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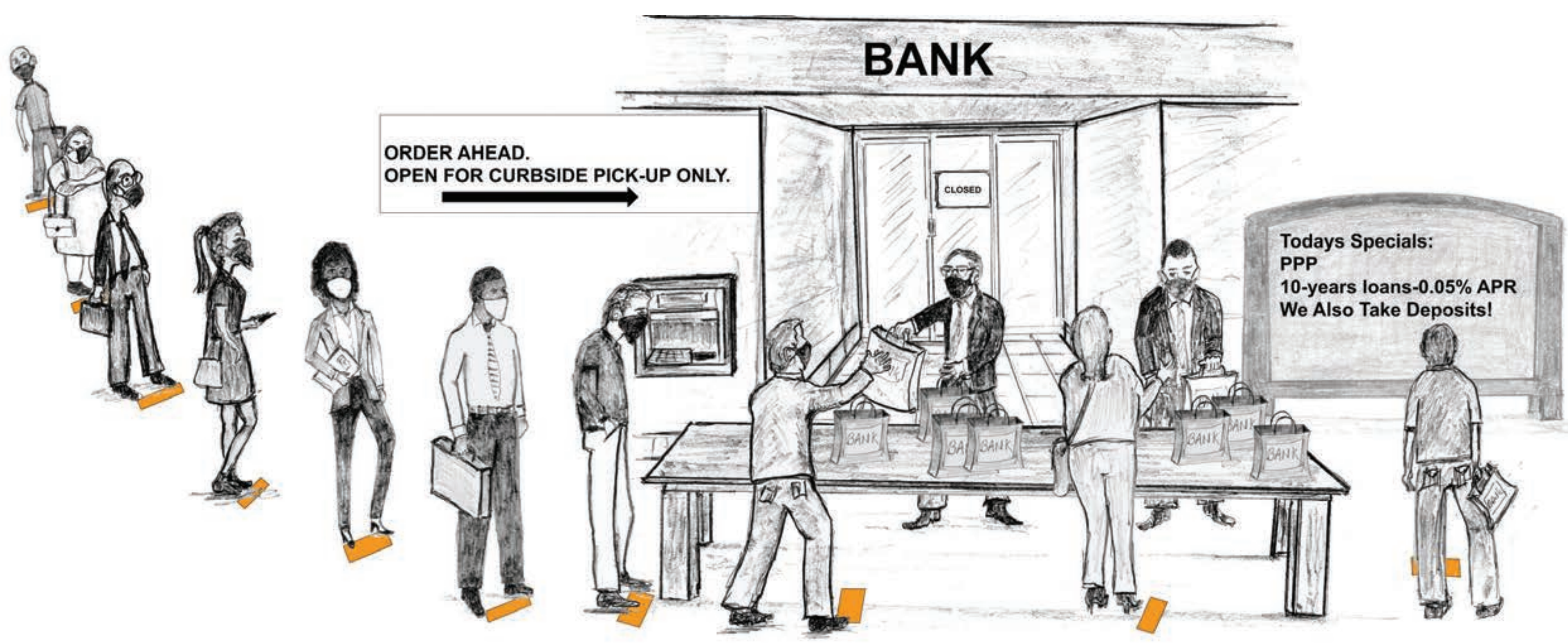

The "New" Normal

The Credit Issue

WHAT GETS MEASURED GETS MANAGED:

THE POSEIDON PRINCIPLES AND THEIR IMPACT ON THE SHIPPING INDUSTRY

By James Frew, Maritime Strategies International

The Poseidon Principles were created to encourage energy efficiency; whether the business case exists will depend on their wider uptake by ship-finance players, says James Frew, Maritime Strategies International

The Poseidon Principles are a first of their kind in a number of ways. Globally, they represent the first example of coordinated action by the finance community (excluding public finance institutions) to reduce the carbon intensity of their portfolio within a sector. For shipping, they represent an unusual case of voluntary action by a group of market participants to discriminate against a certain segment of the industry (in this case, ships with poor emissions profiles).

How they impact the shipping industry remains to be seen, but there will be two main channels through which they will make their impact felt. The first is the obvious one: through the potential increase in financing costs felt by higher-emission vessels, if they can be financed at all. The second channel is harder to quantify but, as legendary management consultant Peter Drucker put it, “what gets measured gets managed” — and quantifying vessel emissions may provide an impetus to owners to look at ways of reducing them.

Within the shipping industry, the only obvious parallel is the age limit of 15 years commonly imposed by oil majors on the tankers which they charter. How this restriction impacts the tanker market contains instructive lessons for how the Poseidon Principles could affect the shipping industry.

