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Belief in Oil as a Precious Commodity Enters the Psyche

Hurricanes Feed Long Term Market Fears and Accelerate Crude Oil Price Rises

As the body of this report was completed prior to the two recent catastrophic hurricanes in the United States we felt it would be helpful to add these additional pages to take a brief snapshot of the impact of those terrible natural disasters on the oil and tanker markets. Our fundamental outlook in this report has not changed.

For most of the year, long term fears about crude oil production shortages - caused by (1) high Chinese demand in 2004, (2) the recognition that the data on crude oil reserves was unreliable, and (3) the recognition that investment in oil exploration had been neglected - acted to push up prices. The terrible destruction of September’s back to back hurricanes left the US Gulf crude oil production and refinery industries in disarray and gave further impetus to crude oil prices which have been rising relentlessly since 2Q03.

Product Shipping Benefits Most as Tanker Rates Take Off

Shipping generally seems to benefit from a crisis. The most immediate problem resulting from the hurricanes proved to be the loss of refinery capacity, and as a result the clean product market jumped dramatically (figure 1).

Near/Medium Term Outlook Back to “Normal” by Year End

The latest damage assessment (27 Sept) indicates that 683 platforms and 87 rigs remain evacuated in the Gulf of Mexico, while the cumulative production lost so far totals 36.4 MlnBbls of crude oil and 172.5 Bcf of gas. More positively, it seems that there has been no significant damage to underwater pipelines, while eight of the sixteen refineries shut down have restarted or are attempting to restart.

Despite the continuing serious problems in the US Gulf, the crude oil price has come down from its peak, while upward momentum of clean product rates had stalled by the end of September. It seems that the impact of the weather wild card has tailed off, and this is in part due to the actions of the US Government.

President Bush- heavily criticised for not doing enough to alleviate the human tragedy, and desperate not to be accused of economic mismanagement as well - has done everything to allay fears of crude oil, product and gas shortages e.g. asked the rest of the world for assistance, exhorted producers to pump more oil and dipped into the SPR.

The market has been reassured by the government’s willingness to release stocks from the SPR and to relax product specifications. Figure 2 shows that while crude oil stocks were down at the end of September, gasoline stocks were actually up.

Although, the hurricane season is not yet over, the oil industry is targeting the end of the year as the time when the industry can start to get back to normal. For example, this is the point when the last of the closed refineries will be back on line.
Longer Term Outlook – Looking Beyond Oil

Despite the skill of both the US administration and the US oil industry in managing the physical strain on the energy supply chain and preventing energy prices from spiraling up further, economic slow down seems inevitable.

Rising energy prices have hit consumers hard and it is expected that this will cause a reduction in energy demand as well as in consumer spending generally. It remains to be seen exactly how the US and global economy will be effected.

However, it may well be that the most fundamental impact of the twin hurricanes is that they have served to burn into the general global consciousness the realization that the world’s supply of crude oil really is going to run out. A new era is upon us – for the first time, there will be concerted efforts to develop alternative energy sources and to maximize the efficiency of energy consumption.

Today: nuclear moves up the agenda – wind power completes its transition to the main stream

Tomorrow a new vision: the decentralization of energy generation - the individual becomes an energy collector (solar panels, mini wind turbines, exploiting latent geothermal resources etc.)

Methodology and Scope of the Charles R. Weber Tanker Report

The aim of the Weber tanker report is to provide participants in the tanker shipping industry with an overview into the latest developments in the tanker market and the oil industry that it serves, and also to shine a spotlight on the future prospects for these two markets.

Crude Oil Market

Subjects that are regularly covered are as follows:
- Crude oil supply/demand balances historical and forecast
- Crude oil prices – Brent and West Texas Intermediate
- OPEC announcements and quota changes
- US and Chinese crude oil import/export trade statistics
- Crude oil and product stocks
- Rig activity
- Refinery throughputs

Tanker Shipping Market

Subjects that are regularly covered are as follows:
- Tanker earnings trends historical and forecast
- Tanker spot fixtures
- Tanker investor activity in terms of new orders, secondhand sales and scrapping
- Tanker fleet supply changes historical and forecast
- Tanker fleet demand forecasts – taking into account the impact of tonmiles
- Listed tanker shipping company results and share performance

The publication also tries to illuminate the differences between developments in the different tanker sectors during the most recent quarter:
- VLCC (>=200,000Dwt)
- Suezmax (>=120,000, <200,000Dwt)
- Aframax (>=80,000Dwt, <120,000Dwt)
- Panamax (>=50,000Dwt, <80,000Dwt)
- Product (>=10,000, <50,000Dwt)

Each sector review is written by a Weber broker with direct involvement in the relevant sector.
Tanker Shipping – Following a Familiar Path?

Executive Summary: Market unperturbed by low 2Q05 tanker earnings

Tanker earnings during 2Q05 were undoubtedly very ordinary. However, figure 1 shows that concerns about the future prospects for the tanker market are mitigated by the fact that 2Q05 tanker earnings paralleled reasonably closely the path of earnings at the start of each of the last two years.

Certainly investors in tanker stocks seem to be unperturbed, with figure 2 showing how tanker stock prices (represented by OSG) have held up extremely well over the last few months. Indeed, it would appear that investors are anticipating a significant seasonal rally in tanker earnings during 2H05.

Crude oil demand forecast for 2005 shaded down

There is growing evidence that the current prolonged period of high oil prices is starting to impact on the prospects for world economic growth. For example – in recent months world oil demand forecasts have been shaded down by both OPEC (down 0.36Mnbd between April and July from 1.98 to 1.62Mnbd) and IEA (down 0.2Mnbd in July from 1.78 to 1.58Mnbd).

