What Does the Post-pandemic LNG Market Look Like?

- Assessing Impact on Demand, Pricing & Contracting

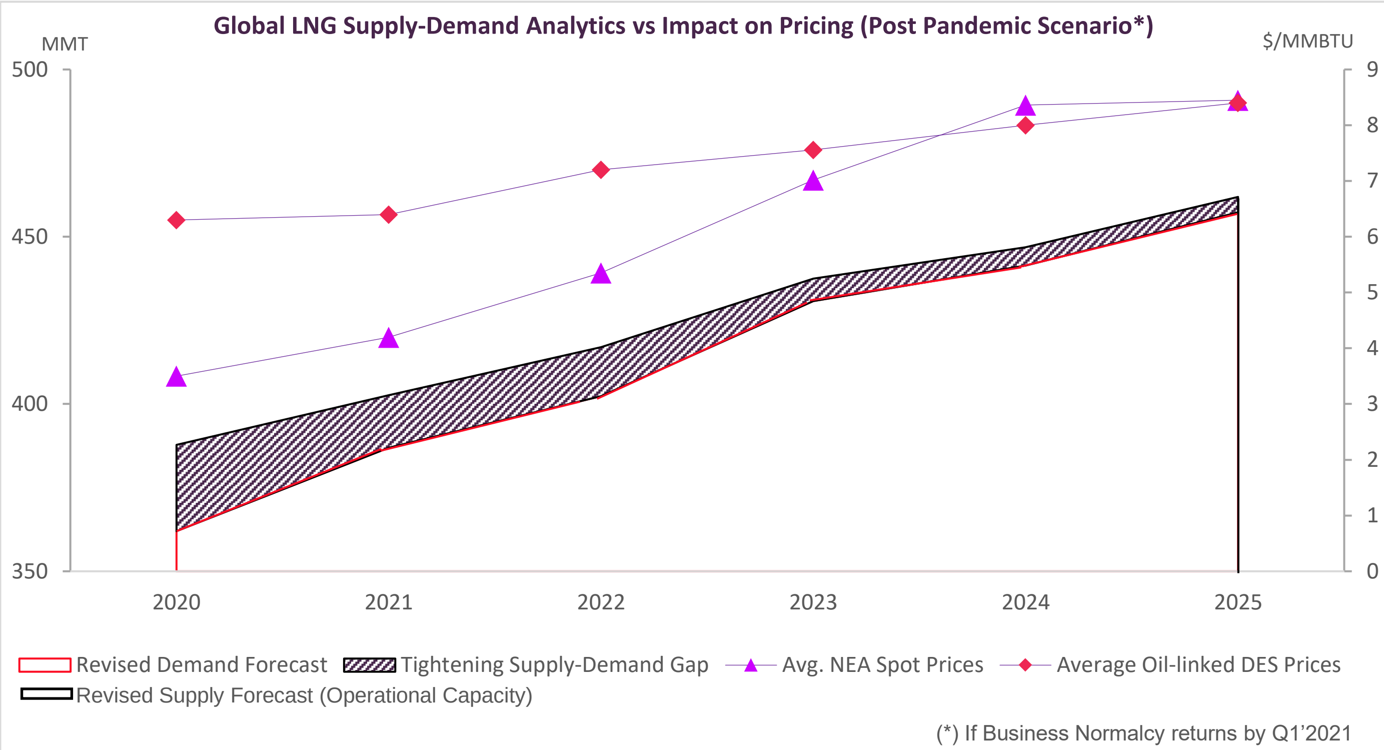
Medium Term Outlook (2021–25)

What Does the Post-pandemic LNG Market Look Like?

Before we delve into the post-pandemic scenarios, here is a quick recap of the developments in the LNG market: The first six months of 2020 were one of the most turbulent phases for the market. The industry battled record low prices (JKM slipped to as low as $1.825/MMBTU in Apr'20), depressed downstream demand, force majeure notices, DQT requests, tank top situation, and increased concerns over the viability of projects and buyers eluding long-term contracting. The already apprehensive market participants became more pessimistic about what 2020 would offer to the oversupplied LNG market.

