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Jet Supplies Tighten In Key Markets As Refiners See Low Sulfur Diesel Profits

Marketers and refiners have naturally switched to products on which they can make a solid profit, and right now that doesn't include jet fuel.

The infrastructure and potential supply problems at North American airports such as **Washington Dulles**, **Toronto Pearson** and **Montreal Dorval** are high profile within the jet fuel industry, but they are by no means the only places where supply concerns are challenging fuel executives. Parts of Europe and Asia are also finding supplies tightening, crack spreads widening and infrastructure taxed by increased demand.

With the advent and expansion of low-sulfur diesel requirements, particularly in Europe, many in the jet fuel industry say marketers and refiners have naturally switched to products on which they can make a solid profit, and right now that doesn't include jet fuel.

"Europe and North America, and Japan as well – the main consuming markets for jet fuel in the world – are structurally short of jet kerosene," notes one industry consultant. "Because the airlines are so fixated on negotiating over little bits of a cent a gallon, they are making the marketing not very profitable and therefore there is no incentive to make that demand through a local refinery. The market

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HIGHLIGHTS

US Pipeline Companies Say ULSD Won't Impact Jet Supplies/Quality

Pipeline companies are reiterating their commitment to delivering jet fuel on spec and in time despite the US move to ultra low sulfur diesel (ULSD) that could make juggling products difficult. New regulations set to take effect roughly one year from now (June 1, 2006) require a move to ULSD with a sulfur content no more than 15 parts per million.

The concern isn't whether ULSD could potentially contaminate jet fuel. In fact, it's the other way around. With jet fuel's sulfur spec of 5,000 ppm compared to ULSD's 15, the danger is that jet fuel shipments will leave trailback that will contaminate the ULSD. The only concern for airlines as purchasers of jet fuel is that jet fuel deliveries could be delayed due to the fact that pipelines will have to separate batches of ULSD and jet fuel by running something in between. "The concern is that other products might delay jet," notes one industry executive. But the source notes that there has been no indication thus far that this will be a broad problem, rather it might crop up in certain limited instances.

"It could even mean taking jet off some of the pipelines," the executive continues, but notes that no pipeline company has indicated it is considering such a move.

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will become even more import dependent."

The consultant says that "the airlines have been just too good in negotiating away the profitability, and now they are going to start paying a price." And he added that there is little relief in sight. "It's difficult to see how this is going to change because the last thing the airlines are going to do is ease up on the oil companies," he continues. "As long as airlines insist on this very aggressive position we're going to have more and more Torontos popping up, where oil companies are saying, 'I'm not prepared to put these resources, these pipelines, these tanks into serving that market because I can't make as much money as I could for distributing low-sulfur diesel, gasoline or other products."

Margin Issues

Margin issues are taking their toll at Hong Kong International, where pressure on margins is making some suppliers reconsider their positions in the market, according to **Jonathan Pardoe,** manager, fuels contracts and hedging for **Virgin Atlantic Airways**. **Robert Bijl**, vice president, general manager fuel for **KLM** also cites Hong Kong as one airport that has immediate jet fuel supply concerns.

According to Pardoe, it's not an infrastructure problem at **Hong Kong International,** where storage is substantial and the airport averages about 14 days stock. Instead, the problem is price and profit margins. "One of the big issues there is a push by the fuel companies to increase the price through legitimate methods of trying to negotiate the price up and not go for business at the low end," Pardoe says. The push by marketers came as no surprise. "We were warned of this happening a year or so ago," he says.

The problem, he says, is that the airport originally had too many suppliers, resulting in cutthroat competition and decimated margins. Chinese companies in particular cut prices to the extremes in a bid for market share and other companies followed suit. But things are changing. "A few of the oil companies are reconsidering whether they can afford to be in there at the levels they were before," Pardoe says. "They're not being quite so desperate to regain business if it means going down to those numbers."

Industry sources also see potential problems at London Heathrow, despite the considerable pipeline infrastructure serving the airport and easy access through other methods. "At Heathrow and other (UK) airports, supply is an issue," notes Pardoe. "Heathrow has very low average stocks, sometimes down below two days – down to one and one half or one and one quarter days stock. The thing in its favor is that there are a lot of pipelines leading into the airport, so there is less chance of a serious disruption, like there was in the US at Dulles, for example."