In July, leading crude oil forecasting agencies came out with their initial forecasts for 2006 demand. This initial forward view anticipates that 2006 will be a virtual carbon copy of 2005.

High Oil Prices - Crude oil has suddenly come to be considered a scarce commodity.

The current high crude oil price environment is primarily the product of a realisation (triggered by the 2004 crude oil demand surge) that there are real structural weaknesses within the crude oil market caused by:

1. the lack of spare crude oil production capacity
2. the lack of spare refining capacity

These twin factors have created a climate of “fear” and uncertainty about the security of supply. Crude oil has suddenly come to be considered a scarce commodity with consumers wondering who will provide the extra barrels required to meet rising crude oil demand.
Consumers feel exposed to any disruption in crude oil supply or to a demand surge. This has led to a twin track policy of (1) building stocks to a higher base level in order to create a buffer against any supply disruption or demand surge, and (2) making increased use of the futures markets to secure forward positions and pricing.

**Tanker Freight Rate Prospects for the remainder of 2H05**

China has so far had a much less dramatic impact on the tanker market than in 2004 with crude oil imports up just 4% yoy – compared to full year growth of 35% in 2004. However, some commentators believe that Chinese crude oil imports will strengthen during 2H05. This will give a boost to tanker demand. Increased Chinese imports in 2H05 will also act as an accelerator by boosting tonmile demand, which reflects the fact that most trades serving China are long haul.

The market will also be underpinned in 2H05 by solid growth in overall world crude oil demand – estimated by leading forecasters to be in the range +1.9% and +2.5%. Although this growth is well below that achieved in 2004 (IEA, +3.6%), it is still well above the average for the period 2000-2003 (IEA, +1.2%).

With China’s lower profile (so far this year) and lower world crude oil demand growth, it is expected that tanker earnings will not match the levels seen in 2004.

The prospect of further strong fleet growth will also act as a drag on tanker earnings prospects in 2H05. It is anticipated that full year fleet growth will reach 6.1% in 2005, which follows on from growth of 6.2% in 2004.

**Prospects for the World Oil Market in 2005-6**

**Crude Oil Demand – High Oil Prices Start to Bite**

-- Forecast for 2005 Shaded Down (as at July 2005)

Range of World Crude Oil Demand Forcasts (a):

<table>
<thead>
<tr>
<th>Demand Fcast 2005 (Mnbd)</th>
<th>IEA +1.58 (1.9%)</th>
<th>OPEC +1.62 (2%)</th>
<th>EIA(USGovt) +2.1 (2.5%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final Demand 2004 (Mnbd)</td>
<td>IEA +2.89 (3.6%)</td>
<td>OPEC +2.61 (3.3%)</td>
<td>EIA(USGovt) +2.7 (3.4%)</td>
</tr>
</tbody>
</table>

There is growing evidence that the current prolonged period of high oil prices is starting to impact on the prospects for world economic growth. For example – in recent months world oil demand forecasts have been shaded down by both OPEC (down 0.36Mnbd between April and July from 1.98 to 1.62Mnbd) and IEA (down 0.2Mnbd in July from 1.78 to 1.58Mnbd).

Nevertheless, although not expected to match the bumper crude oil demand growth seen in 2004 (IEA +2.89 Mnbd, +3.6%), 2005 demand (for all the forecasting agencies used here) is well ahead of the average annual demand growth for the period 2000-2003 (+1.2%).

(a) This report uses three main demand forecasting organisations: IEA (International Energy Agency), OPEC (Organisation of the Petroleum Exporting Countries), and EIA (US Government’s Energy Information Agency)

-- Initial Forecast for 2006 (as at July 2005)

Range of World Crude Oil Demand Forcasts:

| Demand Fcast 2006 (Mnbd) | EA +1.75 (2.1%) | OPEC +1.54 (1.9%) | EIA(USGovt) +2.1 (2.5%) |

In July, leading crude oil forecasting agencies came out with their initial forecasts for 2006 demand. This initial forward view anticipates that 2006 will be a virtual carbon copy of 2005.

Again rising oil prices are expected to undermine demand. OPEC is at the low end of the spectrum at +1.9%. It comments that its forecast “captures to some extent the impact of high international oil prices on oil demand”
High Oil Prices Countered by the China Effect

In 2004, China was the most important factor driving crude oil demand and the world economy – although not the only factor (b). In 2005 and 2006, a strong Chinese economy is again critical for world crude oil demand and the world economy.

(b) Some of the other factors driving crude oil demand and the world economy in 2004: ? Non-Chinese crude oil demand +1.9Mnbd ? US economy strong, high imports ? Hurricane Ivan ?

Figure 4 below provides a regional break down of the IEA crude oil demand forecast for 2005 and 2006. This shows that Chinese demand growth – although well down on 2004 (+15.4%) – is expected to expand by 5.5% and 7.2% in 2005 and 2006 respectively.