Surprisingly, on the contrary, the LNG market has proved to be more resilient in the face of the pandemic so far, compared to that of the impact on the oil market.

Going forward, in the medium-term outlook (2021-25), Evalueserve believes that the LNG supply-demand situation will start to tighten by 2023, resulting in higher spot prices and buyers aggressively looking for supply security at a more competitive pricing. For suppliers, the market will become highly competitive when the impact of COVID-19 eases. They are expected to focus on effectively managing their expiring volumes while securing offtakes and financing for their struck projects.



On the demand side, though resilient, but repetition of the growth story of the last decade in 2020 is highly unlike. LNG demand, in 2020, is expected to hover at single digits or even in the negative compared with the ~13% growth in 2019. Rising cost-competitiveness of LNG, coupled with a push for cleaner air, will propel LNG demand recovery to the pre-COVID levels by 2021 (if business normalcy is obtained by Q1'21). Asia-Pacific will lead the uptrend due to expected strengthening of macroeconomic fundamentals and widening domestic gas connectivity.

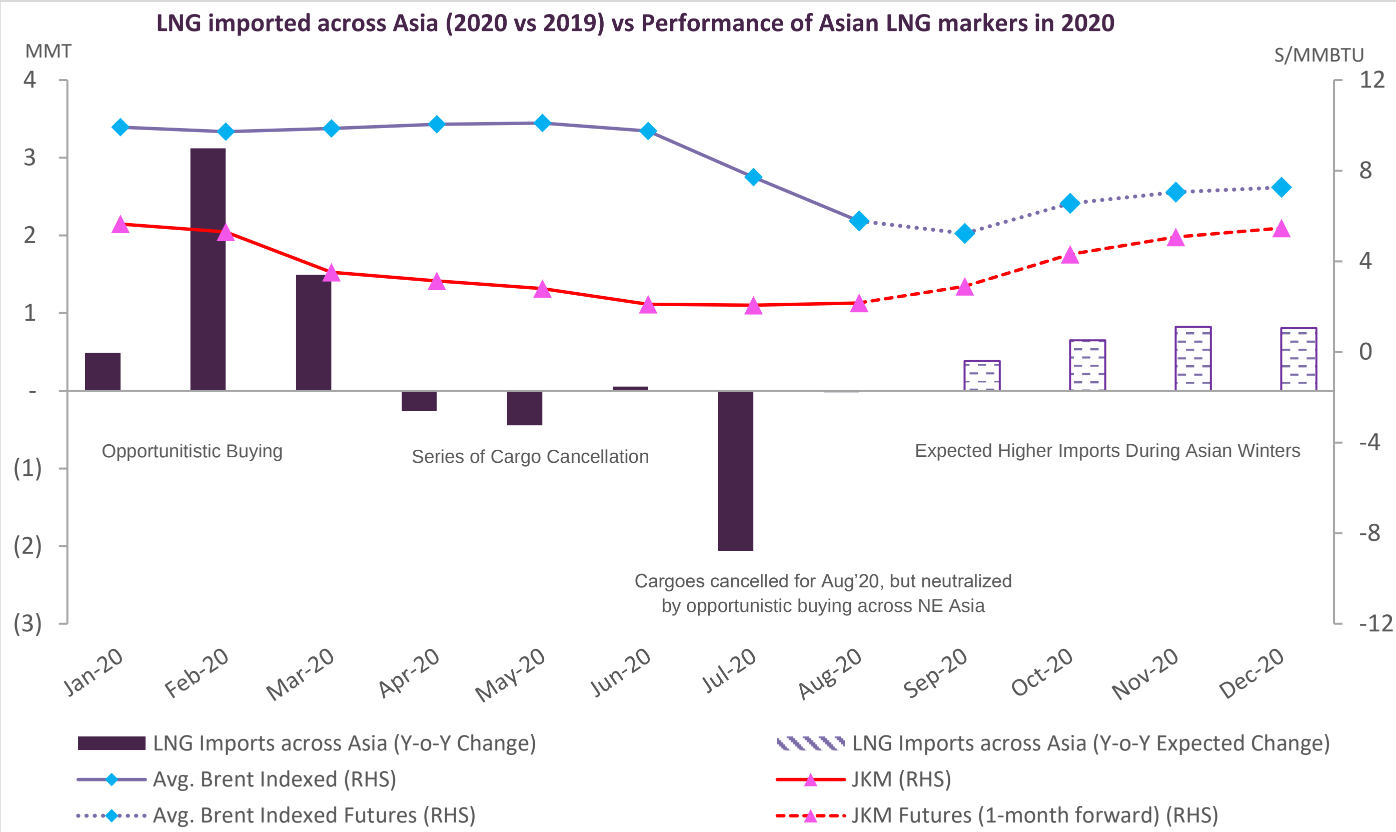
Sellers on the other hand will benefit from strong demand fundamentals (despite COVID-19) across key centres. In the long term, due to increased competitiveness of LNG, COVID-19 could lead to additional LNG penetration and a wider Tier II and III customer base. Although the current bargaining power of buyers will be short-lived, suppliers will need to be proactive in H2'20 and 2021 amid the intensifying competition.

