PDVSA Meltdown Creates Caribbean Opportunity

Investors seek to fill refining and storage void.

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U.S. Energy Information Administration
Ursa
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Underutilized and Starved of Investment

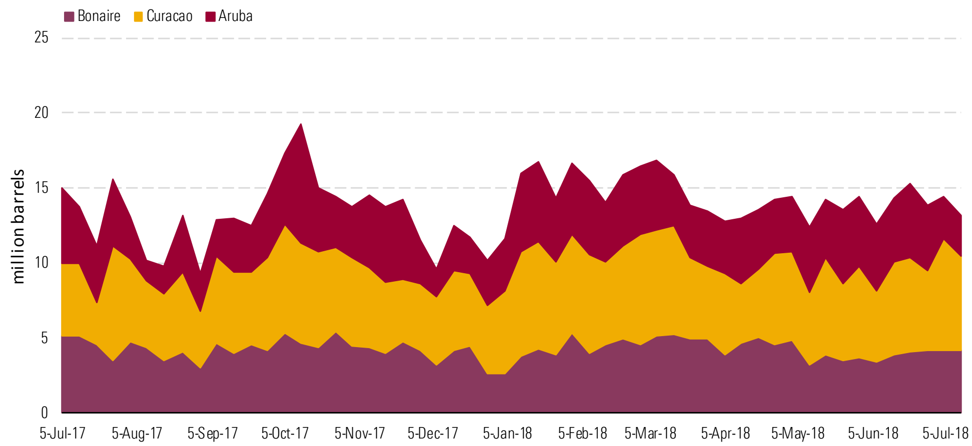
The Caribbean is strategically located at the crossroads of international trade routes between the Northern and Southern hemispheres, as well as the Atlantic and Pacific oceans. It has traditionally attracted oil trading, blending, and refining activity to meet the needs of local and international markets. Lately, the meltdown of Venezuelan national oil company Petroleos de Venezuela, previously a dominant player in the region, has left refineries and storage terminals underutilized and starved of investment. U.S. Gulf Coast refineries have partially filled the gap by increasing product exports to the region, but an opportunity now exists for private investment to fill the refining and storage void left by PDVSA, and also to meet new demand for low-sulfur bunker fuel arising from International Maritime Organization shipping regulations, which will come into effect in January 2020. This note reviews the impact of the PDVSA meltdown and new investment projects under way.

Our July 2016 "Caribbean Crude Storage Outlook" reviewed 13 storage terminals in the Caribbean region. Many of these were being heavily used by PDVSA for crude storage, blending, trans-shipment, and refining. PDVSA leased Caribbean tanks to build bulk cargoes for export and to blend its heavy crude production with lighter diluents. Much of that activity has been decimated in the past two years by the company's financial meltdown in the face of lower production, rising debt, pursuit of its physical assets in the islands by Conoco as liens against an unpaid $2 billion arbitration award, and U.S. sanctions restricting the company's flexibility. Venezuela's oil production continues to plunge—down by over 900 thousand barrels/day, or 900 mb/d, in the past year to 1.36 million barrels/day in May 2018, according to a Platts survey.

The region's 943 mb/d nameplate refining capacity largely relied on PDVSA for feedstock and has faced shortages as Venezuela's crude output declined. PDVSA investments in two refineries in Cuba and Jamaica were taken over by their respective governments during 2017, in frustration at a lack of investment. The government of the Island of Curacao (part of the Kingdom of the Netherlands, located 60 miles north of Venezuela), is searching for new investors to replace PDVSA, whose lease over its 335 mb/d Isla refinery ends in December 2019. The refinery processed a paltry 29 mb/d in June 2018, owing to PDVSA's failure to supply crude and maintain the facility. A 2016 agreement between the government of Aruba (another nearby Dutch island) and PDVSA U.S. subsidiary Citgo promised a major upgrade investment and restart by 2018 of that island's 235 mb/d refinery, previously shuttered in 2012. That investment has not materialized, leaving Aruba searching for alternative supplies and investors. In June, PDVSA was forced to suspend subsidized shipments of crude and products to 11 Caribbean nations under its 2005 Petrocaribe Agreement, choosing only to continue supporting select countries, including Cuba.

Storage levels in the PDVSA crude tanks at Curacao and Aruba, as well as at the 10-million-barrel Bopec terminal on a third Dutch island, Bonaire, have been running at an average 13.4 million barrels, or 34% full, over the past year, according to data from Ursa (Exhibit 1). During May, Conoco obtained liens from the courts in Bonaire and Curacao allowing it to seize assets in place of an unpaid arbitration award from PDVSA, successfully shutting down Venezuela's use of the islands until the latter negotiated a settlement process that lifted the immediate threat of seizure.

