LNG Market Brief

COVID-19 shocks are accelerating current LNG market transformations

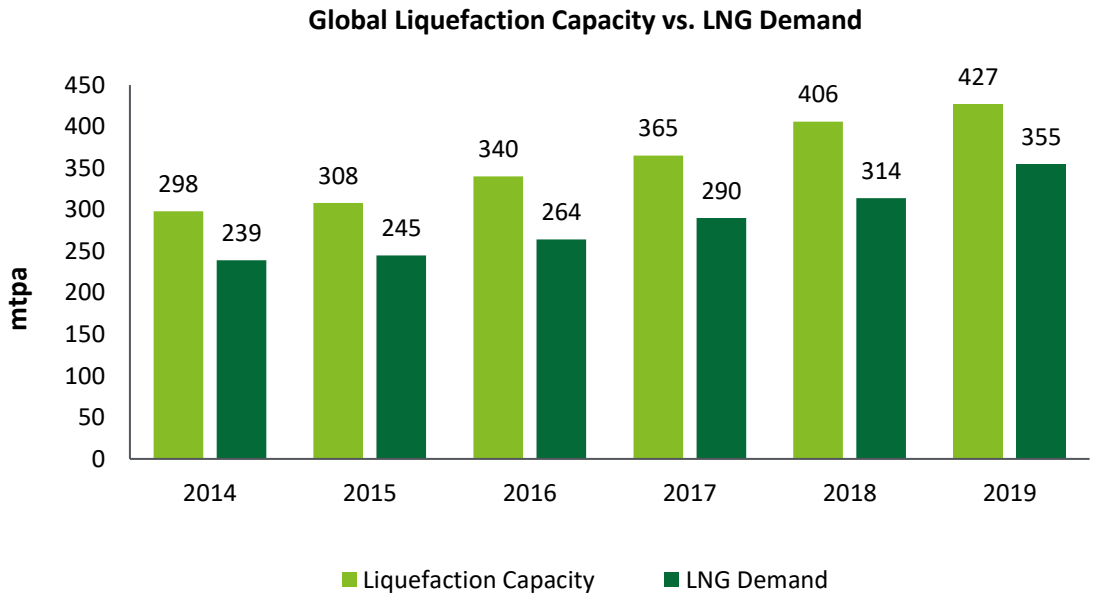
Since the COVID-19 outbreak, global gas markets have faced dramatic demand shocks, which have depressed global gas prices and increased the global oversupply of liquified natural gas (LNG). These volatile market movements have also challenged the economics of greenfield LNG investments, the viability of existing LNG projects, and the profitability of LNG trading.

Even prior to the impacts from COVID-19, excess supply overhang and decreases in demand from established markets had begun to reshape traditional LNG commercial structures. In recent years, LNG buyers' appetites for global and regional LNG price indices and more flexible LNG supply contract terms have increased alongside the development of a more robust LNG spot market. The economic impacts from government responses to COVID-19 have bolstered these emerging trends in the LNG markets. This brief will explore how COVID-19 responses have accelerated these trends, and discuss whether the COVID-19-related gas demand shocks could result in long-term changes rather than just short-term adjustments to global LNG markets.

LNG market oversupply and the continuation of a buyer's market

Gas demand globally has declined as countries attempt to control the spread of COVID-19 within their borders. According to the International Energy Agency, global natural gas demand is expected to fall by 5% in 2020 due to the economic impact of COVID-19.[1] While COVID-19 has triggered a significant demand shock for LNG, a growing supply surplus in the market created by increased investment in liquefaction capacity was already depressing global prices. In 2019, global liquefaction capacity reached 427 million tonnes per annum (mtpa), while global demand was only 355 mtpa.[2] The mild winter in Europe during 2019-20 further strained efforts by LNG suppliers to find offtakers for their cargos.

[1] International Energy Agency, Global Energy Review 2020, April 2020
[2] GIIGNL, GIIGNL Annual Report 2019, April 2020



Source: International Group of LNG Importers (GIIGNL), GIIGNL Annual Report 2019, April 2020

Europe has traditionally acted as the market of last resort to absorb surplus Atlantic basin LNG cargos, due to the market's high degree of liquidity and storage capacity. However, lower global demand for LNG and limited available European storage capacity have rendered multiple sources of LNG uneconomic for European delivery (in April 2020 TTF fell below Henry Hub and has been below $2/MMBtu since then).[3] Utilizing the higher flexibility in US LNG contract agreements, some buyers are deferring or canceling delivery of cargos due to current market conditions, though continuing demand charges provide partial cashflow support to terminals. These US LNG cargo deferrals and cancellations are unlikely to balance the spot market near-term given the significant LNG supply surplus.

