

# Chapter 3

## Discussions in the Working Group Meeting

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## CHAPTER 3

### Discussions in the Working Group Meeting

This chapter will summarise major discussions in the two WG meetings.

#### **3.1 Prospects for the Asian liquefied natural gas market**

Extensive discussions were held on the trends and prospects for the global liquefied natural gas (LNG) market especially for the Asian LNG market. While Asia's growing population and economies are giving rise to energy demand, environmental problems are further stimulating the LNG market. Specifically, Asian developing economies refer to the pollution of air, water, etc. and not to greenhouse gas emissions. One of the important political agenda in developing economies is to alleviate these environmental problems, including serious air pollution in large cities in East China. One effective solution is to promote the use of natural gas, which contains less sulphur and produces no dust when burned. In most parts of Asia, domestic natural gas production fails to keep pace with growing demand. Boosting LNG imports while accelerating the adoption of clean coal and renewable energy technologies could fuel competition and diversification among energy sources.

On the other hand, natural gas demand is on the decline in Europe. Although gas-fired power generation is widely used for peak shaving in Latin America, natural gas is being supplied through pipelines from the US to Mexico. Such trends together could put downward pressure on the LNG demand in these regions. Thus, the Asian LNG market, especially the use of natural gas for power generation, is a key to forecasting the demand for LNG.

Since natural gas demand in Asia is highly sensitive to market prices, LNG should be supplied at affordable prices. Simultaneously, it should remain competitive against other fuel sources, such as coal and oil products, and should be used sustainably. It is also important to extend pipelines for gas distribution.

On the supply front, LNG exports from the US, where many projects are underway, are noteworthy given its supply potential. Specifically, a new market mechanism is expected to be in place since shipping destinations are not restricted and the pricing is not linked to oil prices. In addition, natural gas exports from Russia through the pipeline system is a key to forecasting China's LNG demand (i.e. the LNG supply–demand balance in Asia).

#### **3.2 Impact of lower crude oil prices**

With the oil market being sluggish, since the oil-linked pricing is the mainstream of existing contract, it resulted in a sharp decrease in the LNG prices. Moreover, as the LNG market eases, price gaps are narrowing between Europe and Asia, while they remain between North

America and Asia. The backlash from higher LNG prices, which has resulted in a significant outflow of national wealth, will surely bring economic benefits to LNG importing countries. Given the present circumstances, some importers may accept the oil-linked pricing. However, it makes sense to continue making efforts to create a hub-based pricing system when considering the original intention of pursuing rational pricing mechanism, taking into account the possibility of higher oil prices in the years ahead.

Natural gas is gaining a competitive edge over other energy sources in the US, while regulations on coal are becoming more stringent, prompting the power-generation sector to switch to natural gas.

Meanwhile, decreasing export revenues is having a negative economic impact on exporters and is expected to slow down investments in new gas resource development. For example, there has been a decreased interest by international oil companies (traditional major investors) and Japanese trading houses in investing in new LNG projects in Australia. Russia is no exception – projects for constructing a new LNG project near the Arctic Ocean and gas pipelines to China are likely to fall behind schedule. These situations are undesirable for importers, as well as for exporters. While the LNG market is easing, a slowdown in new LNG projects development could lead to short supply when demand picks up. The market is volatile in nature – the longer and deeper it eases, the longer and stronger the strain will be.

Lower LNG prices and the easing of its market are having an impact on the power balance between sellers and buyers. In fact, the terms and conditions of contracts for both new and existing LNG projects are changing.

Higher oil prices have led to higher LNG prices in recent years, with exporters being in favour of the oil-linked pricing. However, if the present situation continues – where LNG prices remain low due to lower oil prices – exporters may give up the oil-linked pricing for their own benefit. Given that a pricing system that does not reflect actual supply–demand fundamental is doomed to lose the confidence of both the exporters and the importers, the establishment of a sound LNG market and a hub-based pricing is beneficial for both parties.

### **3.3 Functioning the Asian liquefied natural gas market**

The existence of hubs, which provide the market price of natural gas, helps the market function more effectively. Gas and power market liberalisation in importing countries will result in a greater need for well-functioning markets. Take Japan, for example, where the power and gas markets are being liberalised. With future demand increasingly uncertain, buyers are demanding lower prices, fuelling the need to increase the flexibility of LNG transactions. These changes also drive the need to create hubs.

Such flexibility is also important in improving the short-term supply security. An environment where the LNG can be traded any time by any one ensures a balanced supply–demand situation. Also important is the medium- to long-term supply security. For example, the LNG supply can be secured through firm contracts if gas demand is expected to increase over the

long term. Likewise, securing demand over the long term makes it possible to invest in high-risk resource development. Thus, long-term firm contracts remain viable, while both exporting and importing countries are expected to create a balanced portfolio over the short, medium, or long term.

The relaxation or abolishment of destination restrictions is one key condition to creating hubs. It will also stimulate short-term and spot transactions for adjustment purposes which is expected to increase the confidence of a pricing system reflecting real-time market conditions. In reality, however, shipping destinations are restricted by contracts between private companies, leaving little room for third parties to get involved. In addition, the period for reviewing the terms and conditions of the contracts is limited considering that these conditions usually concern long-term transactions. The only possible way, therefore, is to review them in phases when the contracts are renewed. Another option is to make the restriction on destinations illegal like in the case of Europe.

The liberalisation of domestic markets is also a key to increasing the number of traders and the amount of transactions. Europe's example shows the need to take a multilevel approach – such as abolishment of monopolies, institutionalisation of third-party access, improving transparency of usage and pricing of infrastructure, and establishment of regulatory authorities implementing these measures – which requires political determination and an extended period.

The development of infrastructure for natural gas is equally important. In Europe, for example, the extensive network of international pipelines forms the basis of flexible and active intra- and inter-regional transactions. With this network, the existing hubs in Europe have been established. In addition to transactions through the pipeline system, hub can be designed for spot LNG transactions as well. Since the geographical, political, and economic conditions of Asia are different from those in Europe where solid hubs are already in place, hubs that suite the needs of its region should be created.

It is often pointed out that the possible impact of a hub-based pricing system on investment should be taken into account. This is based on the assumption that oil prices are the world's most reliable index and that other indices are considered risky by private financial institutions, and this could dampen their appetite for investment. The fact, however, is that investment levels remain relatively high in the US (where hub prices serve as benchmarks) and in Europe (where hub prices are becoming standards). This is because gas is highly marketable in a highly liquid market, such as the US Henry Hub, though price fluctuation risks remain.

Although the key players in the LNG business are the private companies, the government concerned should support them. It is obvious, in particular, if the infrastructure is crucial for national energy security where the government shall take responsibility, and its investment risks involved are too high for private businesses to undertake. Support measures, however, should not cause significant inefficiency nor should it lead to too much intervention in the market.