LNG in transition: Navigating an evolving market

Are the changes reshaping the market structural or short-term?

By Paul Harrison, Micah Sadoyama, Matthew Secomb and Alexander Woody

Significant energy market developments are raising questions for LNG sector players in Japan and worldwide. Following massive growth in the number of LNG production and export facilities, end-users and shipping capacity, the market is moving toward commoditization. For buyers and sellers, the implications are still playing out.

Changing market dynamics

The demand for more flexible contract terms is a key driver in the increasingly liquid and liberalized LNG market. Flexibility is critical to the growing number of smaller buyers who want smaller quantities of LNG—primarily for LNG bunkering and LNG-to-power projects using Floating Storage and Regasification Units (FSRUs). But traditional buyers are also demanding more flexibility, including shorter-term contracts, rights to divert cargo from one destination to another and rights to adjust quantities.

On the seller side, the growth of portfolio suppliers is having an impact. With their numerous sources of LNG, these aggregators can offer competitive prices. Yet to optimize their portfolios, sellers also want flexibility (as to ship size and source selection, for example).

Deregulation is another factor shaping Japan's LNG market. Competition is increasing among domestic retail electricity providers. LNG importers must now more carefully manage costs, which they cannot necessarily pass on to their customers. The uncertain future of nuclear power has also contributed to these buyers' reluctance to make long-term contractual commitments to LNG, which is perceived as the more expensive option.

Looking ahead, renewables will continue to play an important role in Japan's energy mix. And in the next five years, the expected huge growth of the Chinese market will also be a driving force in the LNG industry in Japan, altering the market with more trading, greater liquidity and a larger volume of gas.

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Challenges for new LNG projects

These changing market dynamics are testing the traditional LNG project financing model, which is typically based on long-term agreements with creditworthy offtakers for substantially all of the LNG produced by the relevant project. Given lenders' requirements and developers' desire to ensure a robust and long-lasting revenue stream, it has been difficult to finance multibillion-dollar projects based on offtake contracts with more flexible and/or shorter contract terms or with smaller buyers with weaker credit.

Market dynamics may therefore create opportunities for portfolio players—to the potential detriment of established buyers. While projects cannot obtain financing based on flexible/shorter contracts or on smaller buyers, a portfolio company can execute the long-term contract the project needs to secure financing and then sell its supply to any buyers and on any terms commercially acceptable to that seller. In this way, aggregators can fill the gap between the credit required to support project financing and the demands of smaller buyers, although developers will want to ensure that the entire equity upside does not move to the portfolio company. As aggregators and their portfolios become bigger and more able to drive the market, established buyers may need to consider the implications: Are price and flexibility more important to them than losing control of the market and, in turn, the strategic benefit of diversified supply?

Approaches to price reviews

Traditionally, long-term LNG sale contracts contain provisions for periodic price reviews in an effort to align the contract and market prices. Historically, Asian buyers have tended to resolve price review difficulties through commercial negotiation, shying away from arbitration. But this practice is increasingly stressed due to deregulation and increased pressure to be competitive in their markets. If a buyer's competitors can import LNG at recent market prices that are lower than the price under a buyer's long-term contract, the buyer will be at a significant competitive disadvantage. These pressures suggest arbitration has real potential to address this challenge.

Paradigm shift or phase?

Many of the changes in the LNG market seem long-term. The emergence of small buyers and small-scale uses will likely continue, as will the trend toward shorter contracts and greater flexibility as well as increased pressure on pricing. While some contracts will continue to be relationship-based, it is likely that, where buyers and sellers have divergent economic incentives, pressure on buyers' bottom lines will force them to be less accommodating. The implications of these trends for greenfield project financing are not yet clear, although the emergence of portfolio companies is one way to square the circle. It will be interesting to see how traditional buyers, who have previously viewed their LNG purchases more strategically, react to this development.

Furthermore, renewable energy projects will have a significant impact on the LNG market going forward. This does not mean that renewables will replace LNG-to-power in the short to medium-term. In fact, it should be possible to combine the two to good effect—LNG, which is relatively low carbon (certainly compared to coal), may prove especially valuable in the transitional period as the renewable energy market develops and becomes better able to support baseload supply.

In the longer term, when battery systems become more reliable, economic and commercial, more questions will arise. But there is reason to believe LNG will have an ongoing role in supplying Asia's power. Despite its promise and importance, renewable energy has limits. For example, challenges may include the robustness of the transmission grid and geographic factors that affect the feasibility of installing solar panels or wind turbines. These factors suggest that LNG is likely to remain relevant.

For now, given the changing dynamics in the LNG market and the potential impact of renewable energy, buyers and sellers will have to live with a degree of uncertainty.

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