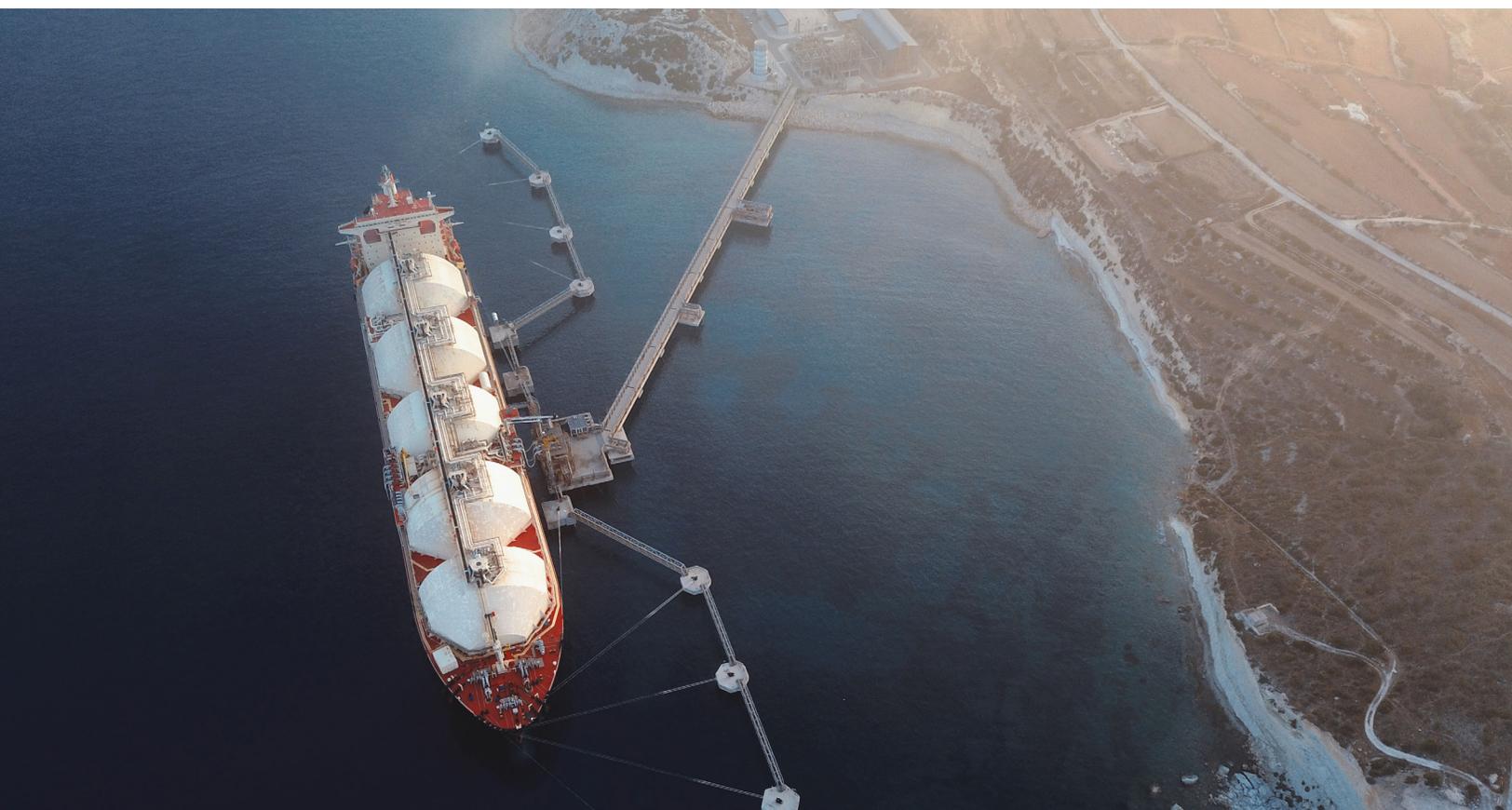


Oil & Gas Practice

How COVID-19 and market changes are shaping LNG buyer preferences

Our recent survey gauges how the pandemic has affected buyer sentiment with expectations of an increased reliance on the spot and short-term market.

by Alessandro Agosta, Nicholas Browne, Giovanni Bruni, and Nicole Tan



Despite current market oversupply and uncertainty, the future of liquefied natural gas (LNG) remains strong. In fact, months after the outbreak of COVID-19, many buyers remain bullish on LNG demand, and some have even increased their expectations. Meanwhile, some trends—such as expected reliance on the spot and short-term market and growing preference for LNG-based contract pricing—appear to have accelerated.

