Producers Pass Buck to Portfolio Players

As large-volume, long-term contracts with end users have been increasingly difficult to find, producers have resorted to selling millions of tons of LNG to portfolio players, who now account for about three-quarters of the buyers in the most recent long-term deals. The vast majority contracted to portfolio players carries no destination restrictions.

The portfolio players, also called aggregators, hold portfolios of LNG supply from different regions as well as various shipping, storage and regasification assets. The concept is that by optimizing their supply and infrastructure, they can provide LNG to end users as well as to participants in short- and medium-term markets more efficiently than the traditional point-to-point arrangements that have dominated the LNG business for decades.

The concept originated at a time of tightness in LNG amid expectations that aggregators could manage their supply and assets in a way that allows the companies to take advantage of market opportunities while still acting as reliable suppliers. However, given that the LNG market is going to be abundantly supplied for at least the next few years, the companies are now looking at how to manage portfolios of millions of tons that do not have buyers.

The expectation among many analysts is that clearing these physical volumes will require the development of more-liquid short-term and spot markets as well as risk management tools that often accompany the evolution of traded markets.

Although it remains to be seen exactly how participants in the markets will adjust to current circumstances, portfolio holders already are grappling with significant challenges. Trading margins that until recently reached dollars per MMBtu have fallen dramatically because the short-term and spot markets are awash in cargoes at a time of soft demand growth. Destination flexibility allows aggregators to respond to existing demand quickly and buyers have many options. Liquidity in the short-term and spot markets has risen notably and spot volumes are expected to continue to grow as portfolio players hustle to place supplies. This is not to say that the traditional commercial models will fall by the wayside. Long-term contracts will continue to play an important role in LNG markets and, unless the markets can develop alternatives, they will continue to be critical to securing project financing. But even the rigid routes that LNG carriers have travelled and normal shipping practices may become more flexible.

New market participants are also making their mark. Commodity house Trafigura is leading the growing number of traders that are entering the market and forcing the industry to adapt. Trafigura’s traded volumes increased 147% between 2014 and 2015 from 1.7 MMt to 4.2 MMt (see LNGWM, May ‘15). Traders like Vitol and Glencore also are working to develop LNG businesses.
Contract structure also is changing in response to shifting fundamentals. The slopes agreed to by portfolio players were the lowest set in 2015. A number of single-digit slopes were written into their contracts while the highest slope agreed to by a portfolio player was in the low 11% range, the most for contracts of 20 years or more duration. In the short to medium term, portfolio players need the low slopes in order to make some small return during the current period of low oil prices and significant oversupply pressuring LNG prices. But in the longer term, when the cycle of oversupply turns to one of undersupply and when oil prices return to higher levels, such low slopes would see many portfolio players making the majority of their money toward the end of their contracts.

In 2015 portfolio buyers agreed to deals to buy close to 7 MMt/y, mostly under long-term contracts, but they concluded deals to sell only about 5.5 MMt/y, mostly under short- or medium-term contracts. That ensures homeless flexible supply is available in the short-term market to aid liquidity, while over the longer horizon portfolio players have not locked in their volumes under a long-term arrangement so, when the LNG market once again tightens, they will have available volumes with which to take advantage of higher prices.

Indexation is also growing and becoming more diverse as the volumes of homeless LNG grow and trading liquidity increases. Of contracts that were wholly or partly indexed to one or more gas hub in 2015, almost two-thirds of the volumes were linked to European hubs compared to around a third linked to the US Henry Hub marker. That reverses the dominance of the US marker in 2014 when it accounted for 95% of hub-indexed contracts (see LNGWM, Jan ‘15). Oil-linked pricing will remain an important part of the market, particularly in Asia where a dearth of robust natural gas pricing and thin spot markets impede the use of natural gas benchmarking.

The rise of European hub benchmarks makes sense given the expectation that price-sensitive demand in Europe will be a key to clearing the global physical market. Low European gas prices will be needed in order to allow natural gas to displace coal in power generation and permit LNG to gain market share. Pricing global supplies against European hub prices will help facilitate this movement of LNG in Europe. If it does not happen, it is very hard to see that the global markets have any chance of absorbing the tens of millions of tons of new supply from US and Australian projects. The greater flexibility of
aggregators and increased liquidity of short-term markets facilitate the clearing of the physical markets.

One issue is that many of Europe’s end users don’t have the expertise to hedge against US hub prices and largely don’t want to, preferring to only buy at the local hub, forcing sellers of US LNG to take on that risk (see LNGWM, Dec ‘15).

One or two players with exposure to the US, including BP, which has 4.4 MMt/y coming on stream in 2018 from Freeport LNG, have already traded gas on Europe’s hubs in dollars per MMBtu in an attempt to get their counterparties on the hubs used to doing such deals before US-indexed LNG is shipped, but it’s questionable whether any but those already exposed to Henry Hub-linked LNG will engage in such a trade.