

Stable LNG Procurement Looming as Challenge

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Stable natural gas procurement amid growing demand has become a key challenge as expectations on this clean energy source with massive supply potential increase globally and as what the IEA termed the natural gas "golden age" is touted as growing likelier. This is a challenge for the entire world and an urgent challenge particularly for Japan.

The reason for the urgent challenge is closely linked to dramatic changes in Japan's energy supply and demand conditions after the Great East Japan Earthquake and the direction of future energy policy reform discussions. This means that we must pay attention to the large additional LNG demand that has emerged as LNG and other fossil thermal power generation has expanded with electricity conservation enhanced to cope with tough electricity supply problems after the disaster. Trade data for the April-August 2011 period indicate that Japan's LNG imports in the period totaled 34.18 million tons, up 18% from a year earlier. If imports are to increase at this pace (18%), Japan's additional LNG imports for the whole of FY2011 to March 2012 may reach some 12 million tons. According to the estimation by our Institute of Energy Economics, Japan, the nation's maximum additional LNG imports could reach 20 million tons if no nuclear reactor is allowed to restart operation in FY2012. It may be needless to say that Japan's future additional LNG imports may depend on its economic trends and electricity conservation efforts after relevant experiences in the summer of 2011.

The recent changes are not limited to the increase in additional LNG imports. LNG prices have basically continued an upward trend since March. Since LNG prices for Japan's long-term import contracts are basically linked to crude oil prices, LNG prices for Japan have risen in a manner to follow crude oil price hikes, irrespective of LNG supply/demand conditions. The spot LNG price for Asia, which better reflects supply/demand conditions, has risen above \$17/million BTU from \$10/million BTU before the March disaster. The spot price hike may reflect the spot price's move to converge with long-term contract prices rather than a tighter supply/demand relationship. Anyway, Japan's LNG procurement prices have risen. As a result, Japan's LNG import value in the April-August period this year expanded by some 550 billion yen or some 40% from a year earlier. The increase may have to be a matter of concern to Japan indicating an overall domestic energy cost hike and a national wealth outflow.

Furthermore, we must take note of the fact that natural gas is growingly expected to play a greater role as a significant alternative energy in Japan's energy portfolio over a medium to long term. At just-started discussions on an energy policy reform, the role of natural gas may become a key point for discussions.

The next stage of discussions about natural gas may focus on the stable procurement of natural gas or LNG. This issue alone has various aspects including diplomacy with resource-rich

countries, access to overseas resources, domestic infrastructure development and the promotion of highly efficient natural gas consumption. A key point for discussion is how to procure LNG for competitive prices. Under the world's natural gas market structure, recent LNG prices in the Asian market including Japan have been higher than in European and American markets. There has been the problem of an "Asian premium" for LNG prices. In this sense, the procurement of LNG for competitive prices is important.

The energy environment for Japan, as described above, indicates that the Asian premium problem is a challenge that Japan as a whole must try to solve. The solution is difficult and may take much time. Possible solutions may include secure abundant supply in the Asian (or global) LNG market and an environment where suppliers compete with each other sufficiently. This is basically important. In addition, various innovative ideas may be required for Japan's LNG procurement. In this respect, one interesting opinion is that the bargaining power of Japan featuring the largest LNG demand in the world could be weakened due to a wide range of small buyers including electricity and gas utilities. In the past, these utilities had formed "consortiums" to procure LNG in large lots. But electric and gas utilities now individually negotiate LNG purchases according to their respective needs and conditions, as market liberalization and competition have been promoted since the 1990s. This indicates an LNG procurement approach change responding to major market changes or trends. The opinion calls for reviewing the current LNG procurement approach including its advantages and disadvantages. In this respect, some small companies have interestingly moved to shift from their independent procurement to secondary procurement from larger firms.

Given the market realities, however, it is difficult to form a consortium of all electricity and gas utilities for bargaining with foreign LNG sellers. None may come up with specific measures to form such consortium. If the expansion of procurement deal sizes is to substantially benefit Japan, however, we may have to seriously consider how to expand such sizes. To this end, policymakers, industry players and experts may be required to combine their wisdom. This is because it is difficult to realize larger LNG procurement deal sizes and devise specific measures to enlarge such sizes. Meanwhile, there is an interesting question that we must ponder before considering such measures. The fundamental question is whether the expansion of procurement deal sizes could help lower procurement price drops. In this respect, I think we must consider two questions – (1) whether the expansion of procurement deal sizes could increase buyers' bargaining power against sellers and (2) whether buyers with greater bargaining power could successfully win lower procurement prices.

On the first question, various market experiences may indicate that larger-lot buyers may have greater bargaining power than smaller-lot buyers. The second question is rather complicated. In this respect, we must question the priority order to be adopted by buyers with greater bargaining power. Cuts in procurement prices are basically important. But the problem is how urgent the need is for price cuts. A mechanism may be required to secure tough negotiations based on the degree of the need. There may be some chance for buyers to give priority to non-price factors in negotiations with suppliers depending on the case. In one potential case, a large-scale buyer may give priority to the greater flexibility of procurement or the acquisition of access to upstream gas resources equity rather than procurement price cuts. The acquisition of access to gas resources equity can contribute to enhancing Japan's energy security and the strength of buyer companies. But another key bargaining goal of price cuts could be hidden behind such priority. It is important to consider a mechanism or an effort for buyers to give top priority to price cuts after increasing their bargaining power. In considering Japan's future energy problems, we must devise bold, strategic ideas without being obsessed with conventional wisdom or past cases. Serious discussions based on strategic thinking may be required on the natural gas or LNG problem.