For shipping, they represent an unusual case of voluntary action by a group of market participants to discriminate against a certain segment of the industry (in this case, ships with poor emissions profiles).

As it stands, the banks supporting the Poseidon Principles represent an influential but relatively small section of the global ship finance industry. Their proponents have always been clear that they want to expand the pool of signatories and, recently, one member suggested that 90% of serious lenders to shipping would ultimately sign up.

Whilst the Poseidon Principles are already useful in providing a clear indication of the direction of travel, the real impact they are likely to have on the industry is by raising the cost of capital for vessels which are not deemed to be compliant with the trajectory of required emissions reduction, either directly via the Poseidon Principals signatories or by being forced to look for more expensive finance elsewhere.

The quantum of this increase will be influenced by the number of institutions still willing and able to finance non-aligned vessels. Here the parallel with the tanker market is relevant; tanker earnings and values decline but do not collapse after assets are 15 years old, as there is still a sizeable pool of charterers – particularly in India and SE Asia – who are willing to accept older vessels. Similarly, the increased borrowing costs for a non-Poseidon compliant vessel – relative to a compliant one – will depend on the availability of willing financiers.

Of course, quantifying this is challenging but, to provide some indicative numbers, in today's market, a traditional lender might be lending at Libor plus 3 percentage points, whilst an alternative finance provider would be around or above Libor plus 5.

If we assume that vessels which are not Poseidon-compliant are forced to resort to alternative sources of finance, then that two percentage point delta would represent the economic incentive to attempt to ensure that a vessel remains Poseidon-compliant for as long as possible.

This financial incentive is not yet significant in monetary terms but, symbolically, it has more power as an effort to incentivise lower carbon shipping – an effort that is gaining traction across the maritime industry. One aspect of this is that concern around what could serve as the 'fuel of the future' to drive shipping's decarbonisation is arguably impeding new vessel orders today. Based on a number of conversations with MSI clients, as well as wider statements in the shipping press, this uncertainty is one of the factors suppressing new vessel orders.

This concern as a factor impeding new vessel orders has been blown out of the water by the subsequent demand-side shock stemming from COVID-19. The trifecta of underlying weak recent demand for many shipping sectors, a poor earnings environment with the notable exception of tankers, and the crushing recession induced by COVID-19 we believe will be sufficient to drive historical deliveries over the coming five years down to levels last seen in 2005. In contracting terms, MSI projects that new vessel contracting this year will total just 13 Mn CGT – a level which, setting aside 2009, was last seen in the early 1990s.

From the point of view of decarbonising the shipping industry, this is a tricky situation, to say the least. The significant deceleration in the fleet post-2008 (a date which conveniently marks the IMO's yardstick from which decarbonisation efforts are measured) coupled with improved efficiency of newbuilding designs has meant that many vessels within the fleet are broadly aligned with this trajectory for now.

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Another unintended ramification of the Poseidon Principles, as they stand, will be that some vessel sizes will be preferred by signatories over others within a similar cohort, though this preference may not always benefit emissions abatement.

As the Poseidon Principles' trajectories have been predefined with knife-edge discrete boundaries, determined by a vessel's size (measured by either deadweight or gross tonnage), once a vessel creeps into a new higher Average Efficiency Ratio (AER) size category, it will be unduly punished, compared to a vessel that hits the ceiling of the lower boundary (although we note that the Principles are dynamic and there may be scope for an update to address this issue).

One possible consequence of this mechanism will be that banks begin chasing vessels at the higher end of the size categories in order to help align their portfolios. This will undoubtedly also push some owners towards these vessels if the cost of financing is, as a consequence, notably cheaper and, ultimately, yards may also bring out new designs to capture this discrepancy.

Regardless of these eccentricities, the Poseidon Principles aim to drive lower carbon shipping by encouraging retrofits and newbuildings at the expense of less fuel efficient vessels. Whether the financial business case exists – rather than the environmental one – will depend on the availability of bank finance to non-compliant vessels.

The two percentage point differential in financing costs posited above would translate to around $380,000 for a 10-year old Panamax bulker financed at 60% LTV over five years which, combined with fuel savings, would make the business case for some vessel retrofits. If the differential were to double as a result of more banks signing up to the Poseidon Principles, then the business case supporting vessel retrofits would be further strengthened.

If the net result of the Poseidon Principles is that more emissions data is available to finance providers and the industry as a whole, then a good part of the environmental case will have been satisfied. As more banks sign up, it might also be the case that a significant number of owners find it uncompetitive to continue operating in a climate where ESG principles garner an increasing level of attention. That could have a potential impact on capacity and the sustainability of those owners able to evolve to the changing climate.