

# Formation of the Asian LNG trading hub — the Japanese perspective

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Japan, the largest importer of liquefied natural gas (LNG), has started to consider means to achieve portfolio optimization through more flexible LNG contracts. Spurred by the recent deregulation of the Japanese electricity and gas markets creating uncertainty about the shape of future demand, Japanese demand for flexible LNG contracts is set to increase. The experience of the significant pricing disconnect for long-term and short-term supply has also heightened this demand for flexibility.

Lack of liquidity in the LNG market is a major hindrance to portfolio optimization that has motivated more market players to support development of an Asian LNG trading market. A liquid Asian LNG trading market would enable Japanese utilities and other players to hedge and cover increasing risk in the form of:

- providing a method of hedging price fluctuation risk after the abolishment of the rate-of-return regulation
- managing long positions associated with the risk of over-procuring LNG through long-term contracts in the future
- enabling optimization of risk through opportunities to resell LNG and generally price hedge
- allowing more options to respond to market changes that present new risks.

Although long-term LNG contracts have been advantageous in terms of supply security, in light of future market requirements, Japanese buyers, among others, need to become more agile and flexible. For this purpose, an LNG commodity market is essential.

## Initiatives underway

In response to such needs, initiatives are under way to develop a liquid LNG trading hub. Singapore leads the efforts with momentum gathering through:

- development of Singapore's second LNG terminal, as well as an LNG bunkering business, which are set to increase physical demand
- the Energy Market Authority announcing development of a secondary gas trading market
- Singapore Exchange launching their LNG futures market
- Singapore providing a ready ecosystem for trading activities in being home to many LNG players such as financial institutions, trading companies and oil companies.

Although the currently low LNG demand could act as a potential drag on the momentum, the expected increase in demand from Southeast Asia could help to increase physical liquidity.

**Japan** is also often seen as a candidate for the Asian LNG trading hub. Japan's advantage is its physical demand platform as the world's largest LNG importer and in having numerous LNG terminals. In contrast to Singapore, Japan does not have as ready an ecosystem of players in commodity trading and would need to attract market players into the country and augment capabilities with investment in training and development. Japan will also need to allow third-party access to their infrastructure to provide easier access for new market entrants.

A second candidate is **China**, which has a pipeline system connected to surrounding natural gas producers such as Russia, providing an environment for arbitrage of pipeline gas and LNG. However, similar to Japan, China needs to allow third-party access to infrastructure. Additionally, China would need to address concerns regarding their legal system, corporate governance and excessive government participation to win the trust of players worldwide.

The development of multiple LNG trading hubs, such as those in Europe, is also possible. Taking into consideration the size of the Asian LNG market, multiple trading hubs could develop, with different locations taking on different roles. For example, Singapore could act as the paper trading hub, whereas Japan or China could act as the physical trading hub. Whether or not one or multiple LNG price indices establish, will depend on the nature of the market development.

### Issues to resolve

Efforts to establish Asian LNG trading hub(s) are certainly gaining momentum, but liquidity remains low and many issues need resolving.

- Firstly, market players are currently restricted to those who can invest in large-scale infrastructure and those with large-scale contracts, and these barriers need to be removed.
- Secondly, LNG varies in heating value between locations of production, causing differences in the unit price per heating value.

- Finally, a transparent price is required for a competitive market and to win the trust of market players.

### Making the breakthrough

These issues have been successfully navigated in other commodity markets that were previously regarded as thwarting trading hub development. For example liquid trading markets for coal and iron ore were successfully developed. Essential for a similar breakthrough in the LNG market will be active participation of market players.

Japan's deregulation of electricity and gas markets can certainly act as a catalyst for similar breakthroughs. Japan can play a major role in the development of the Asian LNG trading market, through making infrastructure investments, forming partnerships with international players and actively taking risk in physical and financial trading of LNG to create a liquid LNG price index.

A liquid LNG trading market would be a great advantage for all buyers, sellers and traders; not just for Japan, but for the whole of Asia and around the globe.



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