These findings, among others, are the results of our 2020 LNG Buyers Survey (see sidebar, “About the survey”). Conducted in April, after the initial COVID-19 outbreak and the decline in oil prices, our survey assessed how buyer needs and attitudes have evolved over the past two years as well as how buyers view new developments such as emissions transparency. The survey also assessed whether the pandemic has had a significant impact on how market participants view the industry.

This article provides context on LNG demand and how buyer procurement priorities are evolving and offers guidance on how companies can prioritize business-development efforts. Specifically, our breakdown of six buyer clusters—by region, buyer type, and experience—can help companies navigate market uncertainty and adapt to changing procurement preferences.

COVID-19 has not shaken confidence in longer-term LNG demand

In the short term, buyers in all regions have reduced their expectations for LNG demand compared with those preceding the pandemic. Most markets saw reduced short-term industrial and, in some cases, gas-to-power demand due to COVID-19 shutdowns, though buyers remain confident in medium- and long-term demand (Exhibit 1).

The fundamentals for LNG demand growth—such as declining domestic production and growing electricity demand—remain unchanged in many key markets. Meanwhile, low prices enable additional LNG penetration. For example, a majority of buyers in all regions of Asia have increased their demand expectations, with Chinese and South Asian buyers expressing the most confidence.

In the event of sustained low prices over the next three years, 90 percent of buyers anticipate a positive market response, particularly in the power sector as gas displaces other fuels, such as coal (Exhibit 2). Again, Asian buyers are the most bullish. In fact, 60 percent of Chinese buyers expect the demand upside to increase by 11 to 20 percent, while 60 percent of South Asian buyers expect demand to increase by more than 20 percent.

About the survey

We previously conducted this survey in 2016 and 2018, creating a unique perspective on the evolution of buyer preferences. This year’s survey involves nearly 60 LNG buyers in 25 countries,

representing major regional markets as well as all types of LNG buyers, such as utilities, national oil companies, infrastructure developers, and traders—as well as established, new, and potential buyers.

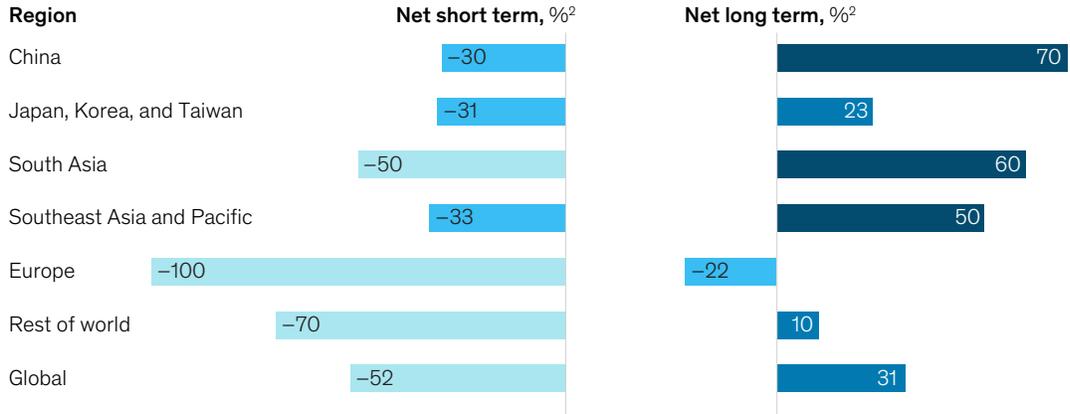
These buyers account for approximately 90 percent of the LNG volume flow. In addition, all survey respondents have active decision-making roles in LNG procurement and contracting activities.

Exhibit 1

Despite disruption due to COVID-19 in the short term, buyers remain confident in gas and LNG demand for the medium and long term.

Net percentage of buyers expecting a decrease or increase in gas/LNG demand due to COVID-19¹

Higher net expecting demand to decrease -100% | 100% Higher net expecting demand to increase



¹Buyers were asked, "Has COVID-19 changed the demand expectations for gas/LNG for a typical firm like yours?"
²Calculated as percentage expecting demand to increase, minus percentage expecting demand to decrease.
 Source: LNG Buyers Survey 2020, Energy Insights by McKinsey

The one outlier is Europe, where buyers see less upside to demand even with sustained low prices. This is a consequence of strong recent demand growth, as low prices have already led gas to displace coal in the power sector—hence the limited additional upside.

Market-based pricing and risk management remain critical priorities

Buyers value more flexibility so they can cope with uncertainty. This can be achieved via increasing reliance on spot and short-term volumes as well as incorporating additional flexibility into long-term contracts.

