

## **Our View: A Distillate Constraint Confronts the Global Economy**

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World environmental regulators have, in general, banned sulfur in gasoil (a.k.a. distillate fuel or diesel fuel), a key fuel in the shipping, travel, and agricultural industries. The production and supply of this crucial is limited due to the chemical nature of crude oils, most notably their sulfur content. For this reason, diesel, jet, and marine fuel prices will likely stay very high until and unless the global economy slumps into a deep recession that depresses demand. This constraint is something oil exporters can do little to address in 2022 or the future.

The distillate supply limitations exist for five reasons. First, crude oils produce various products on distillation, only a portion of which is diesel. This fact is well understood. Second, the amount of distillate produced from a crude varies according to type. This fact is also well understood. Third, the supply of crudes containing essentially no sulfur and thus more easily producing low-sulfur distillate has been declining. This issue is not as widely understood. Fourth, the distillates refined from most crude oils, that is, those with higher sulfur content, must have the sulfur removed to meet the sulfur standard requirements and produce less distillate than light, low-sulfur crudes. Related to this is, our fifth and last reason, the fact that such desulfurization capacity is limited and expensive to construct. Most outside the industry are unaware of these last two factors. At this point in 2022, these considerations have combined to limit the low-sulfur diesel supply.

Today, the gasoil supply squeeze has resulted in a “hoarding premium” of almost \$18 per barrel. I attribute the \$18 hoarding premium today to five factors: the increased demand for low-sulfur diesel, a decline in Nigerian oil production, the limited desulfurization capacity, the substitution of gasoil for natural gas in Europe, and the sanctions imposed on Russia.

The rising prices for distillates, particularly the low-sulfur types, will do little to depress demand for the fuel. Distillates are consumed primarily by intermediaries such as shipping companies, railroads, agricultural enterprises, or truckers. The demand for their services is very price-inelastic, and fuel costs do not account for more than thirty or forty percent of operating costs.

Consequently, distillates could pull crude prices to unimaginably high levels absent a significant economic slowdown. Three years ago, I fretted that the intransigence of the International Maritime Organization could take crude to record highs given the refiners’ inability to meet the demand for low-sulfur diesel. The current market conditions for diesel warn that these concerns may become a reality.

For more on this, see [Notes at the Margin](#), April 18, 2022.