"Saying that, it is still an issue," he continues, "particularly with the recent discussion on increasing the size of the airport even further than the Terminal 5 expansion. They're now talking about a third runway and Terminal 6, and we're going to be stretched with the new Terminal 5."

Heathrow may have several pipelines feeding the airport, but that doesn't mean its always easy to get supply through. The consultant says he was recently involved in a tender, and of the five companies that could have offered supply, three claimed they couldn't get it through the pipeline. "The main pipeline serving Heathrow has major constraints," the consultant notes, adding that permission has been granted to install a pumping station to increase capacity but thus far the pipeline company hasn't acted.

The consultant says the infrastructure problems pale in comparison to the larger problem of the airlines' unwillingness to pay reasonable prices and their seeming inability to manage their price risk. "It's a question of what really matters," he says. "Are you going to get hung up about distribution issues, which maybe you could resolve a lot of them if you gave people a bit bigger price differential over Platts, or are you going to get hung up over the issue of how you're going to manage price risk. I believe the airlines first and foremost

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are hung up over the issue of price differentials above Platts, and therefore there is no incentive for a marketer to invest more money. If they can't make any money (on straight sales), they're going to start figuring out how they can make money, and then they're going to start creating squeezes. One of the ways they can squeeze is through distribution."

Low Sulfur Competition

Marketers are also paying less attention to low-margin jet fuel and more attention to higher-margin products. Generally speaking, the main cause of supply constraints in various airports throughout northwest Europe or Toronto or Montreal is the fact that refiners are switching their focus away from jet fuel and to more lucrative product production. Due to that, jet fuel will continue to command higher prices in places where supplies are tight and refiners have better options. "We see no real crisis in the short term but jet will become tighter and more expensive with higher differentials versus gasoil," says Bijl.

Similarly, **Katja Kleffmann**, manager, self supply and risk management for Deutsche **Lufthansa AG**, says "it's all about low sulfur."

"Refineries in Europe are optimizing diesel output at the moment," she says. "However, this is not happening en masse and the jet supply is not in jeopardy at all." In fact, Kleffmann noted that jet premiums in early June skyrocketed but then tempered a bit due to an influx of cargos expected to Northwest Europe. Prices were also elevated due to scheduled maintenance at the Total Refinery Antwerp and Koch

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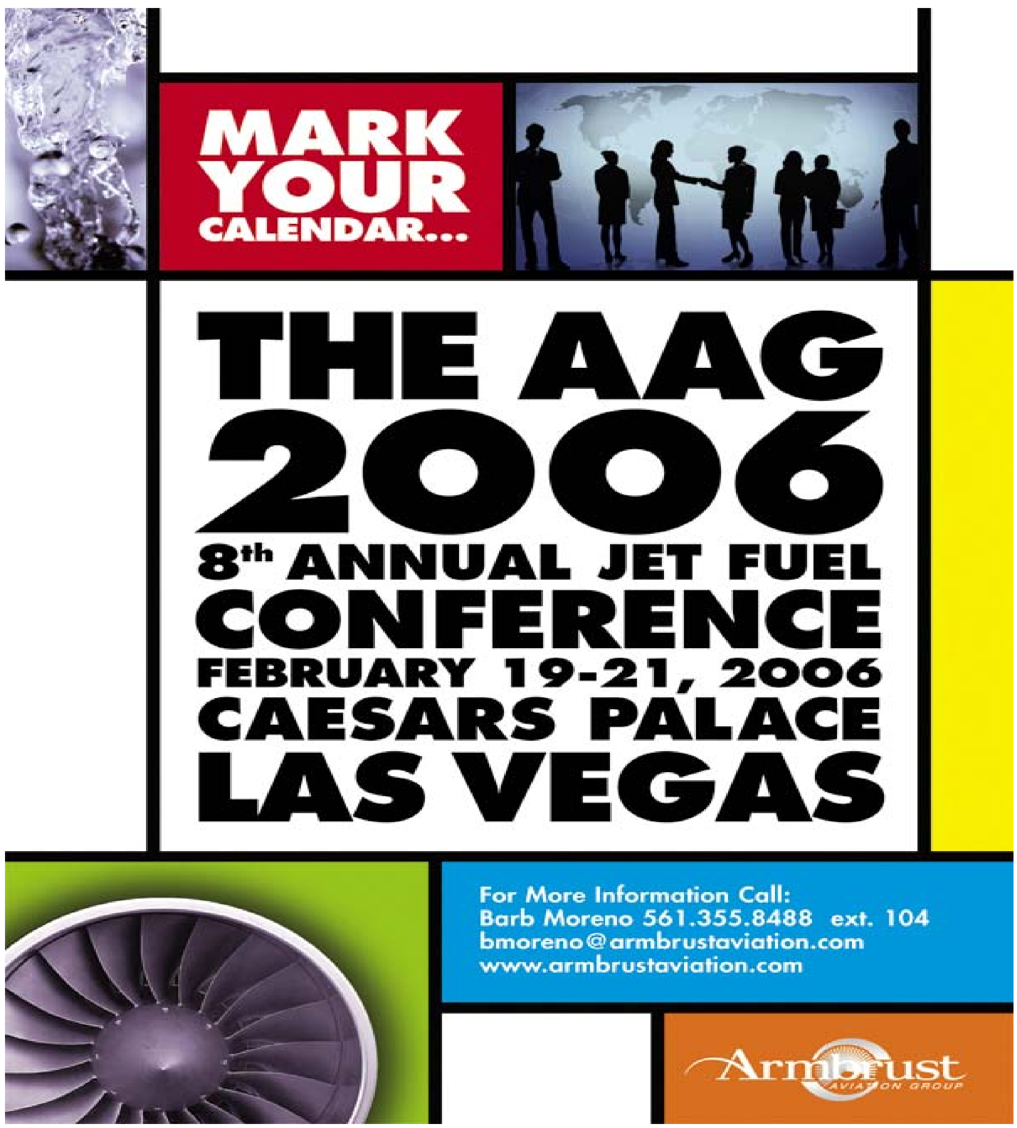

