

Ebb and flow

Despite the peaks and troughs of the commodity cycle, the spot market is growing increasingly robust, liquid, diverse, transparent and central to the commoditization of LNG.



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The LNG spot market has seen steady growth in recent years. But this upward trajectory is not guaranteed. Instead, the next decade is likely to see the size of the spot market expand and contract, depending on a wide range of variable market forces churning global energy and financial markets.

But just like markets do not evolve in comfortable environments, those peaks and troughs of the commodity cycle will be key to full commoditization of LNG.

expansions and rising cargo churn rates. But it will remain a marginal and mutable part of the business; relatively small in size, but unique in its ability to reflect market fundamentals and the issues facing the daily operations of the industry's assets.

It is for this reason that as spot trading becomes more liquid and transparent, spot prices will eventually form the basis of longer-term contract prices.



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Prompt trade volumes have increased significantly in recent years, with physical transactions executed within a 90-day window accounting for roughly 25% of global LNG supply, according to the Paris-based International Group of LNG Importers (GIIGNL), up from 17% in 2016.

The smaller spot market, comprising one-off bilateral transactions, has also experienced growth amid rapid supply

Marginal market

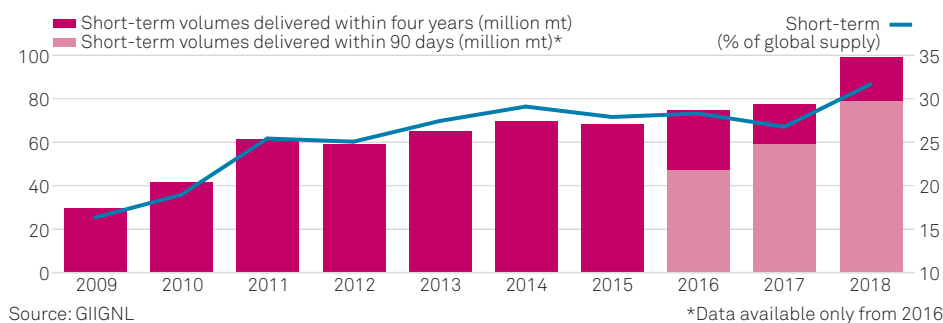
The oil market, the most liquid of all commodities markets, is a stark example of this phenomenon.

The physical spot market in oil ranged from 10% of the overall market to over 50% in the post-war era, as the oil industry moved from the control of the big international oil companies known as



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SHORT-TERM TRANSACTIONS MAKE UP ALMOST ONE THIRD OF GLOBAL TRADE AS SPOT MARKET BECOMES MORE LIQUID, DIVERSE



the “Seven Sisters” to the nationalization of Middle East oil reserves in the 1970s.

“From the 1950s to 1973, IOC third-party sales rose from 7.2% to 22.5%, whereas IOC inter-affiliate transfers declined from just under 93% to just under 70%,” trading house Trafigura said in a 2013 white paper on the changing face of the oil industry.

Independent oil trading contributed to the eventual return of a formal spot market for oil to balance global supply and demand, as oil majors forced out of oil-rich countries had become traders of oil on the open market to maintain supply.

The growth in the spot market for LNG has been driven by similar disruptions, starting from the Fukushima disaster of 2011 that saw major suppliers like Qatar increasing short-term LNG supply to Japan and oil majors diverting record numbers of Atlantic cargoes to North Asia.

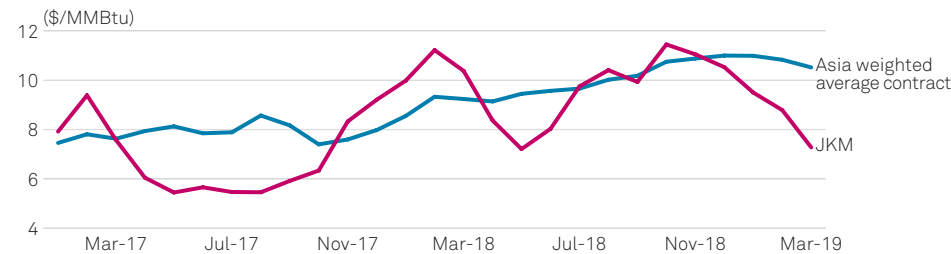
More recently, the US-China trade tensions have seen Chinese LNG importers relying on intermediaries to swap out US-origin cargoes for non-US cargoes, highlighting the role of disruptions and commodity traders in building the spot market.

Volume, price and time arbitrage

While the rise of portfolio traders and commodity trading houses will continue to boost the development of the spot market, there will be market forces constraining the growth.

In the early part of the 2020s, the LNG market is expected to tighten and lower availability could negatively impact spot market growth. On top of this, sustained periods of low prices can also force LNG projects to shut in, a potential scenario in the latter part of the 2020s.

CORRELATION BETWEEN LNG SPOT PRICES AND OIL-LINKED CONTRACT PRICES TO CONTINUE WEAKENING IN THE YEARS AHEAD



Source: S&P Global Platts

Traditionally, commodity spot markets are dependent on the ability to store or warehouse, making commodities like grains, metals and petroleum tradeable through seasonal peaks and troughs. Storage infrastructure and inventories play a crucial role in the spot price formation of commodities.

But LNG is too volatile to be stored for long enough to allow a traditional storage play. The lack of a robust futures curve for a contango play adds to trading limitations.

The fundamentally unstable nature of LNG as a tradable commodity will remain a major constraint for spot trading, but this is also expected to see some changes in the coming decade, both in terms of technology and financial market development.

Full commoditization

Between the ups and down of the classic commodity cycle, LNG will evolve to become increasingly commoditized.

From 2017 to 2019, Singapore effectively became the hub of LNG spot trading in Asia, with buyers and sellers actively seeking out optionality on cargoes.

This virtual “trading hub” has developed along the same lines as crude oil, and other

agricultural and ferrous commodities like iron ore, independent of any physical storage or transit through Singapore.

Conventional wisdom on the development of a trading hub holds that there should be an extensive network of pipelines, storage tanks and physical delivery or loading, alongside a transparent and liquid spot price.

However, Singapore has effectively developed an independent marketplace for spot LNG for Asia Pacific, with both liquidity and transparency, and minimal infrastructure. There are three essential qualities or features for a robust, deliverable spot market, according to John Driscoll, former oil trader and head of energy consultancy JTD Energy.

The first is that spot markets must be liquid and transparent with sufficient supply and trading volumes, both physical and paper.

Secondly, the spot market must be broadbased with a diverse community of market participants.

And finally, it must be supported by a widely accepted price benchmark with a transparent methodology that can inspire market confidence.

In the next decade, LNG spot markets will be pretty close to achieving these.