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European natural gas: Carry appeal

It's been a year of pressure so far for the European natural gas market, as a result of high stocks coming into the injection season and strong LNG inflows. Storage is full, and where the market goes next will depend largely on winter demand and the outcome of Russian/Ukrainian gas transit negotiations

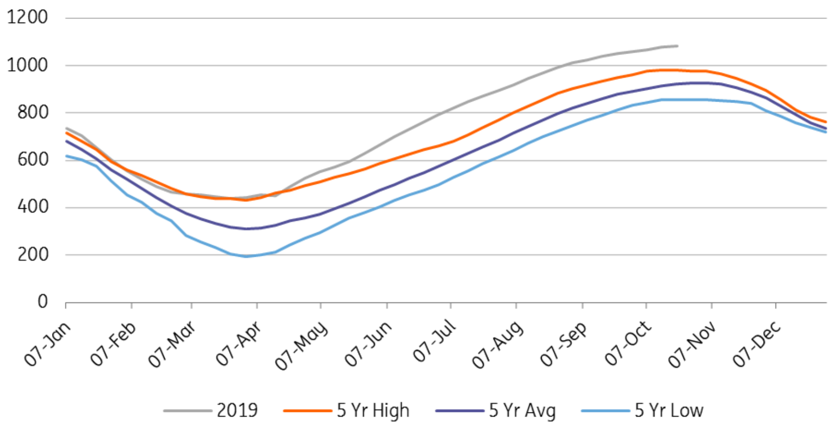
Gas storage tank

Carry what you can

The European gas market has been plagued with high stocks, as last year's mild winter meant that we entered injection season with elevated stocks. Then with the ramping up of Liquefied Natural Gas export capacity, and weaker-than-expected Asian demand, much of this LNG made its way into Europe, only adding further to inventories. The surplus environment has weighed heavily on spreads, and the summer/winter spreads this year have offered an attractive incentive for players to store gas. The issue, however, is that gas storage is basically 100% full, limiting those who can take advantage of the carry in the spreads. As we move deeper into the winter season, with gas inventories standing at least at a 5-year high of 1,080 TWh, and a fairly mild start to winter, spot prices remain under pressure.

If we look at the Title Transfer Facility day ahead-Feb-20 spread there is still an incentive to store gas, with the spread in a contango of around EUR6/MWh, although admittedly it has narrowed in recent weeks. But as mentioned previously, with storage full, there are few who can take advantage. Where there is potential, though, is through floating storage for LNG. We are likely to see LNG vessels slow steaming, in order to try make the most of the carry in the market. However, we have seen a recent spike in LNG freight, with rates rallying from US$60,000/day back in September to US$120,000/day currently, increasing the cost of carry for floating storage.

EU gas inventories (TWh)



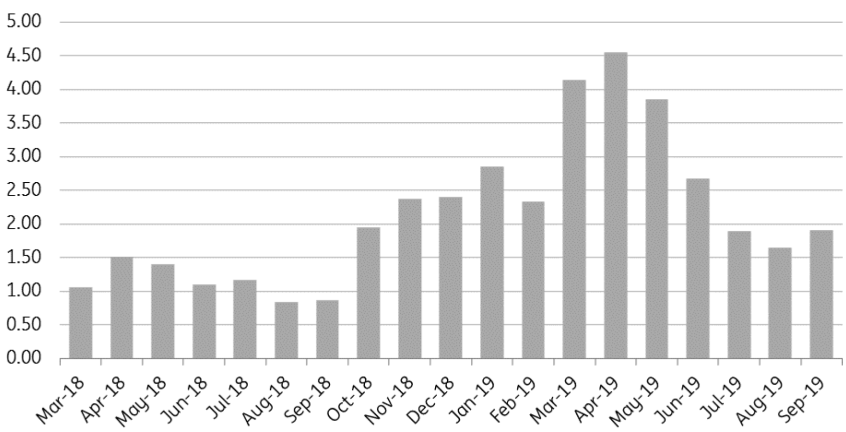
Source: GIE, Bloomberg, ING Research

LNG inflows - where next?

The European market this year has been overwhelmed with LNG inflows, driven by the ramping up of export capacity from the likes of the US and Russia, whilst demand growth from Asia this year has slowed, which has left Europe to absorb much of the surplus. This saw record volumes making their way into NW Europe earlier in the year, which has taken European LNG inventories to record levels.

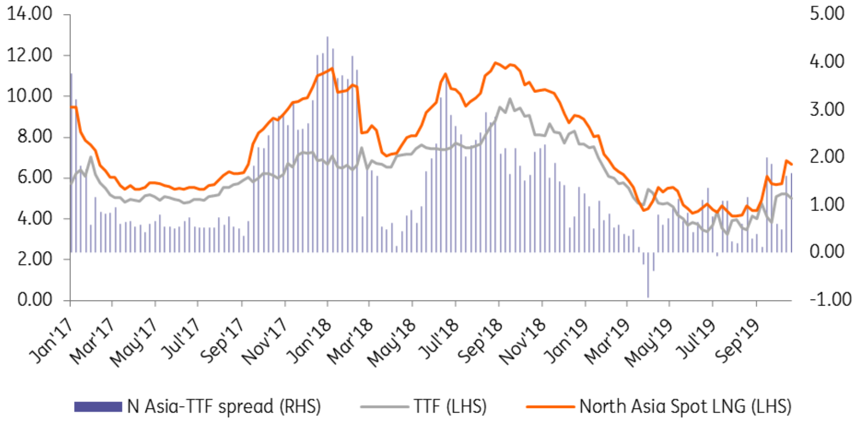
However, since then we have seen somewhat of a slowdown in these flows, as the Asian market starts to strengthen as we move into winter. We would expect that in the coming months Asia will continue to absorb more LNG supply, which should provide some relief to the European market. However, the risk to this is if we continue to see strength in the LNG freight market. Further strength in freight could close the arb into Asia, leaving Europe as the home for this LNG - much like we saw towards the end of last year.

NW Europe LNG imports (m tonnes)



Source: Bloomberg, ING Research

European & Asian gas prices (US$/MMBtu)



Source: Bloomberg, ING Research

The key bullish risk

In an environment where it is difficult to identify much in the way of bullish drivers for the gas market, there is one key bullish upside risk that we can identify for the market. The Russian/Ukrainian gas transit deal is set to expire in January, and negotiations are currently underway to renew. However negotiations are proving tough, with the Ukrainians wanting another 10-year deal, whilst the Russians are more reluctant as they look to diversify pipeline routes into Europe, and with the expected start-up of Nordstream 2. Failing to come to a deal, would leave the European market tight, with almost 87bcm of the 200bcm that Gazprom exported to Europe in 2018 transiting through Ukraine. A no deal would certainly see prices rally strongly, prompting a change to the outlook for the market at least for the next year.

On the flipside, coming to a deal, would likely see the European market entering next year's injection season with fairly large stocks once again, which suggests that we could see a repeat of the deep contango in the summer/winter spreads like we saw this year.

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