Figure 4: Global Crude Oil Demand by Region (million barrels per day) Source: IEA

<table>
<thead>
<tr>
<th>Region</th>
<th>Demand 2005</th>
<th>Annual Change 2004</th>
<th>Annual Change 2005</th>
<th>Annual Change 2004 %</th>
<th>Annual Change 2005 %</th>
<th>Annual Change 2006 %</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>25.61</td>
<td>0.83</td>
<td>0.26</td>
<td>0.33</td>
<td>3.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Europe</td>
<td>16.33</td>
<td>0.17</td>
<td>0.05</td>
<td>0.03</td>
<td>1.0</td>
<td>0.3</td>
</tr>
<tr>
<td>OECD Europe</td>
<td>8.64</td>
<td>-0.18</td>
<td>0.11</td>
<td>0.06</td>
<td>-2.0</td>
<td>1.3</td>
</tr>
<tr>
<td>China</td>
<td>6.79</td>
<td>0.86</td>
<td>0.36</td>
<td>0.49</td>
<td>15.4</td>
<td>5.5</td>
</tr>
<tr>
<td>Other Asia</td>
<td>8.80</td>
<td>0.47</td>
<td>0.28</td>
<td>0.27</td>
<td>5.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Subtotal Asia</td>
<td>24.23</td>
<td>1.15</td>
<td>0.75</td>
<td>0.83</td>
<td>5.2</td>
<td>3.2</td>
</tr>
<tr>
<td>FSU</td>
<td>3.78</td>
<td>0.15</td>
<td>0.04</td>
<td>0.05</td>
<td>4.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Middle East</td>
<td>6.07</td>
<td>0.33</td>
<td>0.30</td>
<td>0.31</td>
<td>6.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Africa</td>
<td>2.89</td>
<td>0.07</td>
<td>0.09</td>
<td>0.09</td>
<td>2.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Latin America</td>
<td>4.95</td>
<td>0.19</td>
<td>0.10</td>
<td>0.11</td>
<td>4.1</td>
<td>2.0</td>
</tr>
<tr>
<td>World</td>
<td>83.88</td>
<td>2.89</td>
<td>1.58</td>
<td>1.75</td>
<td>3.6</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Trade data for 1H05 (see figure 5) provides further evidence of the continued health of the Chinese economy. Although obviously not immune to the impact of high oil prices, China appears to sit implacably at the other end of the seesaw to high crude oil prices helping to keep the world economy on an even keel.

However, not all the evidence for China is positive. Figure 6 shows crude oil imports for 1H05. This reveals a very uneven pattern of imports with two bumper months in March and April sandwiched on either side by two mediocre months.
Overall crude oil imports for 1H05 are 4.1% ahead of the corresponding period in 2004. This rate of growth is below the IEA forecast of 5.5%. Therefore, a significant improvement is required in the second half of the year.

IEA argue that the relatively lacklustre performance of crude oil imports has been in part due to government policies that have inhibited demand. Most notably government price restrictions on transport fuels and power are making it uneconomic for domestic refiners and utilities (c) to maximise output. Liberalisation of either market would have the effect of increasing domestic oil demand. However, there are no signs of a change in policy in the near term.

(c) In the case of the utilities, while substitution for lower priced fuels has proved a key motivation, the increased availability of hydroelectric power has also contributed to a reduction in demand growth for fuel oil.

The impact of the government’s policy of limiting increases in the retail price of key products has had an even more significant effect on product imports, which have fallen sharply during 1H05 (-21%) (see figure 7). Conversely product exports have started to rise.

**Crude Oil Supply – Who Will Provide the Extra Barrels?**

At its latest meeting in June, OPEC increased its quota level by 0.5Mnbd to 28Mnbd. It also made provision for a further 0.5Mnbd of extra production should the market require it ahead of its next scheduled meeting in September.

**OPEC Quota Changes 2004 - July 05**

OPEC invariably comments at its meetings that the market is well supplied with oil. With both crude oil and products stocks tending towards the upper end of their five year range (see figure 9), there appears to be merit in this claim on this occasion. However, why are crude oil prices at record levels?
The above charts appear to show that the usual relationship between prices and stocks has been broken i.e. a period of high stocks might more usually be accompanied by weak oil prices.

The root cause of this broken relationship goes back to the crude oil demand surge witnessed in 2004. The market was shocked by the strength of crude oil demand growth (IEA, +3.6%) because it meant that crude oil producers were pushed to there capacity limits. The lack of spare capacity meant that security of crude oil supply – more usually threatened by wars (e.g. Gulf Wars) or bad weather (e.g. Hurricane Ivan) – became the primary concern or “fear” of crude oil consumers. These concerns were heightened by (1) comments from some industry experts that the era of “peak oil” (a) was imminent, (2) continuing concerns about the shortage of world refinery capacity following years of underinvestment.

(a) “Peak oil” – the idea that crude oil production has peaked with new capacity can no longer outpace failing capacity.

During 1H05, fears about the lack of spare capacity have remained at the top of the agenda, as fearful consumers study conflicting reports about the amount, quality, and start up time of existing spare capacity, as well as the timetable for new capacity coming on stream and the investment plans of oil producers for future oil exploration.

“Fears” about the lack of spare capacity have been exacerbated by the forecast of relatively strong crude oil demand growth (2-2.5% per annum 2005-2006). Consumers have been left wondering just who will supply the extra barrels to meet to world’s rising demand.

It can be considered that the oil market is driven by two separate sets of considerations: (1) long term/deferred, (2) short term. PIRA argues that long term considerations are dominating (e.g. concerns about long term supply security). Positive short term fundamentals (e.g. increased OPEC quota levels) are over powered, while negative short term factors (listed below) are fuelling the prevailing mood of the deferred market.

- Geopolitical Risks (The London Bombings, the death of King Fahd of Saudi Arabia, political unrest in Iraq, Nigeria and Venezuela)
- China – could there be another demand surge like that seen in 2004?
- Russia – the uncertain future of Yukos – will Russian crude oil production stagnate
- Refinery Capacity Shortages – Years of underinvestment have left the industry short of spare capacity and vulnerable to unexpected outages e.g. the separate BP and Murphy refinery fires in July
- Hurricane season – will there be another hurricane to match the destructive Ivan in 2004

A New Phase, Not a New Era

The market’s “fears” about the lack of spare capacity have led to a twin track policy aimed at securing future crude oil supply: (1) building up stocks to act as a buffer in a potential crisis when crude oil production cannot expand to meet demand (e.g. High demand: another China demand surge, or Low Supply: another Hurricane Ivan), and (2) increased activity in the crude oil futures markets.