As the supply-demand dynamics changes over time, we can expect an impact on the pricing, contracting, indexation, and long-term sustainability measures. In this report, we will tackle the following questions:

- Has the market really been that grim across Asia? What does the rest of 2020 have in store?
- Contracting in 2020 – what will be a 'Win-Win' situation for buyers, suppliers, and traders/aggregators?
- Post-pandemic roadmap for LNG contracting – what are the buyers looking for?

Is the market really been that grim across Asia?

Despite the panic that had gripped the market following cargo cancellations and force majeure notices, NE Asian and subcontinent countries continued to absorb most of the excess global LNG supplies in 2020, as also predicted by Evalueserve in an analysis published in Q1'20. The region observed opportunistic buying, first by subcontinent countries in Q1'20 and then by Tier II & III Chinese buyers, as the COVID-19 situation eased.



As per the data from the General Administration of Customs, China recorded a 29.2% and a 13% Y-o-Y increase in LNG imports in Jun'20 and Aug'20, respectively. India also reported a 6% Y-o-Y increase in Jul'20, despite the prevalent monsoon season and record number of COVID-19 cases. A similar increase in LNG demand was seen across South Korea, while Bangladesh procured its first-ever spot LNG in Aug'20.

What can we expect during the rest of 2020?

As major LNG demand centres across the globe have begun easing lockdown measures and are gradually opening up the economy, thick pockets of LNG demand started to appear in early Q3'20, particularly across Asia.

The uptick in LNG demand has had a significant positive impact on global price markers. In Aug'20, Platts JKM witnessed an almost 46% increase, while Brent-indexed term prices started to recover after seeing ~50% reduction in Q2'20. The trend is likely to continue during the rest of 2020 amid moderate growth outlook for Brent prices, increased LNG competitiveness in 2020, and the upcoming winter demand season.

As per the latest weather predictions by Maxar Technologies - Below-normal temperatures are forecasted for Northern China, while near-normal temperatures are expected for the rest of JKTC - marking a significant improvement over last year's unusually warm winters, in turn, supporting hopes of higher demand in 2020.

With winter just around the corner, it can be safely assumed that the worst for the LNG market is over and a rebound is the most likely possibility. As per Evalueserve estimates, the cumulative LNG imported across Asia is set to witness a moderate increase in 2020; though, growth is likely to be very low compared with the pre-pandemic levels. However, external factors such as the second wave of COVID-19, warmer than usual winter, economic stimulus, rate of implementation of domestic infrastructural projects, and trade/geopolitical tensions may impact both demand as well as future prices.

Did contracting activities slow down in 2020?