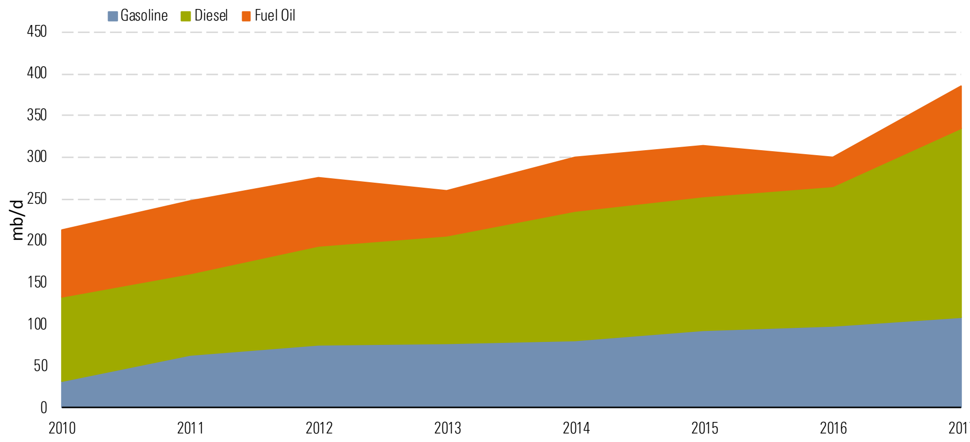
Exhibit 1 Caribbean Crude Storage Levels



Source: Ursa, Morningstar

The gap left by PDVSA's collapse offers two opportunities for outside investors in Caribbean refineries. The first is to at least partially replace or compete with product exports from U.S. Gulf refineries into both the Caribbean and the greater Latin American regions over the past eight years, which have more recently helped plug the gap left by PDVSA's meltdown. Data from the Energy Information Administration shows that annual average gasoline exports from the U.S. Gulf to Caribbean countries increased by 348 % from 31 mb/d in 2010 to 108 mb/d in 2017. Distillate exports to the Caribbean region averaged 226 mb/d in 2017—up 222% from 2010 (Exhibit 2). This increase in gasoline and distillate exports reflects declining output at regional refineries and increased demand from growing economies. Exports to the Caribbean region alone represented a market of nearly 400 mb/d of refined products in 2017. As we have previously detailed (see our May 2017 note "Mexican Downstream Opportunity for U.S. Refiners") Gulf Coast refined product exports to Latin America, including Mexico, have also grown substantially, up 228 % from 572 mb/d in 2010 to 1.3 mmb/d in 2017.

Exhibit 2 Gulf Coast Exports to the Caribbean



Source: EIA, Morningstar

The second opportunity is to supply marine bunker fuel to the busy Caribbean shipping market when IMO regulations change in January 2020 to require lower-sulfur fuels (see our June 2018 note "Fuel Oil Sulfur Spreads Set to Widen Through 2020"). Aside from the damage rendered by PDVSA's meltdown, regional refineries are not equipped with upgrading units needed to manufacture low-sulfur bunker fuels. The Caribbean market for marine bunker fuel reflects demand from local shipping as well as through traffic, especially container and tanker vessels passing through the Panama Canal. Two years ago, the Panama Canal Authority inaugurated a third set of locks that allow for the transit of larger vessels, increasing demand for fuel (see our July 2017 note "LNG and LPG Shippers Celebrate Panama Anniversary")

Merchant Refinery Plans

Two private-company storage and refinery investment projects have been announced this year that would be located on Caribbean islands.

The first is a proposal by Oban Energies to build a 4-million-barrel storage facility and a 50 mb/d refinery on the island of Grand Bahama. In February, Oban signed an agreement with the Bahamas government to invest $5.5 billion in the project. However, the deal was shelved in April after allegations of corruption emerged. Since then the project has been in limbo but still exists on the company's website. On June 25, the local Bahamas press reported Oban Energies officials revealing that the deal would be resuscitated, with some new heads of agreement with the government to be signed "in the next few weeks". An environmental impact statement required for the project's approval has not yet been delivered.

A second proposal comes from two joint-venture partners, Arclight Capital and Freepoint Commodities, which have owned and operated a 13-million-barrel storage facility known as Limetree Bay Terminal since January 2016 on St. Croix, one of the U.S. Virgin Islands. The Limetree Bay Terminal is located on land formerly occupied by a large refinery run by PDVSA and Hess, which processed as much as 600 mb/d of crude in its heyday but was shut in 2012. In early July, Arclight and Freepoint announced an agreement with the St. Croix government to rebuild and restart a refinery on the property to process an initial 150 mb/d. The project is subject to a final investment decision and requires approval from the St. Croix legislature, which will consider it this week (July 25, 2018). The two companies will create a joint venture, Limetree Bay Refining, owned 80% by Arclight and 20% by Freepoint, and will invest up to $1 billion in the project. The plan is that the refinery will be up and running by 2020, in time to produce low-sulfur fuels for the bunker market.

In addition to meeting regional Caribbean needs, the proposed St. Croix refinery can also serve the U.S. East Coast, which is a net importer of gasoline and diesel (see our July 2017 note "East Coast Refineries Recover From Shale Loss"). The Virgin Islands are exempt from the Jones Act, which requires that more expensive U.S. flag vessels be used to ship goods between U.S. ports. That exemption would allow Limetree to use cheaper nonflag vessels to compete with East Coast imports from Europe and undercut shipments from Gulf Coast refineries that use more expensive Jones Act vessels.

Further Coverage

We will provide further coverage of these Caribbean refinery investment proposals in the coming months as they progress, as well as a more detailed update on Caribbean storage, including new investments.

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