Both aspects of this twin track policy have fuelled crude oil price rises (b).
(b) In the case of increased futures activity, OPEC argues that speculators (non-commercials) have also become very active and that they have contributed to the high price environment.

IEA, which appears unconvinced by those that argue that “peak oil” is just around the corner, interprets this new policy as a new phase – a market readjustment to a realisation that the period of tight production capacity is here for some time to come. However, IEA points out that the market has not entered a new era because over the next few years additional investment means that spare production capacity will be built back up and oil prices will retreat.

**The Long Term Effects of a High Oil Price Environment**

However, what if the high oil price environment continues for a prolonged period?

It is clear that a period of high oil prices must have a negative effect on the world economy. However, economists are nowhere near able to form a consensus about the degree of this negative impact.

The argument that oil spikes inevitably lead to a recession has been discredited. It is generally considered that the world economy is less dependent on oil than in the 70s and 80s, and that governments are more skilled at managing the economy.

The more negative economists see high oil prices and inflated property markets as presaging recession. However, other economic forecasters (e.g. PIRA) point out that high oil prices in recent years have not be accompanied by significantly increased inflation (see figure 11).

**How Long will Concerns about Spare Capacity Last?**

Just as there are divergent opinions about the long term impact of high oil prices, so (as discussed in our last report) there are wide ranging views about the prospects for building up spare capacity, and whether this issue or the shortage of refinery capacity will be the biggest factor threatening the limit the industry’s capacity in future years.

In June 2005, BP published its latest Review of World Energy. This provided impetus to the “peak oil” lobby as it showed that proved crude oil reserves at the end of 2004 (1188.6 thousand million barrels) were virtually unchanged on 2003 levels. (Note: reserves in 1994 were 1017.5 thousand million barrels).

Among those countries struggling to maintain their crude oil reserves are the UK, USA, Indonesia, Mexico, Norway, India and China.

United States crude oil production has been in decline for many years (see figure 12), and consequently it has become increasingly dependent on imported oil. In August, President Bush signed the first comprehensive energy bill in over a decade. Supporters of the energy bill say that in the long run, the new law will refocus the nation’s energy priorities and promote cleaner and alternative sources of energy. Bush has said he believes the nation must find new ways, besides fossil fuels, to power the economy. However, the new bill is aimed at the longer term. It will have little impact in the short term on United States reliance on crude oil imports or on high oil prices.

**United States Crude Oil Production**

![United States Crude Oil Production](figure12)

Few countries have been successful in expanding oil reserves in recent years. Brazil and Russia were among the few countries to increase their reserves in the period 2003-2004.
In recent months, OPEC has been voluble in its claims for increased investment in developing new production capacity. It sees the lack of investment in refining capacity as the main capacity limiter for the oil industry in future years - pointing out that new production capacity is being added much faster than refinery capacity. It welcomes a recent agreement by the G8 to develop measures to encourage the development of new refinery capacity.

OPEC estimates that its production capacity will grow by 3.5-4Mnb/d between 2006-2010 (710Kbd to be added in 2006), in addition to gains of 1.5Mnb/d in OPEC NGLs and other liquids.

The IEA is similarly optimistic about the prospects for non-OPEC supply growth. It calculated that the upstream industry had been investing to meet 1-2% annual global demand growth, and that the market was thrown out of balance in 2004 because world oil demand shot up by 3.6%. It estimates that new projects will generate 1-1.5Mnb/d of incremental non-OPEC capacity through to 2009.

It also envisages that high oil prices may provide a boost to production capacity by pulling forward the start up date for some fields and by encouraging operators to sustain mature fields in production beyond originally planned closure dates. High oil prices may also make projects previously thought too costly viable.

IEA suggests that, in addition to investments that were in place prior to the 2004 oil demand shock, producers are putting in extra funds to build production capacity. It points out that upstream spending surveys covering 2005 from Lehman Brothers and Citigroup show a sharp increase versus equivalent studies undertaken at the end of 2004. High rig utilisation also provides evidence of the increased emphasis being placed on exploration.

The combined IEA and OPEC forecasts for incremental capacity gains total 1.7-2.2Mnb/d per annum over the next 5 years. This compares to crude oil demand forecast growth of 1.5-2.1Mnb/d for the period 2005-2006. This suggests that limited spare capacity will remain an issue for at least the next five years. This finding is reflected in the EIA’s assessment that spare capacity, which fell from 5.5Mnb/d in 2002 to less than 2Mnb/d in 2003, will remain close to 1Mnb/d in 2005 and 2006.
Tanker Market Performance in 1Q05

Tanker Earnings tumble in 2Q05

Figure 14 shows that crude oil prices continued their upward progress in 2Q05, while tanker earnings performed poorly. Average VLCC spot earnings were around $30,000pd at the start of August compared to a peak of $220,000pd in November 2004, while crude oil prices found a new record level at the start of August breaking through the $65bbl barrier.

This disconnection between crude oil prices and tanker earnings during 1H05 over turns a long term positive correlation between the two time series. Dry bulk rates also performed poorly in 2Q05. However, in contrast to the tanker market, figure 15 shows that the positive correlation between dry bulk rates and steel prices has remained intact with both sliding considerably in the last quarter.

The divergence between tanker rates and crude oil prices looks dramatic and unusual. As discussed in our last report, it is necessary to review the reasons why the relationship between tanker earnings and crude oil prices has been broken.