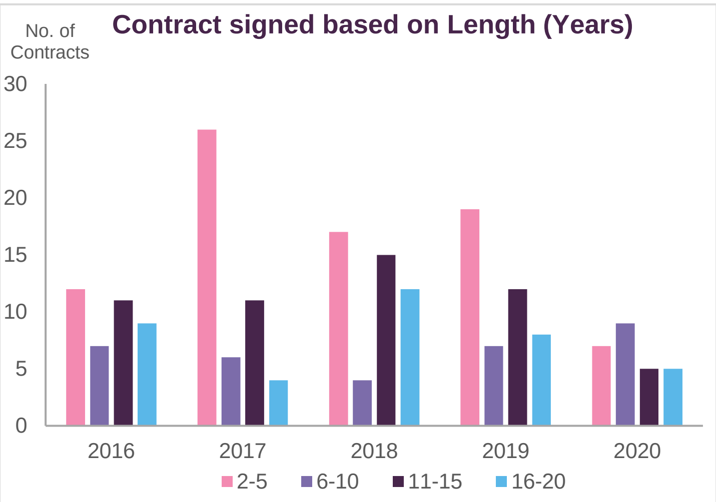
During Q1'20, there was a prevalent market sentiment that the 'urgency to sign LT contracts has decreased amid COVID-19, which is going to impact the number of new contracts to be signed in 2020'. In addition, several C-suite executives expressed fear that travel restrictions would reduce face-to-face discussions and slow down contracting activities.

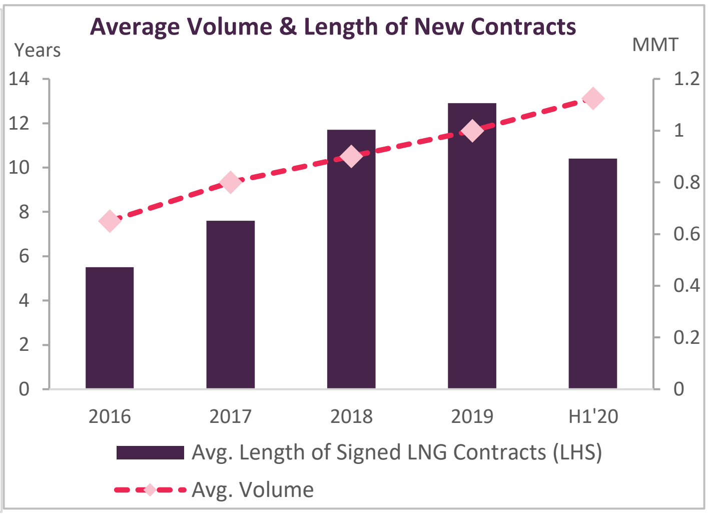
However, 24 new contracts were reportedly signed in H1'20, up ~70% Y-o-Y. Overall, 26 new contracts have been reportedly signed this year. Contract discussions picked up significantly towards the end of the second quarter when countries started lifting COVID-19 restrictions.

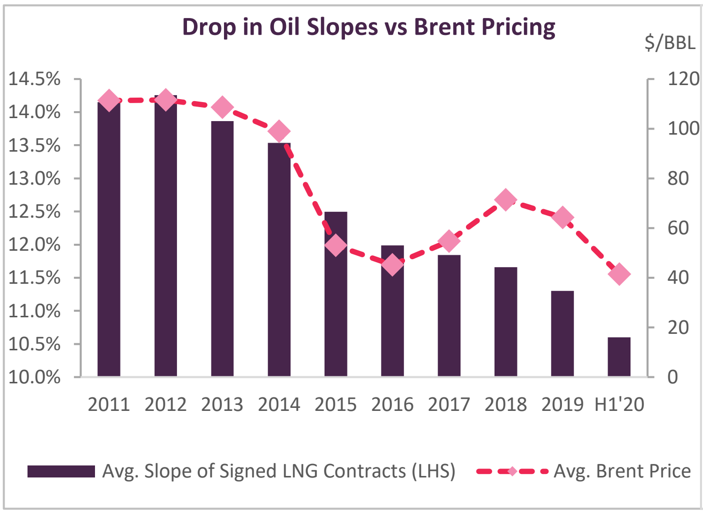
Unlike the trend seen in previous years where equity investment was a hit among buyers, ~18 contracts in H1'20 were from legacy projects with scheduled contract expires. As most of the legacy projects had already achieved expected returns, plants offered greater flexibility and enabled players such as Qatargas to secure new contracts. However, the average length of the contracts was 6–7 years compared with an average of 15 years signed with greenfield projects.

