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LNG supply in a transforming industry – impacts for buyers

KPMG Global Energy Institute

Introduction

The global liquefied natural gas (LNG) market is transforming. In early 2016, the USA started LNG exports from the Gulf coast; this was unthinkable even 10 years ago. Australia will soon be an exporter on a scale to rival Qatar. LNG importers are becoming exporters and vice versa, but low prices threaten new projects and the profitability of existing ones.

This transformation combines three key trends:

— **The LNG market is globalizing** as the numbers and types of buyers and sellers expand.

— **Pricing models are changing** under the stress of increased supply and lower energy prices. Low prices destroy supply, but price has to be competitive to create demand. Prices are converging between the major markets, while new pricing hubs may emerge.

— **There are major uncertainties over supply.** There are many possible new projects, but their progress depends on anticipated demand and price levels, and on the capability of sponsors to see them through to completion.

This report, following *Uncharted waters: LNG demand in a transforming industry* (KPMG, November 2015), is the second in a series exploring LNG markets — how they are changing, why, and how participants should react.

Key strategic considerations for each part of the market are:

LNG producers: Project developers need to decide when the optimal window for new projects will open. Meanwhile, they need to focus on reducing capital costs, sharpening project delivery capability and seeking out synergies, to give their LNG plans the best chance of success. They may trim their portfolio of undeveloped resources, but need to hold on to their best growth prospects.

LNG traders: New supply offers new trade routes, as well as different pricing bases. If they decide to own a stake in physical assets, they need to ensure it adds real value, including information, and does not result in overexposure to commodity price risk.

Governments: Lower prices and intensifying competition between jurisdictions put more stress on resource-holding governments to facilitate LNG projects' progress, while still achieving community, fiscal and environmental benefits. Regulatory and taxation frameworks designed for a high-price environment may need to be rethought.

LNG buyers: The lower price gives LNG buyers the chance to rebuild their end-user markets. LNG needs to be competitive against coal, in both Europe and Asia, as well as competing pipeline gas. Asian and some African countries have the opportunity to complete the displacement of oil in industry and power generation, build out gas-using infrastructure and create new demand. They also have the chance, at reasonable prices, to take minority stakes in existing and future projects, building vertical integration and a portfolio hedge. But LNG buyers need to choose carefully for future supply, from robust projects with the best chance to be delivered competitively and on schedule and on budget.

LNG supply uncertainties

Short-term	Medium-term	Long-term
Project completion and startup; cash costs versus coal	Absorption of current oversupply; capital cost cuts; price outlook; new investment decisions; unconventional gas supply costs; floating liquefied natural gas (FLNG) success	Demand outlook; new pricing models; Iran and Russia strategies; new resource opportunities

KPMG has set out four strategies for LNG buyers

1. Understand bargaining positions

The current market provides buyers an upper hand. Long-term buyers need to balance the desirable objectives of portfolio diversification and supply, including jurisdictional, commercial models, terms and investment along the value chain; matching LNG pricing basis with their downstream customers; and flexibility.

2. Balance contract portfolio

Shorter terms reduce the risk of over-committing to purchases with uncertain demand but create exposure to longer term price and volume certainty. A bundle of contracts of different suppliers, periods and pricing bases can help, as can a greater role for intermediary trading companies who can manage demand risk across their portfolio.

3. Engage on end-use regulation and policy advocacy

LNG demand is strongly influenced by regulation and government policy. Examples include the public commissioning of LNG import facilities, targets for fuel mix or diversity of suppliers, air quality regulations, carbon pricing and greenhouse gas emission standards and cleaner transportation policies.

Government-to-government negotiations may be required between major LNG sellers and importers, to give regulatory development and operation certainty and to broadly ensure gas a role in the market.

4. Create buyer alliances

Create buyer alliances to reduce duplication of redundant demand and strengthen negotiating positions. JERA may point the way to future buyer alliances; for instance, as proposed between Chubu Electric of Japan and GAIL of India, and between Tokyo Gas and Korea Gas. The implications for pricing will be explored in a subsequent KPMG Global Energy Institute report.

In considering buyer alliances, issues regarding minority interests held by many buyers in LNG liquefaction plants and/or the LNG value chain need to be further explored. For example, do all buyers in the buyer alliance cooperate on such shareholding and the accompanying LNG purchase commitments?

Buyer alliances may also raise competition law/anti-trust concerns, which would require specific legal advice. As well, the potential response of LNG sellers to buyers' alliances will need to be considered. Alliances between Northeast Asian and Middle East buyers might help match seasonal demand patterns.

Conclusion

The LNG industry is cyclical, even more so than many commodity markets. Even with a more flexible industry, LNG projects remain very long-term endeavors, which cannot easily adjust to rapid changes in underlying oil and gas prices. There are major uncertainties over future supply: in the short term, the number of projects proposed far exceeds the number needed to meet demand.

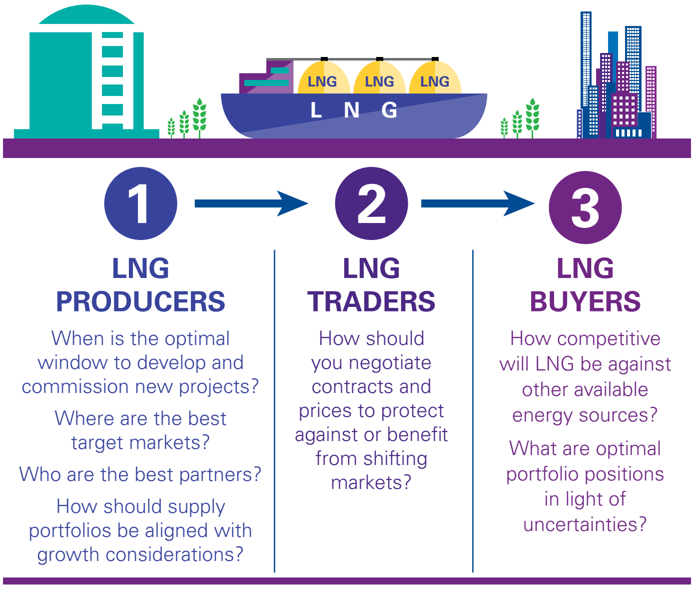
LNG output is quite granular. A single large project can add 3 percent or more to global supply, unlike for oil. The Japanese LNG market (the world's largest) showed a peak-to-trough period of 15 years, with another 14 years to get back to peak.

On top of the natural shifts in supply and demand, it is exposed to sweeping and sudden changes in geopolitics, regulation, recessions, economic competitiveness, technology, natural disasters and progress in alternative energy sources.

In the face of this long-term cyclicity, suppliers — existing and new — will have to make sure they can weather difficult times, while being prepared for the upswing. Key approaches that suppliers will have to make to match buyers' expectations include:

- Maintain a rigorous cost discipline.
- Engage with strategic patience.
- Ensure portfolio flexibility.
- Form winning partnerships.

LNG market strategies



Source: KPMG International, November 2015

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Mary Hemmingsen brings over 20 years of experience as a North American energy business leader in asset management and related business development. This includes leadership in the development and delivery of policy, strategy and initiatives for energy, power, utilities and related infrastructure businesses in a range of capacities in both the public and private sectors and for major utilities and global energy and asset managers.

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