

A New Development for Japan's Procurement of U.S. LNG

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In late July, a new development came for Japanese companies' procurement of liquefied natural gas from the United States. In their press release on July 31, Osaka Gas Co. and Chubu Electric Power Co. stated that they had executed binding liquefaction tolling agreements with a subsidiary of Freeport LNG Development, L.P.

Under the agreements, Osaka Gas and Chubu Electric will each acquire an annual LNG production capacity of 2.2 million tonnes at a train of a new natural gas liquefaction facility to be built in Freeport, Texas. The facility is projected to have a total of three trains, each with an annual capacity of 4.4 million tonnes. The facility will be constructed at the Freeport LNG terminal that Freeport LNG Development now owns and operates. The terminal, which has been built for importing LNG, now includes an LNG receiving berth, an LNG tank and an LNG regasification system. Given the sharp change in U.S. gas supply and demand conditions after the "shale gas revolution", however, Freeport LNG Development has been planning to build a gas liquefaction facility for LNG exports. In a manner to join the plan, Osaka Gas and Chubu Electric reached the agreements.

Under the plan, Freeport LNG Development will proceed with the construction of the natural gas liquefaction facility and work to obtain approval by the U.S. government (including the Department of Energy) on LNG exports to Japan and other countries that have no free trade agreements with the United States. The two Japanese firms plan to start LNG procurement in 2017. If the project is successful, Osaka Gas and Chubu Electric will procure some 30% and 20% of their respective FY2010 LNG imports from a new source under a new LNG pricing system based on U.S. Henry Hub prices.

I here would like to discuss the significance of the new development for LNG procurement from the United States to the two Japanese firms and the whole of Japan.

First, the deal to import U.S. LNG from a new source will contribute to securing a new LNG supply source and diversifying LNG import sources for stable LNG procurement. As noted above, securing the new supply source and diversifying supply sources are clearly important for the

two companies. For the whole of Japan, successful LNG imports from the United States under the deal will be coupled with other Japanese companies' North American LNG procurement projects to diversify LNG supply sources. Of Japan's LNG imports (totaling 83.18 million tons) in FY2011, Malaysia accounted for the largest share of 18%, Qatar for 17%, Australia for 16%, Indonesia for 10%, Russia for 9%, Brunei for 7%, the United Arab Emirates for 7% and Oman for 5%. The eight largest LNG exporters to Japan covered about 90% of Japan's total LNG imports. LNG procurement under Freeport and other U.S. LNG projects involving Japanese companies will cause a major change in Japan's LNG import mix. For the entire world, U.S. LNG projects are significant for the expansion of LNG supply capacity to meet a rise in LNG demand.

Second, the deal is significant in that it will introduce a new pricing system for Japan's LNG procurement. As mentioned above, the deal adopts the U.S. hub-linked pricing system instead of the traditional Japanese LNG import pricing system linked to Japan's crude oil import prices. Given Henry Hub gas prices and Japanese LNG import prices at present, LNG imports under the deal could cost 20-30% less than those under the existing contracts in average. The latest deal may thus contribute to improving Japan's price competitiveness in LNG procurement. Since market prices fluctuate always, however, the price advantage under the deal cannot be guaranteed. Despite the price advantage, the deal may not necessarily substantially reduce overall LNG procurement costs for the two companies as far as most of their LNG imports are based on the existing contracts. But the introduction of the new competitive pricing system at present may contribute to lowering LNG procurement prices under other deals and may be significant for discussions on the pricing system for the existing deals. For the buyers, the additional LNG procurement and the new pricing system under the new deal will be significant for improving their bargaining power and hedging risks through the diversification of their LNG portfolios.

Third, it is characteristic and significant that the Japanese electric and gas utilities have cooperated in clinching the deal for direct LNG procurement. The deal thus meets the promotion of resources users' involvement in upstream resources development phases as one of the five principles under the resources security strategy that was released by the government in June. It can also be interpreted as representing joint procurement that has been considered as one of Japan's measures to enhance stable LNG procurement. Although electric and gas utilities had formed consortia for traditional LNG procurement, they have recently tended to individually procure LNG under the electricity and gas market deregulation. Under such situation, the possible joint procurement has become subject to consideration as one measure to enhance procurement capabilities. In this sense, we can interpret the deal as indicating that the two LNG user companies, which can pursue common interests, have joined hands to participate in the specific project and contributed to clinching the deal as foundation buyers. They have made actual joint LNG procurement efforts. We can also take the deal as representing a new successful approach for enhancing Japanese companies' LNG procurement capabilities.

We have thus seen a new development that is very significant. The deal still has some

challenges including the construction of the gas liquefaction facility and the pending acquisition of the U.S. government's approval on LNG exports to countries having no FTAs with the United States. If the project is implemented successfully with the challenges solved, the deal will bear significant fruit. As the deal is very significant for securing stable energy supply in Japan, we may have to closely watch future developments of Freeport and other projects for Japan's LNG procurement from the United States.

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