In section 1, it was shown that the current high crude oil price environment is not primarily the product of artificial factors, rather real structural weaknesses within the crude oil market (exposed by the 2004 crude oil demand surge):

1. the lack of spare crude oil production capacity
2. the lack of spare refining capacity

However, psychological factors undoubtedly also have a part to play in underpinning prices with uncertainty over the real impact of non-commercials in the futures market, and hyper anxiety over the smallest supply disruptions.

The fact that crude oil prices are high primarily because of fears about security of supply rather than high demand explains why tanker earnings have not followed crude oil prices up. However, this does not explain why tanker earnings have fallen so sharply.

Following the Usual Seasonal Pattern

Figure 16 shows that tanker earnings in 2Q05 paralleled closely that path of earnings at the start of each of the last two years.
This established earnings trend coincides with normal seasonal second quarter demand weakness as illustrated by OECD Europe crude oil demand (figure 17).

Other Factors that explain the weakness of tanker earnings during 2Q05

(1) Continued Strong Fleet Expansion, +1.8% in 1Q05

Figure 18 shows that the pace of tanker fleet expansion (up +6.1% in 2004) was unabated at the start of the year with a net increase of 5.06MnDwt (+1.8%) during 1Q05. This increase built on the net increase of 7.8MnDwt (+2.4%) during 1Q05.

Although tanker deliveries were lower in 2Q05 compared 1Q05, scrapping was also down to just over 1MnDwt from 1.5MnDwt.

Tanker Fleet Expands by 1.8% in 2Q05

(2) High Bunker Prices

As discussed in our last report, high bunker prices are continuing to undermine tanker earnings. Figure 20 shows the positive correlation between bunker prices and crude oil prices.

Independent Tanker Investors Keeping a Low Profile in 2Q05 as State Oil Companies Move In

While independent tanker owners have been keeping a low profile throughout 1H05, state oil companies have entered the market. National Iranian Tanker Co has been the biggest mover with orders for 7 VLCCs and 3 Suezmaxes at Hyundai, 3 VLCCs at Daewoo, and most recently (August) 3 VLCCs at Samsung. It is anticipated that Vela and KOTC may also announce multiple orders soon.
In an era when tanker newbuilding prices are at record levels, independent tanker owners are in no position to compete for orders with Middle Eastern state oil companies emboldened by the profits accrued from selling oil at record prices, and not put off by weak tanker earnings or the long delivery times for newbuildings. For example the earliest delivery date for a VLCC is 3Q08.

Despite the increased ordering activity by oil companies, the rate of tanker ordering is still much lower than in 2004 (see figure 21). If current levels are sustained at current levels, total orders for 2005 will reach 25MnDwt which is 12MnDwt down on 2004 ordering.

Investor Activity Fitful 2Q05

![Investor Activity Fitful 2Q05](image)

Tanker secondhand sales were very buoyant up until November 2004 when sales activity peaked at 6.3MnDwt. However, with 5 year vessels close to the price of newbuilds by the end of the 2004, investor secondhand activity has tailed off considerably – averaging 2MnDwt per month for the period December 2004 to June 2005.

The next section looks at the prospects for tanker earnings for the remainder of 2005.

Prospects for Tanker Earnings

This section provides a short term and a long term forecast for tanker earnings

-Short term Tanker Freight Rate Forecast (2H05)

Summary: China has so far had a much less dramatic impact on the tanker market than in 2004 with crude oil imports up just 4% yoy – compared to full year growth of 35% in 2004. However, some commentators believe that Chinese crude oil imports will strengthen during 2H05. This will give a boost to tanker demand. Increased Chinese imports in 2H05 will also act as an accelerator by boosting tonmile demand, which reflects the fact that most trades serving China are long haul.

The market will also be underpinned in 2H05 by solid growth in overall world crude oil demand – estimated by leading forecasters to be in the range +1.9% and +2.5%. Although this growth is well below that achieved in 2004 (IEA, +3.6%), it is still well above the average for the period 2000-2003 (IEA, +1.2%).

With China’s lower profile (so far this year) and lower crude oil demand growth, it is expected that tanker earnings will not match the levels seen in 2004.

The prospect of further strong fleet growth will also act as a drag on tanker earnings prospects in 2H05. It is anticipated that full year fleet growth will reach 6.1% in 2005, which follows on from growth of 6.2% in 2004.

However, the tightness in the crude oil market created by limited spare production capacity and limited spare refinery capacity mean that - during the period of rising seasonal demand in 4Q05 - there is the opportunity for tanker rate spikes towards the end of the year in the event of any crude oil supply dislocations or even a late crude oil demand surge from China.

The following section expands on the theories behind the short term tanker forecast.

Tanker share prices still holding up

As with our last report, the review of the prospects of tanker earnings includes taking a look at the performance of tanker shipping share prices during 2Q05, as it is considered that share price movements provide an alternative perspective on the future strength/weakness of tanker earnings to extrapolating earnings trends or looking at seasonal earnings cycles.

Figure 22 - which plots Baltic Dirty Tanker Index against the Overseas Shipholding Group share price – reveals that
tanker stocks continue to be unaffected by the prolonged period of depressed freight rates or even reduced tanker company earnings in 2Q05 as revealed in figure 23. In fact tanker stocks have followed very closely the trajectory of crude oil prices (and are also in line with general stock market indices such as Dow Jones).

The consensus amongst economists is that (notwithstanding the onset of recession) the high crude oil price environment is here to stay for some time. Therefore, it can be assumed that those investing in tanker stocks believe that tanker earnings in 1H05 have followed normal seasonal patterns and expect earnings to correct upwards in the second half of the year with the onset of increased seasonal demand.

