LNG in World Markets
SPECIAL UPDATE

Russia and Saudi Arabia: Is US LNG the Next Target?

With global markets reeling from the combined effects of the Saudi-Russia price war and impact of the Covid-19 outbreak, it is easy to think that things could not get worse. But uncertainty about Russian intentions raises questions about whether US LNG could be caught in the crossfire.

While it is unlikely Russia intended to provoke Saudi Arabia into an angry response that has sent Brent prices from around $50/bbl to below $35/bbl, it is clear that Russian officials were growing increasingly concerned about the impact of rising US shale oil and gas production. Rosneft CEO Igor Sechin – a close ally of Russian President Vladimir Putin – was reportedly lobbying for moves to sharply lower oil prices as a way of forcing overly indebted US shale producers out of business.

LNG prices, already driven lower by a global supply glut and weak demand caused by slowing global growth, demand destruction caused by the Covid-19 outbreak and a warm winter – have held up. And natural gas prices, particularly in the US, have risen modestly as markets price in the view that that lower oil prices will reduce US crude production, and therefore output of associated natural gas.

If Russia is seeking to batter US shale, it has the means to do so. Currently, Russian natural gas via pipeline accounts for about 35% of European gas supplies. There has been talk that the Russians may reduce spot sales into Europe in an effort to boost prices.

However, if Russia's priority is sending a message to US shale producers, it could instead increase supply, driving European natural gas prices even lower. This could hurt US LNG, already barely competitive or even uncompetitive in Europe, depending on whether freight is viewed as a sunk cost. With Henry Hub around $1.90/MMBtu and US-European freight at around $0.50/MMBtu, the variable cost of landing US LNG in April looks to be about $3-$3.20/MMBtu, including terminal charges. With May TTF prices under $3.00/MMBtu, US LNG may be running out of places to go. Netbacks to Asia have recently improved, but whether this is sustainable into the summer months is not clear.

An effort to drive European prices lower would likely result in additional LNG cargo cancellations, which could drive US natural gas prices lower, adding to the pain of US shale producers especially in areas like the northeastern US where much of the exploration gas-based. It would also benefit Russia by creating space for additional European imports of Russian LNG from the Yamal project.

It is impossible to know if Russia will do this. There are questions about how sensitive Gazprom is to low European gas prices, which could deter export volumes this year as happened in summer 2019 auction sales. The treatment of the producer's short run marginal costs for supplying gas to Europe is a perennial uncertainty because a significant share of its delivery costs is in the form of taxes and export duties paid to the Russian government and transit fees paid to Ukraine. The Russian government will surely want to continue to receive those tax payments, but in the event of a market share squeeze from LNG, it could reduce taxes to keep gas flowing. The 2019 Ukraine-Russia transit deal committed Gazprom to pay upfront for transit, meaning those costs could now be viewed as sunk.

There are already concerns about Russia having too much of the European gas market. Increased exports would feed those concerns, though it is unclear if European countries would object to a flood of cheaper gas given the weakness in their own economies. It is also unclear how an increase in Russian gas supplies would affect US gas markets, which are largely driven by US domestic factors. And the market may drive prices lower on its own due to slower economic activity. For example, demand in Italy has fallen sharply due to quarantine measures there, an effect that could be seen elsewhere as Covid-linked lockdown measures are introduced.

Anyone hoping that Russia will step in to support gas and LNG prices should temper those hopes with the knowledge that Russia has complex interests in play and that US LNG and natural gas markets could find themselves in the gunsights during the current market unrest.

US production leveling off or falling

US LNG production appears to be leveling out or even falling as producers react to low prices and expectations that the next few months will be challenging. Cheniere's Sabine Pass has seen a sharp drop in feedgas entering the plant since late February due to unexpected maintenance at train 2. There also was a decline in feedgas entering the company's Corpus Christi facility.

Gulf Coast projects Freeport and Cameron both appear to be producing around their recent peaks as new production flows from additional trains, though there is significant volatility in their operations and at least Freeport appears to have had a number of issues with exports caused by dense coastal fog, which is typical around its facility.

Chinese imports continue to face challenges

The Chinese major oil companies continue to struggle to manage imports given low demand and full tanks. They are looking to take back slots awarded to third-party importers because, they say, they need the flexibility to import as and when they choose.

PetroChina declared *force majeure* on its long-term LNG and pipeline contracts on March 4 and did not give a time or quantity in its notice to suppliers. Despite that, suppliers said the company continued to perform on its contracts and rescheduled March cargoes to future delivery dates. Sinopec has deferred cargoes from Total and PNG LNG. CNOOC had wanted to take back Zhenhua's third-party slots, but after negotiations, CNOOC rescinded its decision.

The terminal issues have affected second-tier buyers, who would like to buy cheap cargoes but cannot access infrastructure. ENN – one of the largest second-tier players – to date has not had to defer cargoes as it has managed to continue to ship significant volumes by truck from its facilities.

The collapse of oil prices has brought Brent-linked supplies closer in price to spot tons, thereby reducing the incentives for importers to declare *force majeure* solely on the basis of price. One oil major is discussing lifting deliveries above contract levels with buyers via the Upward Quantity Tolerance contract clause, as buyers see now as a good time to make up for taking less in previous years. As a result, the focus among Chinese buyers and their suppliers is now on managing supply chains and reaching accommodations whenever possible rather than on the price of LNG.