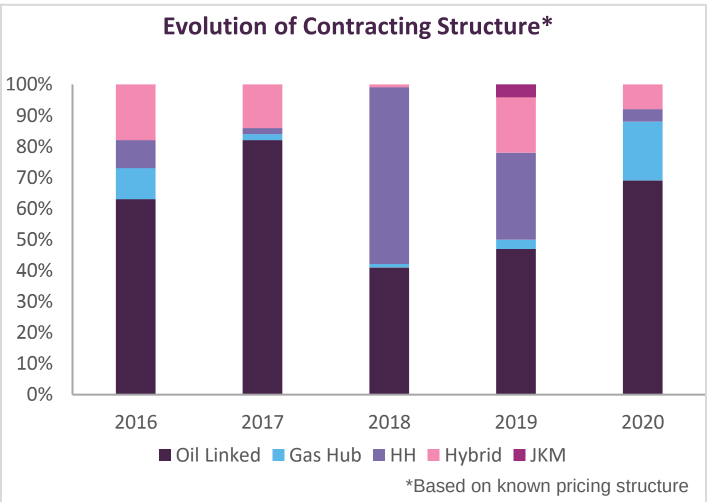
Legacy players such as Qatargas have remained highly active in manoeuvring their cancelled/deferred cargoes and securing new contracts. Qatargas' 15-year, (up to) 3 MMTPA contract with Kuwait Petroleum was the first in 2020. The latest contract (at the time of writing of this report) was Qatargas' rumoured deal with Sinopec for a 10-year, 1 MMTPA LNG supply secured via competitive tendering at a 10.19% oil slope.

LNG Contracting Evolution









Note: The exact terms of deal remain classified. The above information has been taken majorly from company & media reports, as well as primary research conducted by Evalueserve with industry stalwarts.

Contracting in 2020 – 'Win-Win' situation for buyers, suppliers & traders/aggregators?

Despite the rising questions around the viability of term contracting and pricing sustainability, Evalueserve believes that contracting discussions will remain on the higher side for the remainder of 2020 as well as for 2021. The primary reason behind our forecast is the reinitiating of negotiations for several of the 50+ ongoing new term deals (~52% were reportedly across Asia, majorly China and Southeast Asian countries).

LNG players (particularly suppliers from Middle East & Australia) would also be keeping a close watch on the outcome of US elections (scheduled in Nov'20), which may decide the fate of the trade tensions between the US-China – a key factor for a large number of expected LNG deals.

As the supply-demand gap decreases, buyers/traders/aggregators will need to leverage the situation created by the pandemic to their benefit and secure enough LNG supplies at competitive pricing. Suppliers may witness renewed competition in 2021 as they race to attain FIDs and place their expiring (+new) supplies. Therefore, the remaining months of 2020 as well as 2021 needs to be effectively managed by value chain players to ensure that they attain a 'win-win' position in contracting.