The prices airlines have been so successful in negotiating down to the bone are impeding their ability to command priority among refiners or affect many of the distribution changes that are necessary

Rotterdam.

While not at the crisis point yet, Bijl says that the UK is short on jet fuel and continental Europe is "moving to a jet shortage situation." Kleffman says there is no easy answer. "We can try to hedge our demand as good as possible and of course try to explore new or (our) own ways to supply ourselves." And Bijl points to the increasing dependence on imports, saying one solution is to bring in more imports, although he notes that only a handful of airlines are able to do that.

But the consultant says the industry's reliance on imports is risky from a pricing perspective. "The refiners are basically saying their going to make the product that they're going to make the biggest margin on, and where they can just make a small turn – a fraction of a cent a gallon – they'll be import dependent," he says.

"That's a very risky position for the airline industry to be in, because it means that the companies that are doing the importing can position themselves with regard to physical cargos and then in the paper markets to a much greater extent," he continues. "They can make huge trading plays, huge amounts of money by buying various types of paper product, depending on the physical position they've taken."

Clearly, airlines are stuck in a unenviable position. The prices they've been so successful in negotiating down to the bone are impeding their ability to command priority among refiners or affect many of the distribution changes that are necessary. The sky high price of oil and the intense corporate focus on costs has made hedging much more difficult, but at the same time all the more necessary. As the consultant says, "the airlines are very exposed." **JFR**

US Pipeline Companies Say ULSD Won't Impact Jet Supplies And Quality

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Benjamin Cooper, executive director of the **Association of Oil Pipe Lines**, also points to that possible scenario, but then adds that he believes his group's members will do everything possible to ensure timely delivery of jet fuel, as they will for all products running through their pipeline systems. "I guess there is a threshold decision on whether you are going to carry jet or not since it is 5,000 ppm sulfur and you have to carry 15 ppm sulfur product in the same line," he says. "Jet is the major source of contamination. Pipelines might decide this is too much of a pain in the ass."

Colonial's Move

Colonial Pipeline is the first of the major US pipeline companies to set sulfur specifications for ULSD. Last month the company announced a system origin specification of maximum 8 ppm for shipment of ULSD. The company said it will undertake extensive pipeline and system modifications to limit the increases in sulfur content during pipeline transportation of the product.

Steve Baker, a Colonial spokesperson, says the company is committed to jet fuel despite the new ULSD requirements that will make juggling product a bit more difficult. "The jet fuel industry will see no changes in their service or their deliveries or our quality commitment," he says. "All the changes being made are to accommodate the handling of the ultra low sulfur diesel. There won't be any intermingling batches involving jet fuel. We will manage the sequencing of our products to help create the best efficiencies that we can while preventing intermingling."

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"We are looking at changes in how we handle (the products), our processes as well as physical changes to our system."