The growth of spot and short-term contracts has been one defining feature of the LNG market over the past five years. Our survey highlights that buyers expect this trend to accelerate. In fact, buyers expect that close to 60 percent of their portfolios will ultimately consist of spot and short-term volume—a marked increase on expectations compared with our 2018 survey when the figure was slightly more than 40 percent.¹ Current oversupply appears to be making buyers more comfortable that market liquidity can meet their supply needs. As a result, they are willing to increase reliance on the spot and short-term market.

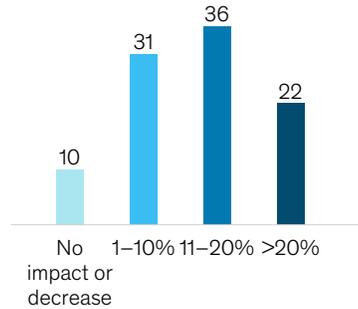
¹For more on how companies can develop and optimize their portfolios, see Gillian Boccara, Dumitru Dediu, and Xavier Veillard, "Winning the race for world-class LNG optimization capabilities," March 12, 2020, McKinsey.com.

Exhibit 2

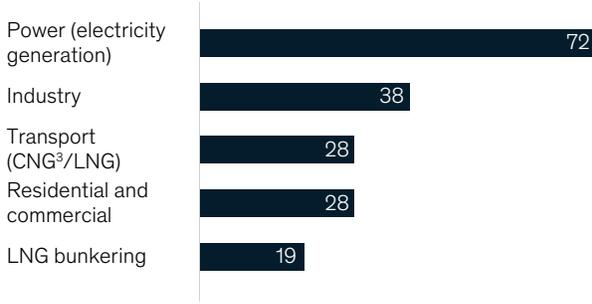
Power generation will see the biggest increase in LNG demand if low prices are sustained.

Expecting greater increase in demand 

Extent of demand upside,¹
% of responses



Area of biggest demand upside² by sector,
% of responses



¹Buyers were asked, "How much room is there for LNG demand in your market to increase within the next two to three years if LNG prices remain below \$5/mmbtu within the next two to three years?"

²Buyers were asked, "If demand will increase, please select the sector(s) that will be the most substantial contributors to that," and were able to select multiple sectors only if they believed demand would increase.

³Compressed natural gas.

Source: LNG Buyers Survey 2020, Energy Insights by McKinsey

For long-term contracts, buyer preferences continue to evolve in terms of indexations, durations, and requirements. Diving deeper into these requirements, we assessed the importance of seven criteria, which are ranked by order of importance (Exhibit 3).

Flexible destination and volumes (delivery schedules, destination free, take or pay,² and volume range) are highly valued. More specifically, eliminating destination clauses and increasing flexibility in volume to adjust to fluctuations in market demand are considered to be very important by nearly all buyers, regardless of geography or buyer type.

²Under a take-or-pay contract, the buyer pays the full sales price for the entire contracted quantity, even those it does not take.

Buyers expect that close to 60 percent of their portfolios will ultimately consist of spot and short-term volume—a marked increase on expectations compared with our 2018 survey.

Exhibit 3

Buyers across regions value flexible delivery and volumes above all else.

Ranking of importance of seven factors in term contracts in 2016, 2018, and 2020¹



¹Buyers were asked, "How important are the following factors in a term contract?"
Source: LNG Buyers Survey 2020, Energy Insights by McKinsey

Market-based pricing is considered very important by several key segments, including all European and Chinese companies as well as some other Northeast Asian power players. Market-based pricing—such as long-term contracts linked to Henry Hub and European hubs—is already an industry standard. But beyond that, several Asian players now view LNG indexed contracts as very important when considering new long-term contracts, even if these have yet to be offered widely by suppliers.

Supplier reliability has decreased consistently across each of our surveys on the back of growing market liquidity. However, it remains a priority for around 50 percent of global buyers, particularly established gas companies in Japan and Korea, buyers in South and Southeast Asia, and many new buyers globally.

Meanwhile, other contract requirements—particularly flexible payments, rich-gas quality,³ investment partnerships, and transparency in

emissions intensity—may be considered very important by some specific buyer types but not universally so. Emissions intensity was a new criterion examined this year and was identified by some buyers as very important.