Further strong tanker fleet growth threatens tanker earnings in 2H05

However, as discussed in sections 1 and 2, although tanker earnings have typically tracked crude oil prices (see figure 24), tanker earnings and crude oil prices have become disconnected during 1H05 as a result of specific factors. Therefore, although tanker earnings will receive a seasonal boost during 2H05, it cannot be necessarily assumed that tanker earnings will return to the high levels of last year.

The most significant factor likely to depress tanker earnings in 2H05 is continued strong fleet growth. It is estimated that fleet growth in 2005 will total 6.1%, which follows on from fleet growth of 4.2% and 6.2% in 2003 and 2004 respectively.

The expansion of the tanker fleet has been such that a leading supplier of tanker fleet information reported in August that “after 27 years the tanker fleet has at last passed the December 1977 peak and today we have, officially, the biggest tanker fleet ever”.

Figure 24 shows that in most – but not all – years, tanker rates have followed crude oil prices.
Crude oil demand growth will help underpin tanker earnings in 2H05

The threat posed by fleet expansion will be offset in part by crude oil demand growth. However, forecast crude oil demand growth in 2005 (range +1.9% to +2.5%) is lower than growth in 2004 (IEA, +3.6%). However, it is very important to remember that 2004 was an exceptional year and that growth forecasts for 2005 are well above the average for the period 2000-2003 (IEA, +1.2%).

Nevertheless, crude oil demand growth can not be expected to exert as positive an influence on tanker earnings as last year, especially as there has been no Chinese wild card played so far this year.

More than half way through the year and with Chinese crude oil imports up just 4% yoy – compared to full year growth of 35% and 31% in 2004 and 2003 respectively – the crude oil imports up just 4% yoy – compared to full year growth of 35% and 31% in 2004 and 2003 respectively – the United States has been particularly disappointing with almost no growth in crude oil imports yoy, while Chinese growth (4% yoy) has also been relatively modest – although some commentators expect a second quarter rebound.

In 2005, China and the United States have so far played a much less significant part in growing tanker tonmile demand. The United States has been particularly disappointing with almost no growth in crude oil imports yoy, while Chinese growth (4% yoy) has also been relatively modest – although some commentators expect a second quarter rebound.

The tables below (figures 26 and 27) break down the distribution of Chinese and United States crude oil imports by exporting country.

Long haul trade growth in 2005 will have less impact on tanker demand in 2005

It has been an accepted fact in tanker shipping for more than thirty years that the Middle East with its relatively large crude oil reserves will eventually dominate world tanker seaborne trade. Middle East seaborne trade routes are generally longer than for other export regions.

Tonmile demand is a truer reflection of tanker demand than simply using crude oil demand. It takes into account the distance traveled to deliver each tonne of crude oil. Obviously, long haul trades will generate a higher tonmile demand than short trades for the same amount of cargo delivered. Therefore, long haul trades require more vessels than short haul trades for the same amount of cargo delivered.

The importance of long haul crude oil trades has also been boosted by the preference for sweet/light crudes such as those from West Africa and the North Sea. (Heavy/sour crudes include certain grades from Saudi Arabia, Venezuela and Mexico).

Estimated Annual World Oil Demand Growth 2000-2005

In 2004, China and the United States were responsible for around 50% of the total increase in world crude oil demand. The Middle East was the major source of this extra demand, benefiting from problems with Nigerian and Venezuelan production coupled with declining North Sea production. The dependence on the Middle East for incremental crude oil demand acted as an accelerator for tanker demand in 2004.

China Crude Oil Imports 1995 - June 2005

Source: Global Trade Information Services

Based on crude oil imports for 1H05, Chinese crude oil imports are forecast just 3% higher yoy, following two successive years of 30%+ growth. However, not all trades have suffered. Trade with Saudi Arabia, the largest exporter to China, is projected to grow by 25% in 2005, while Iran (another long haul trade) is projected to grow by 16%.

The tables below (figures 26 and 27) break down the distribution of Chinese and United States crude oil imports by exporting country.
In contrast to China, US crude oil imports are not so dependent on long haul trades. Near neighbors - Canada, Venezuela and Mexico – were the top three exporters to the US last year.

**United States Crude Oil Imports 1995 - March 2005**

Source: Global Trade Information Services

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Saudi Arabia was the largest exporter to the US in 2003, but was only 4th largest in 2004. Its exports fell by 13% in 2004 (based on full year data), and are projected to be unchanged in 2005 (based on 1Q05 data)

Other long haul trades to the US have also suffered during 1Q05. Imports from Iraq and Kuwait, which were up 50% and 13% respectively in 2004, are projected to fall by 23% and 25% respectively in 2005.

**Long term Tanker Supply/Demand Balance Forecast 2005-2010**

Figure 28 compares world crude oil demand and tanker supply (fleet >=10,000Dwt) for the period 2000-2004 and then projects forward for the period 2005-2010.

**World Crude Oil Demand v Tanker Supply**

History 2000-4 & Forecast 2005-10

There are two crude oil demand forecasts: The “low” case is based on annual average growth of 1.3%, which corresponds to the average historical growth rate 1998-2003. The “high” case is based on the IEA forecast (July 2005) of 1.9% for 2005, and 2.1% for 2006. For the remaining period 2007-2010, we assume an annual average growth rate of 2.3%, which is 0.5% higher than the average growth rate for the last 10 years. (The growth rate has fallen below 1.3% on three occasions in the last 10 years – in 1998 (0.5%), 2001 (0.9%), and 2002 (0.8%)).