	Buyers	Legacy Sellers	Greenfield Developer	Traders/Aggregator
Motivation	Leverage the pandemic to secure long-term supply at competitive pricing	Large number of upcoming contract expiries, can afford new pricing structures sought by buyers	Any new deal could provide the much-needed financial stability to move ahead with the project	Opportunity to ensure competitive supply portfolio for the future, when supply-demand gap decreases

Strategies of Value Chain Players

Win-Win Situation – Why players across the value chain are returning to the negotiation table?	
Buyers	Buyers believe that the current low prices are a 'temporary' cushion and thus they are looking to aggressively push for the lowest slopes to ensure supply security at competitive pricing. They are also of the view that (if contracting activities are delayed further than 2020) - The market may become supply deficient, making it difficult to secure competitive pricing post pandemic.
Legacy Sellers	Marketers of most of the legacy projects have their finances managed and cost recovered (e.g., QG, NLNG), which offers them the flexibility to agree to the desired low pricing slopes, structure & terms of the aggressive buyers in the market. Additionally, they need to secure a new destination for their expiring volumes, before competition from greenfield project developers starts to kick in.
Greenfield Project Developers	Most greenfield project developers have been most affected by low oil & gas prices as well as are facing increased pressure from investors over project delays. Any new deal signed during the pandemic will provide some financial cushion to these players and in turn, could ensure timely advancement of their projects, which is set to face stiff competition in 2021 and beyond a large number of project developers aggressively engage to secure deals from limited pool of buyers post 2020.
Traders/ Aggregators	Sensing the need to ensure supply security at competitive pricing and ensure better trade margin gains in the future, they are moving ahead to strike long-term supplies. Players such as Vitol, Trafigura have remained as one of the most active players in contracting discussions during H1'20.

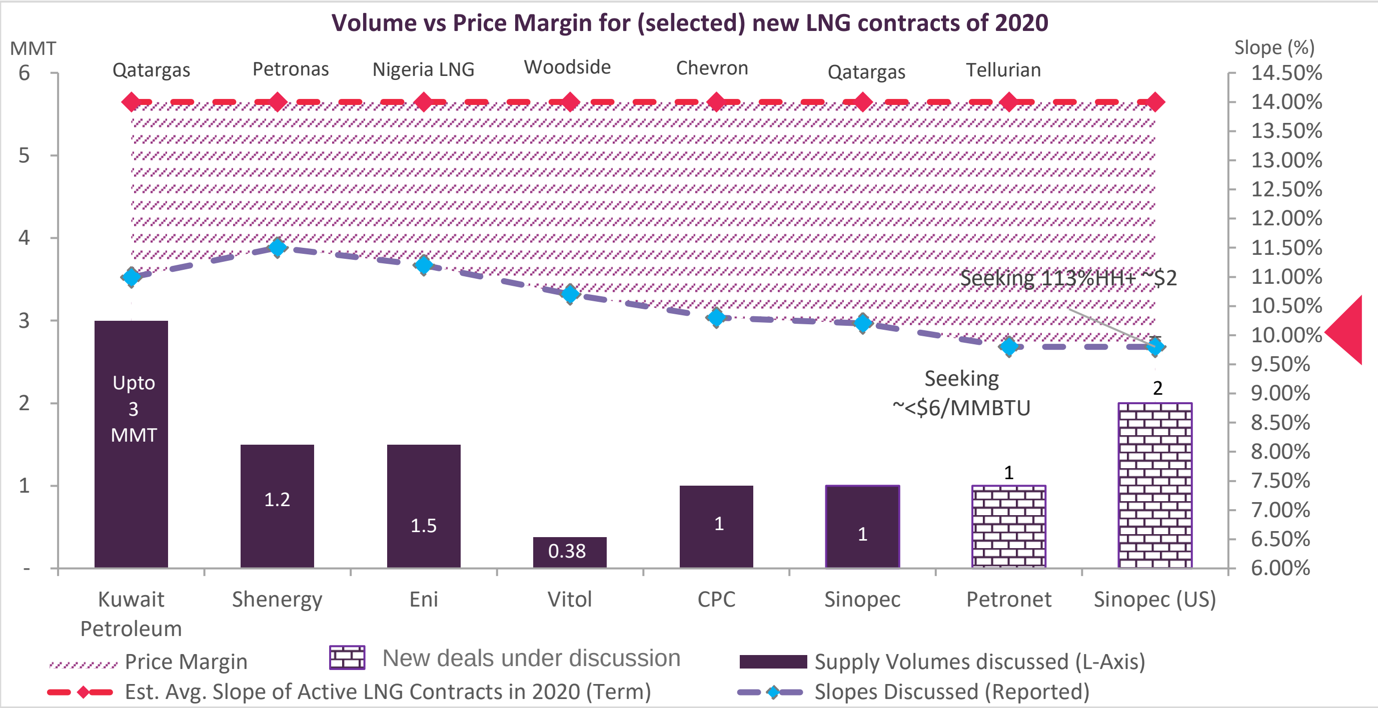
How have contract prices for term deliveries evolved?