Six buyer clusters have emerged in response to different factors in term contracts

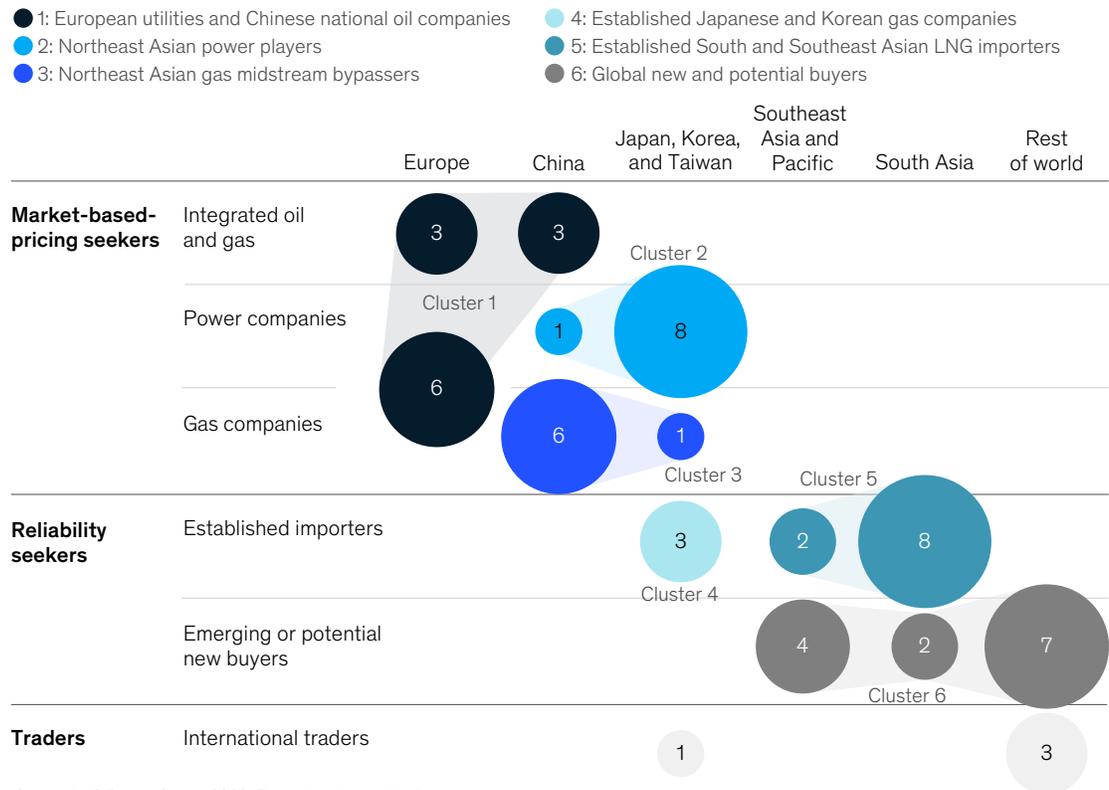
The LNG market remains far from commoditized and there are clear differences between buyers. Our survey indicates six buyer clusters that have emerged based on contract requirements:

- 1) European utilities and Chinese national oil companies,
 - 2) Northeast Asian power players,
 - 3) Northeast Asian gas midstream bypassers,
 - 4) Established Japanese and Korean gas companies,
 - 5) Established South and Southeast Asian LNG importers, and
 - 6) Global new and potential buyers.
- The preference for market-based pricing and supply-security concerns are the most significant differentiators between buyers (Exhibit 4).

³Rich gas contains less than 95 percent methane and more than 5 percent ethane, propane, or butane.

Exhibit 4

Six buyer clusters illustrate priorities across regions.



Source: LNG Buyers Survey 2020, Energy Insights by McKinsey

Similarities between buyers have spread beyond geographies and types of companies. For example, established Chinese national oil companies and European buyers (cluster 1) consistently favor flexibility and market-based pricing over other considerations. Meanwhile, compared with previous LNG Buyer Surveys, gas companies from China (cluster 3) and power companies from Japan, Korea, and Taiwan (cluster 2) have also started to move in this direction. Elsewhere, a multitude of other buyers are emerging globally with differentiated requirements as well as a consistent emphasis on the importance of supplier reliability to meet their supply-security concerns.

Buyers are ultimately distinguished by their specific appetites for flexible payment terms, emissions-intensity transparency, investment partnerships, and rich gas—as well as the level of importance they attribute to market-based pricing (compared with supplier reliability). Identifying and prioritizing business-development efforts to focus on buyer clusters will be critical in today’s uncertain and ultracompetitive market. Those that do so will be best positioned to respond early and decisively to market shifts and procurement trends, improve their negotiations, optimize their portfolios, and benchmark their supply sources.

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