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THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 82 (415) • September 10, 2012 • © PISM

Adding Fuel to Gas Market Changes: Liquefied Natural Gas Development in the EU

Lidia Puka

The EU has traditionally pursued the option of LNG imports for reasons of security of supply. Recently, however, the economic benefits have become apparent. The LNG option strengthens the negotiating position of European gas buyers vis a vis pipeline exporters, as well as triggering market creation and price reduction. The current drop in the LNG import volumes has, however, been seized upon by critics to highlight its vulnerabilities. To overcome these, a concerted commitment to LNG is needed on the part of the EU, its Member States, and terminal operators, not least in Poland where the impact of the first Eastern-European LNG terminal will largely depend on the transition of the domestic gas market.

The Benefits of LNG. The dwindling indigenous production of gas (which has seen a 50 billion cubic metre drop in the last decade) has made the EU an attractive market for gas deliveries, bringing the bloc clear security benefits. This decade has seen a threefold increase in the EU's capacity to convert LNG back into gas (179 bcm), and up to a quarter of gas imports to the EU in 2011, thus reducing the EU's dependence upon neighbouring pipeline gas exporters such as Russia, and diversifying the sources of its gas supplies (Algeria, Qatar, Nigeria, Trinidad & Tobago, Egypt, Libya, Oman, and the United Arab Emirates). Moreover, the buyers have the flexibility to switch between LNG suppliers – in 2011, the drop in imports from Libya was largely balanced by Qatari gas.

There has also been a growing appreciation of the economic benefits of LNG. Its import strengthens the hand of EU-based buyers in the periodical renegotiation of long-term contracts (LTC) for piped gas. In 2009/2010 this resulted in a decrease in the contracted volume and price of Gazprom gas, as well as pushing Norway's Statoil to increase the hub-based benchmark in the LTC and Algeria's Sonatrach to move towards more flexible short-term contracts. At the same time, LNG imports increase competition, indispensable for effective gas-market liberalisation. In 2009–2011, in spite of the recession, the LNG economy and import volumes actually expanded, largely due to global gas oversupplies (caused by reduced import volumes to the USA, and increased Qatari and Australian production).

Structural Challenges. In 2010, LNG projects in the EU reached a highpoint. If completed on time, the EU would, by 2020, have the capacity (384–438 bcm) to cover local demand for gas imports with LNG. However, this capacity would be spread unevenly across the EU, in turn pointing to a clear problem: regasification terminals are costly to develop, and as a result are concentrated in the north-western and southern markets with obvious gaps in Eastern Europe. The leaders in the field are the most liberalised markets—Great Britain in the northwestern hub (95.85 bcm import capacity including France, Netherlands, Germany, and Belgium), and Spain in the south (90.25 bcm including France, and Portugal, though not connected to LNG capacities of Italy or Greece).

The largest projects to increase capacity have been planned for Italy (from 11 to 91 bcm), and France (from 23.3 to 52.5 bcm). Capacity-expansion in Eastern Europe is occurring on an altogether smaller scale (Poland, the Baltic States, and Finland, up to 10–15 bcm). Interestingly, in the EU's economic powerhouse, Germany, the LNG projects have lacked political support, as the country has secured gas supplies by enlarging storage capacity and through business interdependence with suppliers. That said, approximately 10% of the German market benefits from spot-based trading, and E.ON and RWE invest in LNG projects abroad.

Europe's LNG Import Crisis. Concerns about investing in LNG capacities have deepened in the past months. Since November 2011, with the exception of Italy, LNG volumes have decreased radically. In May, they were at around half the level they were at in May 2011. In the recently built or expanded terminals, volumes were reduced to less than a third, with two British terminals not being used at all. This coincided with financial liquidity problems amongst major companies, which have already lead to the cancellation of project in Italy (British Gas in Brindisi), while the remaining Italian terminal projects are seeking financing, as well as to the suspension of projects in Germany (E.On in Wilhelmshafen), in Great Britain (Calor on Canvey Island), and in Spain (Gascan on Gran Canaria, and Tenerife). In light of the continuous drop in net profits and market shares of EDF, the future of the Dunkirk terminal in France depends heavily on the condition of its partner companies, including Total (capitalisation of which, however, is the highest in the Eurozone). Only those few companies which have increased their share value despite the crisis enjoy brighter perspectives for conducting the projects. This pertains to Enagás (in the Spanish El Musel) and Vopak (in the French Fos-sur-Mer).

The Need for Investment. If the EU is to bring security to its LNG imports, and accrue the broader benefits, it needs to commit to LNG as an option and invest in those projects which have the greatest added value. In contrast, drop-off in its commitment will only cement LNG's vulnerabilities.

There are two reasons for this. First, a lack of market consolidation at home will leave the EU even more exposed to international uncertainties in LNG supply. A better integrated, more fluid and thus more attractive market is a necessary condition for securing LNG imports. The EU has been losing out to Asian markets, with Japan alone importing twice as much LNG as the whole EU. The problem has been augmented by the disconnected and different pricing systems in the European, Asian, and North American LNG markets, hence limiting the EU's capacity to capitalise upon the dramatic drop in gas prices in the U.S. ($3 at the American Henry Hub versus $53 at British National Balancing Point). Moreover, for better integration of the market, the fluidity of LNG sales needs to be improved, as currently they are predominantly based on long-term-contracts (average 5–10 years) with the price pegged to oil.

Second, and connected to this, LNG-import levels are still dependent on the volumes and pricing of piped gas. The provisions of the LTC for the latter currently give the contractors flexibility of approximately 85–115% of purchased volumes. Within this margin, they retain the power to block LNG competition and defend the *status quo* of oil-linked pricing. To break this opposition, the EU would have to work towards a repetition of 2009 market conditions: an oversupply of gas, together with pressure on the incumbent wholesale gas companies, which were left with uncompetitively priced LTC gas and decreasing sales. This situation forced the incumbents to move the volumes to spot sales, and to renegotiate gas volumes and prices with producers.

Recommendations. In some ways, the LNG option is a victim of its own success. With only limited investment, it strengthened the hand of EU-based suppliers when negotiating with foreign pipeline producers of gas, in turn making these other forms of supplies more attractive to domestic consumers and cutting LNG's competitive edge. However, if the EU wishes those benefits to be anything more than fleeting, it needs to commit to LNG. The EU should therefore work to increase the efficiency of the global LNG market connections and the liquidity of supplies by means of strong and concerted diplomacy. The European External Action Service should promote the EU gas market abroad, and strengthen the EU's diplomatic relations with LNG producers. Internally, the EU should work on fostering hub-based sales, greater market transparency, shorter and standardised LNG contracts, and better interconnections with the Member States in which the regasification capacity is already large.

These demands are particularly clear for Poland. As the home of the first Eastern European LNG terminal project, in Świnoujście (5 bcm by 2014), Poland aspires to become a leader in regional gas sales. The timely completion of the project will promote market liberalisation and facilitate the switch from coal, all without increasing one-supplier dependence. However, to achieve these goals Warsaw will need to create suitable national market conditions and the possibility of short-term spot trading, restructure the incumbent national company, and increase the profitability of terminals by extending the range of uses for LNG, such as in the form of ship fuel sales.