Our analysis of the recently signed term deals as well as those under discussion tells us that buyers are seeking prices as low as 10% Brent indexation. Similarly, as per reports and industry experts, the second wave of US LNG project developers has reportedly received price requests to as low as 113%HH+$1.93/MMBTU – when compared with that of 125% HH +$3.5/MMBTU (average) received by the first wave of project developers.

Why have the prices slumped?

The current volatility in global macroeconomics and demand disruption have delayed FIDs for multiple greenfield projects (majorly second wave projects). Buyers (particularly Asian) have realized that their commitment for offtake is highly essential for these project's developers. In a bid to avoid competition and project delays, several sellers are reportedly agreeing to the competitive prices sought by buyers.

On the flip side, legacy plant owners, such as Qatargas and NLNG (whose DES slopes have averaged 13–14%), could afford a 10–11% slope, as their costs have majorly been recovered. The sudden reduction of slopes by Qatargas to low 10% – *a requests which it tried to pass for a long time, will change market dynamics significantly*. This low 10% pricing is going to pose tough questions for sellers from greenfield projects, and might even result in some project cancellation.

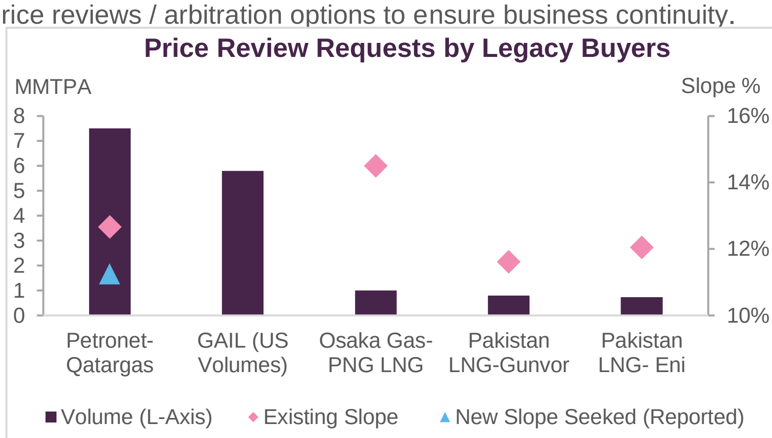


Price reviews – Growing pressure on legacy buyers to ensure competitive supplies

The collapse of spot prices, competition in domestic markets, and low-priced contracts by new buyers (due to market liberalization) are forcing legacy buyers to consider price reviews / arbitration options to ensure business continuity.

Legacy buyers such as Petronet and Gail have aggressively bid for price reviews. It is reported that Japanese buyers have become 'more aggressive in price reviews' and have even considered arbitration options – a rare practice in Asia.

Although sellers wouldn't want to reduce the pricing for the existing supplies, can they afford to lose out on legacy buyers, particularly amid the slump of slopes for the new supplies?



LNG contracting – Way forward after the pandemic

COVID-19 has highlighted a major fault in LNG term contracting. Prior to the pandemic, many legacy players had not considered clauses that define measures (force majeure or cargo deferment/diversion) to mitigate unforeseen situations such as those created by the pandemic. Many buyers wanted to follow similar suite of force majeure/cargo cancellations announcements, that were reportedly taken by CNOOC and Petronet, but couldn't, as their contract didn't allow such flexibility.