There are also two tanker supply forecasts: The “high” case reflects deletions based on IMO’s phase-out schedule, and orders based on scheduled orderbook deliveries for 2005-7 and for 2008-10 deliveries based on estimated annual average deliveries for the period 2002-7 (a boom period for tanker deliveries). The “average” case reflects a 20% increase on IMO’s phase-out schedule, and deliveries based on scheduled orderbook deliveries for 2005-7 (as for “high” case) and for 2008-10 deliveries based on 2001 orders (the low point for deliveries in the period 2000-7).

Our forecast position is unchanged in that under both the “high” and “average” supply cases there will be enough tonnage overall to match/exceed the “low”/“high” demand scenarios until 2009. However, in 2010 the sharp acceleration in removals under IMO phase-out schedules will create a potential shortfall of tanker tonnage (1). It should be noted that the forecast methodology is a relatively simplistic approach to supply/demand balancing. For example in the case of measuring tanker supply, there is no allowance for changing trade patterns which impacts on the average transportation distance of a barrel of crude oil (measured in seaborne tonne-miles). This is an important consideration when calculating how far tonnage supply will...
stretch i.e. effective supply.

It is also remains the case that the tanker market is in a potentially perilous position. Today the tanker orderbook is equivalent to 24% of the tanker trading fleet. Under the “average” and “high” supply cases, the fleet is set to expand at between 4.4% and 6.0% p.a. over the next 5 years (2005-9), which is revised up from 4.2% and 5.8% respectively in April 2005, and 3.9% and 5.5% respectively in January 2005. This compares to average demand growth of 2.2% p.a. under the “high” demand case.

Notwithstanding, the growing importance of long haul trades (2), the tanker market will be extremely vulnerable to demand fluctuations during this period. For example, a continuing concern is that China will not sustain its phenomenal growth rates of the last few years.

Therefore, strong crude oil demand growth of 2%+ p.a. and a further significant shift towards long haul trades are the key factors in ensuring consistently strong tanker rates for 2005-10.

If “effective” demand (taking into account tanker tonmiles) falters, it is unlikely that the supply curve will follow either that shown in the “high” or “average” supply cases. It is perhaps more likely that supply will follow a third way or “low” case. With little scope to halt fleet growth through a slow down in orders (the orderbooks are virtually full up to the end of 2007), it is the rump of tanker single hull (as well as double side and double bottom) tonnage that will come under pressure to scrap even more rapidly than in the “average” supply case (20% higher than the IMO scrapping rules demand) in order to slow down the rate of tanker supply expansion.

(1) The majority of tanker single hull tonnage will not be finally phased out until 2010, and even then the Continuous Assessment Scheme (CAS) affords a further extension to the trading life of these vessels. However, as discussed, if tanker rates come under significant downward pressure, this rump may exit the market earlier than the 2010 cut off – especially with the extremely high level of scrap values and opportunities for larger tankers to find alternative employment as storage or FPSO vessels. It is not yet clear how many tanker owners have so far embarked on putting their vessels through CAS, although it is probably only a handful.

(2) As discussed the impact of a shift towards long haul trades was crucial to the strength of the tanker market in 2004. World crude oil demand of 3.6% was effectively boosted by the growth of long haul trades, so that demand more than offset the burden of 6.2% tanker fleet growth. The growing importance of long haul trades will continue in the short and long term. For example, the rapid economic rise of China will continue to foster long haul trades from regions like West Africa, the Black Sea and even the North
A Review of the Tanker Market in 1H05 by Vessel Sector

In order to help highlight the key developments in each vessel segment, a system of rankings has been put together (figure 29) to reflect the development of key performance indicators in 2005. Amongst other things, these rankings show which segment has attracted the most investment so far in 2005, and which has grown fastest.

### The Rankings 1H05
(all figures as % of relevant sector trading fleet)

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<th>Scrap %</th>
<th>Orders %</th>
<th>Sales %</th>
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The above table shows that the Panamax sector remains the most popular sector with investors. The equivalent of 7.8% of the Panamax fleet was contracted during 1H05, which has maintained the orderbook at a level equivalent to more than 50% of the trading fleet.

By contrast the Suezmax sector has received very little interest from investors at the start of the year with orders equivalent to just 1.5% of the Suezmax fleet.

The Panamax sector has the highest delivery percentage for 1H05 (9.5%) and – despite also recording the highest percentage of deletions (2.6%) – is also the fastest growing sector (+7.1%).

The ranking table for 2004 is included here for to allow comparisons to be made with 2005.

### The Rankings 2004
(all figures as % of relevant sector trading fleet)

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<td>26.5</td>
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<tr>
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<td>9.1</td>
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Sector Reports From the Weber Trading Floor

### VLCC Sector

Moving into the fourth quarter, the VLCC sector anticipates its annual rate strengthening, as cold weather consumption in the northern hemisphere plays out its usual supply-demand effect.

Increased demand to meet the winter market requirements puts additional pressure on already balanced tonnage positions. Seasonal eastbound winter cover charters, while not as abundant as last year (note the diminished Chinese demand), still puts increased ton miles into the market, and in turn greater demand on charterers to cover this need. To complicate matters, the serious domestic supply disruptions in the USG following hurricanes Katrina and Rita, while yet to be fully understood in terms of actual lost production and repair schedules, will undoubtedly put further demand on long haul transportation.

As of this writing, tonnage chartered prior to Rita’s arrival in the Gulf was still being juggled and moved about in an effort to get offloaded, thinning the available tonnage pool further.

This loss of domestic oil and gas production has jump-started the fourth quarter, where we have already seen rate levels in the West Africa/USG trade leap from a fairly steady WS 90 market to a fairly hyped-up WS 145 market.