"We still have some time to finalize our plans but we are looking at changes in how we handle (the products), our processes as well as physical changes to our system," Baker continues. "That could include additional tanks rearranging some manifold systems and some piping within tank farms to help keep the ULSD as segregated as we can."

Paula Farrell, investor relations for **Magellan Midstream Partners** also says her company will also undertake upgrades to ensure they can effectively handle ULSD. While the pipeline company hasn't come out with a sulfur spec for ULSD yet, the company is in the planning stages of assessing how to handle all products effectively.

"We are analyzing, working with our customers to ensure their needs are met and also preserving the quality of the products that they own," Farrell says. "Obviously we're not planning to change the specifications for jet fuel or anything related to that. Instead we are spending some capital in order to help keep those two products separate, so there won't be potential commingling between jet fuel and ULSD. We're working on things like changing manifolds and valves – things that will allow us to keep those products separate.

Teppco Partners LLP expects to publish its sulfur spec for ULSD in July, a spokesperson says, adding that "there will be no changes in our handling of jet fuel."

A Little Leeway

At the same time as pipeline companies are trying to assess how best to handle such divergent products, they are also concerned that they may not be able to fully meet ULSD demand by the June 1 deadline. In a March 25 letter to US **Senator James Inhofe** and US **Representative Joe Barton**, the Association of Oil Pipe Lines joined with the **American Petroleum Institute** and the **National Petrochemical & Refiners Association** to request a phased-in approach to the new standards.

"Obviously we're not planning to change the specifications for jet fuel or anything related to that.

Stressing that they are not seeking changes to the standard, the groups requested "reasonable flexibility" in the implementation process. "In order to address transitional distribution system issues and ensure that the nation's fuel demands are met, API, NPRA and AOPL have requested that EPA allow some reasonable flexibility in the supply and distribution system early in the program. This will enable product to be supplied while the system resolves technical difficulties that are likely to arise." The letter also noted that without flexibility, the industry may not be able to supply ULSD for all new buses and trucks in some markets.

In the same letter, the groups noted that "one significant variable is the effect that a long distribution chain may have on ULSD fuel."

According to the AOPL website, EPA has at least verbally agreed that some flexibility in necessary. According to the site, "EPA has recognized the need for a transition policy that extends the time when retail sales of diesel must meet the 15 ppm requirement from September 1, 2006 until October 15, 2006 in addition to allowing 22 ppm fuel to qualify as ULSD between June 1, 2006 and October 15. This proposed policy change will reduce market shortages by allowing the distribution system time to transition from higher sulfur product to ULSD and to continue working out necessary system changes. EPA intends to implement this new policy recommendation through a direct final rule."

At least for now, major pipeline companies seem committed to providing the same service on jet fuel that they always have, and hopefully the transitional kinks on ULSD can be worked out without any disruption to jet fuel supplies. JFR

News Briefs

The measure would provide for accelerated depreciation for new refineries or for refineries that are increasing their capacity.

The Alitalia plan calls for a capital infusion of US$1.5 billion, which the EU ruled is not illegal state aid.

Bill Would Offer Tax Breaks For Refinery Expansions

Washington DC… A bill that would provide tax breaks for refineries that increased their capacity is being considered in the US Senate. On May 18, **Sen. Orrin Hatch** introduced S. 1039, the Gas Price Reduction Through Increased Refinery Capacity Act of 2005.

The measure would provide for accelerated depreciation for new refineries or for refineries that are increasing their capacity. This would be accomplished by permitting a taxpayer to currently expense those investments made to expand refinery capacity (a minimum of 5% over the facility's capacity reported to EIA on January 1, 2005), where the expansion is placed in service prior to January 1, 2012 (pursuant to construction contract entered into prior to 1/1/08). All refinery property investments would receive five-year treatment, down from the current 10-year recovery period for these assets.

At press time, the bill was set to be taken up by the **Senate Finance Committee,** and if passed would be added to the energy bill currently being debated in the Senate.

Air France/Swissport In Ground Handling Deal

Zurich/Paris… **Swissport International** said it has concluded a four-year ground handling agreement with **Air France** that initially covers 11 airports and will later be extended to further destinations. The deal builds on Swissport's comprehensive agreements with **KLM** and **Swiss Airlines.**

Swissport said that under the deal, Air France will benefit from "tangible cost savings" as well as enhancements in administrative and quality assurance terms. For Swissport, the deal allows the company to further intensify its existing contracts, provides a means of enhancing productivity at various airports as well as a long-term revenue flow.

