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LNG Exports

Qatari Catalyst: Uncertainty Rattles World's Biggest LNG Shipper; Summer Demand Heating Up

The Takeaway:

> *Last week, six Arab countries abruptly severed diplomatic ties with Qatar, allegedly over Qatar's support for organizations regarded as terrorist, including the Muslim Brotherhood and Hamas. Several of these countries, including the UAE and Egypt, are prominent importers of Qatari LNG and natural gas. Globally, Qatar is the largest LNG supplier with nearly 80 million metric tons (mtpa) exported last year, representing over 30% of the supply in the 263 mtpa global market. So far, LNG exports from Qatar continue relatively unimpeded, though the UAE imposed a ban on all vessels heading to or coming from Qatar and blocked access to a key refueling port in Fujairah. Tensions between Qatar and the blockade countries have not cooled, despite attempts by Kuwait and the U.S. State Department to mediate. Regardless of Qatar's assurances that the blockade will not affect LNG shipments, we believe that this unprecedented blockade casts uncertainty over Qatar's ability to meet summer demand requirements. This uncertainty creates an opportunity for the U.S. to prove its mettle among risk-averse Asian LNG buyers heading into the tight summer demand season.*

› The decision last week by certain members of the Gulf Cooperation Council, including Saudi Arabia and the UAE, to isolate Qatar highlights longstanding tensions between the region's two power-house countries: Saudi Arabia and Iran.

› So far, the conflict shows no sign of abating, with Kuwait's Emir Sheikh Sabah Al Ahmad Al Sabah saying last night that divisions among the GCC countries may lead to "undesirable consequences".

› LNG exports from Qatar proceed unimpeded (with some minor cargo substitution for GCC countries participating in the blockade), though the escalation of tensions just ahead of the peak summer demand season will likely make risk-averse LNG buyers cautious about Qatar's role as a major LNG supplier in the future.

› There are a lot of reasons that buyers want to shake Qatar's influence, after all, most of which are driven by economics rather than politics. In particular, the next generation of LNG contracts will likely feature greater flexibility on the destination of cargoes and a shift to pricing based upon a gas hub, as U.S. contracts already do.

› LNG suppliers in the U.S., like Cheniere (**LNG**), Tellurian (**TELL**), and Sempra (**SRE**), are lining up to take advantage of the tightening spot market and geopolitical instability in the Middle East.

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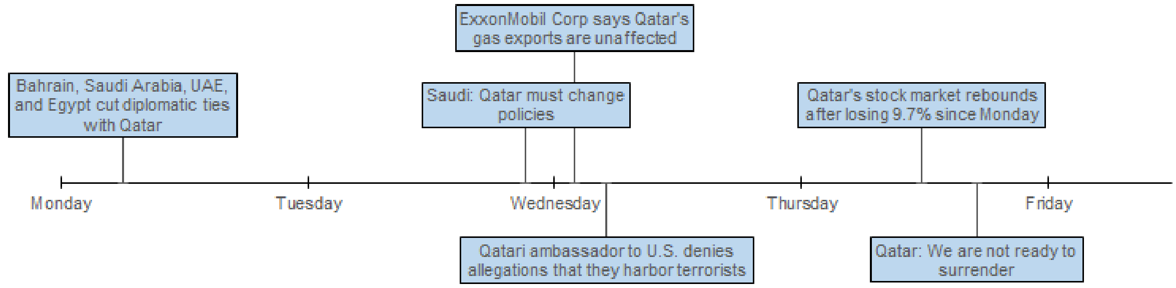
The Qatar Problem – Context and Resolution

Gulf Coast countries, including Saudi Arabia, Bahrain, the United Arab Emirates (UAE), as well as Egypt and the government for the Eastern part of Libya cut diplomatic ties with Qatar on June 5, demanding that all Qatari diplomats leave within two days and all Qatari citizens within two weeks. Additionally, travel to and from Qatar is heavily restricted. The unprecedented move thrusts the region into uncertainty on the heels of President Trump's visit to the Middle East, which he optimistically heralded as a trip that "may someday be remembered as the beginning of peace in the Middle East." So far, the administration has been unable to help bring the two sides together, and developments indicate that countries find themselves more or less in a tense diplomatic standoff (Figure 1).

Figure 1. Timeline of Qatari Conflict, Selected Events (June 5-9)



The pressure on Qatar to capitulate to Saudi Arabia and others' demands is intense. The country is in the middle of preparing for the 2022 FIFA World Cup, preparations for which have likely halted in the wake of the travel ban. Additionally, while Qatar's government and others so far insist that there will be no disruptions to energy trade, the position is precarious. UAE has waffled this week over whether Qatari-origin or destination vessels can stop at their port in Fujairah; yesterday, UAE re-issued the ban with no clear explanation. At a minimum, Qatari commodity export costs will rise. At worst, the blockade could portend future action to encumber Qatar's access to the Strait of Hormuz or to the Suez Canal. Many LNG tankers use boil-off gas to power their engines, though roughly 60% of ships use a two-stroke reliquefaction and diesel engine or an entirely diesel electric engine (33% and 26%, respectively).