However, if the COVID-19 crisis prolongs, disagreements between buyers and sellers could increase and buyers may not shy away from taking more aggressive steps.

Few of the additional developments across contracting that we foresee taking place in the near future are:

Greater operational flexibility

Inclusion of force majeure clause

LNG contracting discussions may steer towards the inclusion of force majeure clause, where buyers may aggressively pitch for a well-defined mitigation roadmap, in case of an unlikely event such as the pandemic or demand destruction by such unforeseen situations.

The volatile LNG market may result in buyers pitching for greater operational flexibility in terms of diversion/cancellation rights. Additionally (or as a substitute) to price review clauses, some buyers may also pitch for incorporating other provisions, such as change of circumstances and hardship clauses, which may allow for contract adjustments in difficult times.

Contracting that allows carbon management for buyers

The past one and half year has witnessed implementation of innovative techniques such as carbon-neutral LNG supply to promote carbon-management. In Jun'19, Shell Eastern Trading (Pte) became the world's first company to supply carbon-neutral LNG to Tokyo Gas & GS Energy. Similarly, cargoes were later received by CPC Corporation (Taiwan) in Mar'20. To ensure long-term sustainability, buyers may also pitch / prefer sellers that offer commitment to buyer's carbon management measures, i.e., carbon-credit based contracting or inclusion of carbon-neutral LNG supplies in their annual delivery plan. Buyers across JKTC (Japan, Korea, Taiwan, China) have reportedly already started asking suppliers about their carbon offset solutions in new contract negotiations. Nevertheless, discussions on who would bear the additional charges for carbon-neutral LNG, needs to be effectively settled.

European Model of price review – highly unlikely

The year, 2019, was a witness to a rare phenomenon in the LNG market – Asian buyer (Osaka Gas) filing of the arbitration case again ExxonMobil-backed PNG LNG. This was seen as a move that could start a trend of Asian buyers challenging contracts that have become untenable amid COVID-19 scenarios.

Evalueserve firmly believes that barring few legacy Japanese players, it is very unlikely that buyers of Asian origin would follow the 'European' model of 'price arbitration & contract cancellation' to a larger extent.

The implementation of the 'European model' might hamper Asian buyer's prospect of ensuring competitive supplies in the future. Though the market being currently favourable, Asian buyers would definitely not want to hamper their business relations with suppliers, particularly when market starts to become supply deficient by 2023-end – earlier than expected. As a result, buyers may pitch for a 'win-win' situation with suppliers for ensuring competitive supply security.

Renewed pitch for flexible contracting terms

Reduction of contract length

With increasing volatility across the LNG market, particularly post COVID-19, buyers may look to do away with longer length contracts – a trend visible in 2000s until 2010s. They may look for a competitive portfolio with enough supply security, i.e., a mix of long-term and mid-term contracts, with few short-term (1-3 years)/spot supply tenders to meet seasonal demand.

Quest for diversified price indexation

With a series of legacy contracts set to expire by 2024, it is highly unlikely that buyers would do away with Brent-pricing/oil-indexation, which still remains as the most preferred form of indexation for Asian & Middle Eastern buyers. In the long run though, they may instead pitch for the adoption of a diversified & innovative form of contract pricing, such as the hybrid, domestic gas hub-based model of indexation, which reflects on-ground market realities.

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Source: Evalueserve Analytics, OIES, Global LNG Hub, Lexology, Shell LNG Outlook, Thomson Reuters Eikon, EIA, GIIGNL ET Energy, PPAC, GACC China, IGU, Petroleum Economists, Maxar Note: The slopes used above are taken based on ongoing market discussions and industry experts, however, it hasn't been confirmed

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Yashika and Pritam cumulatively holds around 20-years of work experience and are currently spreading the LNG practices of Evalueserve. Evalueserve is a strategic intelligence partner for many LNG firms serving in the areas that potentially has the greatest business impact: strategy & planning, supply-demand analytics, sales proliferation and new growth avenues prioritization, knowledge management & augmentation, and support in green initiatives, amongst others.

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