In related news, Swissport International has concluded a five year partnership agreement with **Swiss WorldCargo.** The new agreement covers the handling of more than 200,000 tons of cargo a year.

CAO to Almost Certainly Lose Chinese Monopoly

Beijing… China Aviation Oil (CAO) has refuted published reports it will almost certainly lose its virtually monopoly of China's $1 billion jet-fuel market once it completes its restructuring and settles more than $500 million in debt.

The Singapore Business Times cited an affidavit from a CAO closed-door meeting with creditors in which Gu Yanfei, currently leading CAO's restructuring efforts, admitted that China was seriously discussing deregulating its jet fuel market as part of its entry into the World Trade Organization. "It's absolutely certain that the monopoly will be broken up," Gu told the creditors, the paper reported. "However, such a process is a relative process. It will not happen overnight. In other words, this breaking up of the monopoly is a progressive exercise."

The affidavit on the meeting was filed with the High Court by Deloitte and Touche executives who are advising the jet fuel supplier on its restructuring. But CAO said the Chinese jet fuel market will remain its core business. "The company would like to state that the jet fuel business will remain the core business of the company. In addition, the company is confident that its parent company, China Aviation Holding Company will remain the major supplier of jet fuel in China throughout this reforming process," it said in a statement. "The company is of the view that such reform process will not happen overnight and will take some time." CAO also suggested that Gu's comments were taken out of context. Last week, the vast majority of CAO's creditors approved a new debt repayment and restructuring scheme that in essence save the firm from liquidation.

Alitalia Restructuring Plan Approved By EU

Brussels... The **European Commission** has given struggling **Alitalia** the OK to split into two separate air and ground companies, and said it should proceed with a critical restructuring plan, while warning Italy not to provide direct state aid.

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World Jet Fuel Prices

Spot Cargoes Trend

Rotterdam			Mediterranean			Middle East			New York			US Gulf Coast		
6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3
566.0	549.7	506.1	557.8	543.6	497.4	67.8	65.5	58.9	169.2	166.1	150.4	165.0	162.7	147.9
Chicago			**Los Angeles**			**Pacific NW**			**CIF Japan**			**Singapore**		
6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3
168.0	165.0	150.0	171.7	168.8	156.0	171.9	169.0	156.2	71.0	69.1	63.5	69.4	67.4	61.6

Futures/Differentials Trend

IPE Gasoil*			NY Heating Oil			WTI Crude			Brent Crude			Rott Jet/IPE Gasoil		
6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3
526.2	518.1	491.5	169.8	162.0	152.2	55.6	52.5	51.9	54.4	53.5	53.3	39.8	31.6	14.5
			NY Jet/Heating Oil			**Gulf Jet/NY 2 Oil**			**Gulf/Los Angeles Jet**					
			6/17	6/10	6/3	6/17	6/10	6/3	6/17	6/10	6/3			
			8.33	7.90	10.38	3.33	4.30	6.71	-6.69	-6.10	-8.10			

Key: U.S. weekly averages cents per gallon, WTI Crude, Asian jet in $/barrel, Europe, Medd $/Ton *Sources: Opis Jetfax, JFR*

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The Alitalia plan calls for a capital infusion of US$1.5 billion, which the EU ruled is not illegal state aid. "On the basis of a thorough and detailed analysis, the Commission has concluded that these recapitalizations do not involve any state aid," EC Transport Commissioner **Jacques Barrot** said. "This would have been prohibited by the 'one time, last time' principle which we scrupulously uphold." Alitalia has proposed splitting into **AZ Fly** and **AZ Services** and with state-owned holding firm **Fintecna** taking a major stake in AZ Services. "The state's minority participation in the future EUR1.2 billion increase in the capital of AZ Fly must take place at the same price and under the same conditions as private investors," the Commission said in a statement. The EC also ruled that a US$491 million loan it had authorized Italy to guarantee in 2004 had been used properly.

Guerin Appointed CEO Of Servisair/GlobeGround

Paris… **Penauille Group** has appointed **Jacques Guerin** as CEO of **Servisair/GlobeGround**, its airport services division. He replaces **Jean de Courcel.** Guerin has a long history in aviation, including stints with **Aeroports de Paris** and the **Air France Group**. Most recently he was marketing and sales director for the mail business line at **La Poste Group**.