Lloyd's List Intelligence

Ripping Up the Rulebook: Zero-carbon energy transition and the disruption to traditional ship ownership

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Summary

Environmental, Social and Governance (ESG) capital requirements will trigger the need for scale, stability, and consolidation - married with long term cargo trends and interests; together stimulating a tectonic shift in shipping business models.

In our recent Thought Leadership piece ("Red Light or Green Light: The Dilemma Facing Shipowners" December 2020), we examined the deep implications of the decisions shipowners need to make now on how they will meet emissions targets over the coming years.

In this accompanying piece, we delve further into the impact that zero-carbon transition will have on the entire business model of ship ownership and what it could mean for the future of the industry.

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Not all of today's shipowners are going to make it to 2050.

Looking to the horizon, challenging issues arise as shipowners require increasingly integrated partnerships with long-term cargo interest commitments to bridge the price gap between carbon and zero-carbon fuels. That, in turn, assumes a significant shift in the competitive landscape of vessel ownership. In the long term we anticipate ESG capital requirements will increasingly favour the stability of consolidated fleets matched against long term cargo interests, eliminating much of the generational privilege felt by traditional ownership models.

Assets and liabilities

The global call to decarbonise is only raising costs while leaving revenues vulnerable. Just because the fuel is changing doesn't mean the industry's ability to yield a return on invested capital will. And given shipping's parlous history in that regard even the most optimistic forecast would concede that risk is growing for shipowners.

The route to shipping's decarbonisation deadline is likely to be littered with casualties, and the banks understand that better than anyone. Given the questionable past lending practices that fuelled cycles of overcapacity, the banking sector has a vested interest in making sure their clients make the right decisions from here on.

Yet, the tectonic shift of decarbonisation, underpinned by digitalisation, is only part of the increasing risk for traditional shipping business models in the long term.

The zero-carbon transition will challenge traditional ownership models ill-equipped to adapt, but decarbonisation alone is not a business strategy and the overall ability to yield a return on invested capital in shipping will not improve just because the fuel mix changes.

Risk and structural change

We anticipate more structural shifts as part of the energy transition longer term that will in part be driven by ESG requirements; political, regulatory and financial transparency requirements; cost of capital and shifting trade patterns. While that will not necessarily equate to a sea change for all sectors and individual companies, those factors will encourage trends towards companies with scale, likely integrated into cargo supply chains, where the predictable stability of long-term contracts and financial requirements end speculative building cycles.

The obvious sectoral risk is the energy shipping sector, which currently represents 43% of seaborne trade volumes. While the timing and navigation of a global energy transition to renewable zero carbon sources are too far out to predict with any certainty, tanker owners can anticipate a general decline in fossil fuel trade flows in the run up to 2050. Shipments of new, alternative fuels can of course provide some upside - alternative fuels as we know them today have lower calorific content than oil and hence larger volumes required. However any strategic business planning at this stage would be conceptual and riddled with risk.

Perhaps the bigger influence on strategic planning for those looking beyond the immediate practical consequences of the energy transition will be the trend towards ESG-fuelled capital requirements increasingly favouring the stability, consolidation and corporatisation of long-term cargo interest integration in shipping models. The natural conclusion of which will increasingly challenge mid-sized, private entities that have dominated shipping's fragmented business models for much of the last century.

The response from the financial industry

Lending to shipping has already begun to hinge on shipowners' ability to satisfy the banks' environmental, social and governance criteria.

While many of the remaining bank lenders to shipping and capital market providers have long held so-called ESG targets linked to projects, a combination of regulatory pressure from governments keen to accelerate climate change policy and ratings agencies factoring in sustainability risk on rated debt has intensified pressure on lenders to tighten standards on lending.

That is a process expected to accelerate and while banks have no ambition to regulate by proxy, they also have no obligation to lend. Banks and financial institutions merely have to figure out which clients to select and that will increasingly be a case of capital only flowing in the direction of companies that are doing 'the right things'.

Growing expectations

Pressure from charterers is heading in the same direction. Today, the big miners, energy companies and traders are all under huge pressure to clean up their act. Regulators are demanding better risk management, investors are looking for commitment to future clean growth, and campaigners are fighting for bolder commitments. The nascent emergence of plans from cargo interests to introduce bunker levies to cover cost differential in opting for zero carbon fuels, together with transparent charterparties accounting for carbon emissions indicates a future where cargo interests call the shots in terms of vessel choice.

Changes in size and shape

Scale is not the goal but is a by-product of the process.

Smaller owners will have access if they meet the required standards, but ultimately cost of capital will be a determining factor in delivering those standards. While the cost of capital today is less of an issue due to sustained low interest rates, making scale less of a competitive issue, over time larger companies will get longer term cheaper capital.

Start-up projects that meet the right ESG criteria and large companies able to hit the required governance standards will be in a better position than smaller private companies with limited resource to adapt.

Size will matter much more and not just in terms of fleet size — the ability to consolidate and make joint ventures across the value chain or create more integrated companies that are able to use more than one capital source and utilise the breadth of the capital markets to become more competitive, is ultimately going to be a matter of financial survival.

Arguably these factors will apply regardless of the energy transition, although the shift to zero carbon is changing many of the value drivers in the market and therefore business models will have to adapt. Given the pace of change from cargo interests, currently characterised as the ‘get to zero’ coalition of the willing, we anticipate a cascading effect as the value chain associated with these first movers requires customers to adapt.

Outcomes

The emergence of such market dynamics is reliant on several uncertain assumptions, not least a near-term regulatory structure and public policy to help bridge the initial zero-emission fuel cost premium and kick start the transition. However, it seems clear that the pathways to 2050 will fundamentally alter the competitive landscape of shipping with different value drivers requiring different business models. That in turn implies significant uncertainty and risk for shipowners currently assessing strategic investments, but it also offers the opportunity of a more stable future where supply of tonnage is matched against cargo demand and shipping is more standardised, efficient and ultimately profitable.

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