Last years rate levels at this time were averaging in the WS 190's for the WAFR/USG market, soon to jump to WS 242.5 for Q4. In the AG, Eastern trades averaged WS 170 with an increase to WS 240 for the Q4 while the AG/West market averaged WS 127.5, soon to improve to WS 173 for Q4.

Owners are aware that this year the jump off point in all markets lags well behind last years set-up (currently WS 145 for WAFR/USG, WS 100 AG/East and WS 90 AG/West), but it could be argued that last years “China” could this year be “Katrina-Rita”. Certainly owner confidence is seasonally optimistic, and even if rates this Q4 don’t quite reach Q4 2004, owners have an eye to making a good run at them.

### Suezmax Sector

A forward view for the 4th quarter of 2005 shows promise for Suezmax owners. With the net lost USG production (balanced by needed refinery repairs) not returning anytime soon we would expect rates to remain firm for the next few months.

The usual seasonal effect of weather delays in the North Atlantic combined with limited daylight transits in and out of the Black Sea will help to gobble up ton miles from a market that is already thinly balanced.
We have seen the recent emergence of long haul Med barrels from Algeria/Libya and the Black Sea trying to satisfy the U.S. appetite for crude. This combined with an increase in the Atlantic to US West Coast trade and large exports from Brazil and imports into Chile have added to the long haul freight train.

Owners have fond memories of last year’s market, where positive sentiment ruled the day and rates moved dramatically higher in the last few months of the year. The question is can we duplicate last year’s lofty levels? There certainly is more upside potential than downside risk. The only clouds on the near horizon are the VLCC’s who have and will continue to act as a brake on rising Suezmax rates, with traders co-freighting in order to capture the large deltas between the classes.

The new additions to the Suezmax fleet have all been absorbed as longer trades take center stage and ton miles get stretched.

Time charter interest for Suezmax’s has been tame as owners expectations have put their ideas well above the willingness of charterers to commit for term. Time will tell who was the wiser.

**Aframax Sector**

Making accurate fourth quarter projections after the market achieved new highs as a direct result of the Katrinas and Rita hurricanes could make you either a prophet or a gambler. That being said, let’s be prophetic.

Without exception the Aframax markets should trade within narrower World Scale floor and ceiling bands than they have in the first half of the year. While possibly not maintaining the present strong levels for the remainder of the year, as we move into 2006 we will look back at a firm 2005 for Afras.

While the Caribbean market may be stealing all the thunder with its lofty World Scale rates, a quick glance at the gathering strength of the Med and the UKC markets points to a far less segmented global Aframax market and to the realization that all Afra markets are now inextricably linked.

**Panamax Sector**

As cold weather approaches, the 4th quarter looks hot. We enter the 4th quarter on the heels of a rising market sparked by the relentless pounding of the USG by Katrina and Rita. As a result of the reduction in production capacity, end users will be forced to look overseas to meet expected demand. The increase in ton miles combined with the seasonal delays usually associated with the onset of winter should add fuel to the existing fire.

Owners have become increasingly bullish as they recall the similarities between the current market conditions and those of 4th quarter of 2004. Much of the same underlying factors which held the market up in 04 are again present in 05. As a direct result of these factors owners are reluctant to pursue time-charters. With charterers offering as much as low 30’s for 1 year without enticing any takers, one can easily imagine owners expectations of the next few months.

It takes more than expectations to make a market, however a quick glance around at the fundamentals should be enough to convince even the most bearish that there may be some reason to expect another strong 4th quarter.

**Product Sector**

As we move into the fourth quarter of 2005, we look back on a year of remarkable volatility in the product sectors. As end users worked hard during most of the year to continue building up domestic inventories in spite of strong oil pricing, there was some mid-year concern over fourth quarter freight rates. However, with Hurricanes Katrina and Rita now behind us, it seems safe to predict that the year will finish off with quite a bit of strength.

Extensive delays quickly developed on the USAC and the USG as significant volumes of clean product were fixed from Europe, or diverted from other load areas into the US Gulf. The uncertainty of these positions added fuel to the fire by further reducing tonnage availability, as owners were unwilling to work with uncertain itineraries, which at times seemed to change on more than a daily basis. While delays seem to be working themselves out at this point, current conditions continue to be conducive to more long haul voyages.

With a number of US Gulf refineries expected to remain closed for repairs for some time to come, it is clear that the only alternative sources will be from overseas. We have seen continued strong activity in the MR sector from Europe and the Far East into the States, including an increase in Far East/USG voyages. In fact, according to our fixture database, during the period August 29 (the first post-Hurricane Katrina fixing day this year) through September 30, the number of Cont/States MR fixtures in 2005 is fully double that of the same period in 2004. As of October 5, 2005, the American Petroleum Institute reported that some 20% of U.S. refining capacity remained shut-down, or at least still in the process of being restarted, and the Energy Information Administration reported on October 6th, that the previous week, ending September 30th, had seen record
gasoline imports, averaging over 1.4m bbls/day. In the same report, the EIA reported that gasoline inventories had fallen by 4.3 million bbls from the prior week, and distillate inventories had fallen by 5.6 million bbls during that period. This week's EIA report is expected to see a similar draw on inventories.

With such conditions hovering over the clean market, it is anticipated that demand for product vessels will continue to be robust, certainly for the balance of the year. Even if domestic demand for refined product continues to decline due to continued pressure from recent high pricing, the shortfall in output from domestic refineries will require additional importing for quite a while, until all of the refineries are back up and running. The increased ton-miles resulting from sourcing product in Europe and the Far East will increase pressure on tonnage availability during this period, and should therefore keep rates strong through the entire fourth quarter.

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