Drilling Down: LNG market outlook post-COVID-19

Lower prices may enable new and smaller market players.

COVID-19 and other events have changed the dynamics of the liquefied natural gas (LNG) market. Industry watchers had expected a tightening by mid-2020, but that outlook has been negated by widespread oversupply causing downward pressure on prices.

In this edition of KPMG Global Energy Institute’s Drilling Down, Mina Sekiguchi, managing director and head of Energy and Natural Resources, KPMG in the ASPAC, and Christopher Young, director, Energy Strategy & Operations, KPMG LLP (U.K.), discuss potential outlooks for LNG in the post-COVID-19 new reality, and describe how lower prices may enable a new generation of smaller market players.

LNG market snapshot pre-COVID-19

At our annual KPMG Global Energy Conference in Houston a year ago, we predicted that an oversupply of LNG would continue through the first half of 2020, as record-high final investment decisions (FID) would create excess supply. We expected that the market would subsequently tighten somewhat.

However, the outbreak of COVID-19, along with other significant events, has changed that bullish outlook.

First, in late 2019, Northeast Asia experienced an unusually warm winter, which weakened LNG demand in the region. The excess supply was shipped to Europe, which had excess storage and was able to take advantage of the lower prices to stockpile the LNG for when needed (this transfer is an example of how Europe can play a role in the global LNG ecosystem to balance supply and demand).

Then, in March 2020, an oil-price war broke out between Saudi Arabia and Russia. Crude prices plummeted, with negative prices per barrel for several days. LNG spot prices fell as well, dragged down by the decline in oil. For example, Japan/Korea Marker (JKM) spot was priced below US$2/MMBTU as of the end of May. That’s down 67 percent from its end-of-January level of about US$6/MMBTU.

The oil market volatility wasn’t an overreaction. The issue of oversupply was real, and the only solution was for Saudi to reduce its production.

Not surprisingly, the global spread of COVID-19 stands as the most important event for LNG demand so far in 2020, and its effects are causing more serious and potentially long-term pressure on the demand side. Cities worldwide imposed lockdowns limiting people’s movements and shutting down nonessential business, as well as entertainment and sports venues and houses of worship. These quarantine measures have curbed energy consumption. How long economies will take to recover from the effects of COVID-19 remains uncertain, and many currently shuttered businesses will certainly close for good. Hence, the continuing softening in demand is likely to remain for the time being.

As we look at the market now, few buyers are active, despite a low LNG spot price of around US$2/MMBTU. Demand remains low from Northeast Asia, while Europe has maxed out its storage capacity and can’t absorb any more excess supply.

Global LNG market demand and supply outlook

Demand outlook

The effects of COVID-19 are largely expected to cut global LNG demand by as much 8 percent, compared with pre-COVID levels, and a rapid return to the previous level of demand doesn’t appear likely.
The exception is China, where the government is aggressively pursuing efforts to recover its economy. Market watchers expect that Chinese demand will return to the pre-COVID-19 levels in the second half of 2020.

On the positive side, lower prices for LNG have made it more competitive against other types of fuel, especially coal. In fact, the record low LNG prices may cause the many countries that rely on coal to accelerate their shift to LNG.

Likewise, low prices may also drive the use of LNG for bunkering (that is, using natural gas to power vessels) and other transportation modes, which dovetails with the overall trend toward greener energy.

Supply outlook
The current historically low prices for LNG—especially for U.S.-based projects—are putting significant pressure on producers and suppliers in a difficult situation. As we discussed above, buyers are already at full capacity and can’t take any further supply, particularly Northeastern players and those in Europe. This excess may force producers and suppliers to cancel shipments in the coming months. If producers and suppliers do pull back, they may have to reevaluate their operations and take steps to reduce operating costs to make up for the declining market prices. Those steps could include the delay of new LNG liquefaction projects; however, deferring the construction of these plants will affect supply and demand down the road.

Also, particularly in the U.S., reorganizations among suppliers and producers may lead to a round of M&A and consolidation.

Developing countries, small players to enter the market
LNG has historically been an expensive fuel. Liquefaction facilities are costly and time-consuming to build, and the process is highly technical and complex. Although growing market competition has pushed prices lower than ever before, LNG has still been considered too expensive to satisfy electrification needs in emerging countries. Also, due to the large amount of capital needed to complete a project on time, and with contracts tied to a certain volume, buyers have tended to be large players.

But COVID-19 and the other factors that have put pressures on LNG prices may change all that. Many of the countries in South Asia, South America, Eastern Europe, and Africa have been using coal for their energy because of its low price, even though they are being encouraged to switch to greener energy because of climate change. The lower prices for LNG may make it easier for these developing countries to transition away from coal.

Second, the Chinese government will allow many more non-state-owned enterprises to procure LNG from abroad to increase LNG import for faster switching from coal.

Implications for sellers and buyers
These developments will have a number of implications for LNG buyers and sellers:

1. LNG manufacturers will continue to face pressure on margins, and consequently will need to focus on being highly cost efficient and lean.
2. Sellers are likely to see ongoing pressure on contracts, as low prices reinforce buyers’ preference for spot purchases. Sellers should therefore ensure that they develop and deploy greater commercial capabilities around trading and short-term negotiations.
3. Buyers will continue to push for the freedom to resell cargoes, as they seek to capture value from arbitrage between their home markets and more favorable geographies. This means they will need to acquire a greater understanding of the market dynamics and movements outside of their home regions.
4. The current environment will accelerate the plans of integrated oil and gas players to develop additional downstream positions in LNG fuels and related applications, since their margins in traditional areas will remain challenged. This will require them to accelerate planning their response to the energy transition toward LNG and the rapidly evolving value chains that transition is creating.
5. The prospects of continued low LNG prices will invite more emerging countries and smaller-scale buyers to participate in the market. Producer and suppliers will need to revisit their business model to fit the new set of buyers. These changes may include a more modifiable approach to selling LNG by cargo to increase tradability in addition to offering more flexible contract terms to new market entrants.
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