So far, the countries do not appear to have made any progress towards a diplomatic resolution. The crux of Saudi's demands likely come down to some version of the following:

1. Expel 59 individuals and 12 organizations recognized as terrorist by Saudi Arabia and other Gulf coast countries – particularly the Muslim Brotherhood and prominent cleric Yusuf al-Qaradawi.
2. Shut down or significantly handicap Al Jazeera, the Qatari state-funded news organization.
3. Significantly modify diplomatic ties with Iran, with whom Qatar maintains a constructive diplomatic relationship.
4. Otherwise "get in line" with Saudi Arabia's leadership in the region.

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The blockade ostensibly is designed to pressure Qatar to meet these demands, but so far Qatar seems reluctant to give in (see: "we are not ready to surrender") and has pushed back on making changes to their foreign policy. President Trump's initial tweets that he supported the blockade were probably not constructive – the U.S. must play the role of mediator between Qatar and the rest of the Gulf Cooperation Council (GCC).

Resolution – Tensions Remain High

It is difficult to see a resolution to this conflict that does not involve Qatar distancing itself from Iran. However, the dynamic is not new and much of Qatar's meteoric rise is due to its diplomatic and economic independence from the other GCC countries. Even so, there are several important factors that are likely to ensure that this conflict does not escalate beyond the diplomatic. First, Qatar is readying for the World Cup and is unlikely to seek a strategy that jeopardizes its ability to prepare for the high-profile event. Second, the strategic significance of the U.S. air base Al Udeid outside Doha means that the U.S. is unlikely to accommodate hostility between Qatar and the GCC. To this point, the Pentagon and State Department have taken care to point out that the U.S. has no intention of moving Al Udeid despite the blockade. Finally, Qatar's enormously significant role as an LNG exporter necessarily means any escalation that interferes with LNG shipping would drag powerful countries outside the Gulf region into the conflict, including Japan, Korea, India, and the UK.

That said, the conflict shows limited signs of abating. We believe the blockade will remain primarily a diplomatic issue, not a military one, and the worst case is likely that the status quo drags on, perhaps with some increasing cooperation between Qatar, Turkey, and Iran to meet short-term needs. Longer-term, the pressure is on the U.S., Qatar, and Saudi Arabia to negotiate a satisfactory resolution.

Tension May Accelerate Transition from Qatar-Dominated LNG Market

With the blockade of Qatar showing no clear path to resolution, the two most prominent LNG exporting countries both find themselves facing existential risk to supply heading into the summer. Qatar, obviously, faces the threat of a blockade interrupting LNG cargo shipments. In Australia, restrictions approved by the government earlier this year might allow political leadership to hold back exports, under certain situations, if the domestic market experiences a shortage. While Australia's restriction is largely political in nature and unlikely to be used, buyers will likely view it as an incremental risk, considering that it takes effect during the high-demand summer season.

The LNG industry is undergoing a series of changes, some of which may be all the more prominent in buyers' minds due to the risk of the conflict in Qatar escalating. In particular, buyers today seek contracts with more flexibility in terms of both destinations and volume. Buyers want contracts linked to a local hub (especially European buyers) rather than linked to oil. Qatari contracts (and many old-world contacts) tend to be restrictive in terms of cargo destination and are almost exclusively oil linked. Low prices in the LNG spot market are pressuring suppliers like Qatar, but so far the mega exporter has appeared content to shift

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volumes into higher-priced markets, like India and China, and away from markets like Europe where competition is most intense. Future LNG contracts will likely incorporate a great deal of additional flexibility (as U.S. contracts often already do) and will likely either price off of a gas hub, like TTF in Europe or Henry Hub in the U.S., or will be sold through portfolio players who can offer that ability.

Security of supply will remain paramount in all cases, however. The industry remains risk averse and the conflict in Qatar helps give Asian buyers, particularly, a chance to demand greater flexibility from LNG suppliers. There is a risk that the conflict in Qatar could become more hostile and begin to threaten LNG supply, which would be bad for the entire industry and likely cool some emerging buyers' appetites for LNG. On the other hand, we predict that summer spot cargoes will likely be relatively expensive and hard to come by regardless of the conflict in Qatar, thereby reminding buyers who've stayed on the sidelines and failed to sign long-term contracts in recent years that eventually LNG demand will outstrip available supply once again. We continue to view this summer as an important catalyst for the industry with LNG suppliers in the U.S., such as LNG, TELL, and others, lining up to take advantage.

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RISKS

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