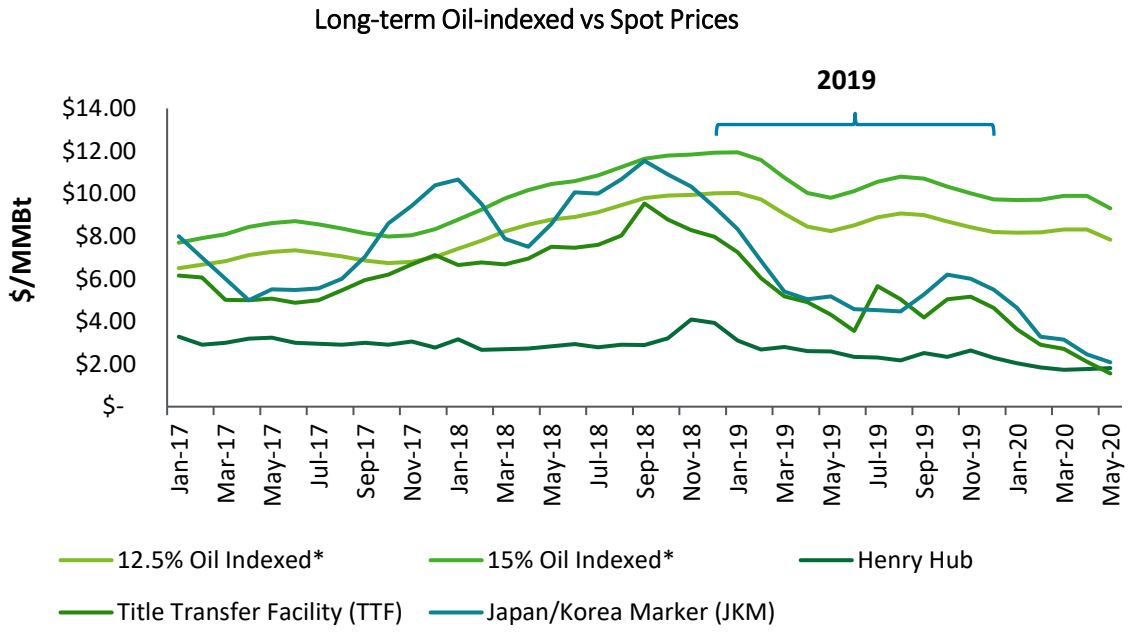
Low gas prices will likely exacerbate this market imbalance in the short-term, but could potentially help balance the market in the medium- to long-term. Because of the current low-price environment, many anticipated final investment decisions (FIDs) for liquefaction projects are being delayed by 1–2 years, which could contribute to a tightening of the market in 3–5 years if demand recovers, as previously expected capacities do not come online.

Increasing attractiveness of the spot market

As a result of the growing LNG supply-demand imbalance, many offtakers with commitments to more expensive, often oil-indexed, long-term supply are seeking cheaper spot cargoes and looking for opportunities to postpone higher-priced committed volumes. While market conditions during COVID-19 are increasing the attractiveness of the spot market to buyers, LNG oversupply started causing the divergence of spot and long-term pricing in early 2019.[4] Further, the amount of LNG traded on a spot or short-term basis has been steadily increasing in recent years, reaching 119 mtpa or 34% of global LNG trade in 2019 (compared to 77.6 mtpa or 27% in 2017).[5] As a result, existing and potential LNG importers are likely to migrate toward the purchase of cargos on the increasingly liquid and price competitive spot market in the near term. This trend could accelerate the development of an LNG price index, as the number of transactions on the spot market

[3] Bloomberg, TTFG1MON Index, May 29, 2020
[4] GIIGNL, GIIGNL Annual Report 2019, April 2020
[5] Ibid

increases, and LNG global prices become more consistent and transparent. LNG could eventually price with a credible spot market term indicator in the same way that the Brent oil price has become the international oil price benchmark. Once again, while COVID-19 reinforces this trend, multiple factors have encouraged buyers to move toward more spot market purchasing.



*oil-indexation formula assumptions: 3-month Brent crude price lag, fixed component of $0.50 for volumes to Japan
Source: Bloomberg, JKL1 COMB Comdty; TTFG1MON Index; NG1 Comdty, May 29, 2020

Long-term Contract Terms Evolution

The decrease in LNG demand due to market responses to COVID-19, especially in Asia, has increased tensions between buyers and sellers engaged in long-term sales purchase agreements. Just as suppliers are struggling to find offtakers for their LNG, buyers are struggling to absorb committed cargos in the face of lower energy demand from industrial and commercial customers. This supply/demand imbalance is reinforcing LNG buyers' desire for contract flexibility and alternative pricing mechanisms. In recent years, contract terms have begun to shift in response to changes in the market; oil-indexation slopes[6] have declined, hybrid pricing mechanisms (oil and Henry Hub) have been introduced, and destination clauses on some contracts have been removed. The current LNG market has highlighted the price risks of oil-indexation for buyers, increasing the desire for an LNG price index that more directly reflects gas market fundamentals, with less dependency on crude oil prices. While buyers search for a viable alternative to oil-indexation, some sellers and cargo financiers have less comfort with the alternatives to more traditional pricing and contracting models, particularly for long-term contracts. COVID-19 may help galvanize support for regional LNG price indices, although a liquid and bankable LNG price index will likely take years to develop. As a result, long-term oil-indexed contracts should continue to underpin liquefaction and LNG-to-power projects requiring creditworthy offtakers and long-term supply agreements. Portfolio players will likely expand their role and share of the market, optimizing cargos to respond to increasing supply diversification and flexible contract terms.

[6] Oil-indexation refers to when the delivered LNG price is made equivalent/at a discount/at a premium to the price of crude oil on a thermal equivalent basis. A lower slope, below 16.7% implies that LNG is sold at a discount to oil. See NatGas.info for more detail.

Conclusion

The spot market is becoming increasingly attractive to many LNG cargo buyers as a result of COVID-19 conditions, accelerating recent trends toward escalating spot and short-term purchases rather than longer term contracts. This market dynamic will likely support an accelerated transition to more buyer-friendly long-term contract structures and alternative pricing mechanisms. These market dynamics could also accelerate the balancing of the LNG market in the coming years, as sponsors postpone FIDs for new liquefaction projects and additional LNG buyers emerge. With the support of financiers and project sponsors, these changes could drive long-term transformations to the LNG market, including the creation of additional liquid LNG price indices outside of Europe and widely accepted contract flexibility for emerging LNG buyers.

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