What coronavirus could mean for Australia's trade with China

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With coronavirus spreading, discussion of how to deal with its dangers and analysis of its potential economic impacts are picking up speed. In the past few days, some media outlets have highlighted a niche but crucial issue that could come to the fore if the crisis deepens.

Chinese companies are considering invoking force majeure clauses in their contracts with foreign liquefied natural gas (LNG) suppliers, a move that could lead to a temporary halt to China's imports of contracted LNG for the next few months.

Force majeure clauses are legal provisions that exist within contracts to protect parties from an 'act of God'. Conventionally, to trigger such a clause, a situation must have three crucial elements. The first is that the event could not have reasonably been foreseen by the parties, the second is that it was completely beyond the parties' control, and the third is that they could not have prevented its consequences.

In this case, a force majeure clause could be triggered because Chinese LNG buyers face unexpectedly low demand due to a warm winter and the unexpected outbreak of coronavirus. Wood Mackenzie, an energy consulting company, has verified this, stating that China's LNG demand had 'fallen off a cliff' since January 2020.

LNG contracts are sometimes very long-term, and can be more than 20 years in length. These contracts come with a restriction that the buyers need to pay the price for a minimum amount of volume – usually 85 per cent of the total contracted volume – whether they need the gas or not. This can lead to financial losses if a buyer's contracted volume is higher than their market demand.

Even though some LNG suppliers have rejected the force majeure claims, the *Financial Times* has reported that LNG suppliers are willing to offer flexibility in contracts affected by the outbreak. Some LNG suppliers may have to divert some of their cargo, previously destined for China, to lower profit markets.

As a result of this, Australian LNG suppliers are expected to face various downward price pressures. This is important as Australia exported an estimated $50 billion of LNG in 2018-19, and the industry has been highly profitable for the country.

Despite the challenges presented by these downward pressures, unexpected opportunities may emerge from the crisis. For instance, a coronavirus force majeure case could provide a testing ground for the potential re-negotiation of long-term LNG contracts in the future.

East Asian economies import approximately 65 per cent of globally traded LNG, and provide the dominant market for Australian LNG exports. In an attempt to get a better deal from exporters like Australia, these countries are making an effort to adopt prices that are generated from trading hubs as an alternative benchmark. This would allow them to move on from using the oil-indexed pricing mechanisms currently prevalent in most long-term LNG contracts.

A transition to new pricing mechanisms could be a crucial shift for LNG contract negotiation. In a liberalised and competitive gas market to come, long-term contract buyers cannot survive when market prices dip lower than the oil-indexed prices laid out in their contracts because new players with market price gas can take over the market.

While China does not have the competitive markets that justify the transition to hub-based pricing, its market liberalisation is underway. As China's gas market liberalises, it seems inevitable that this transition of gas pricing mechanisms will happen at some point in the future. A coronavirus force majeure case that forces a change of LNG trade could be a testing ground for that transition in the future.

A fall in Chinese demand for gas, or, alternatively, less attractive price conditions in China as a result of such a transition, could help divert more natural gas to Australian domestic markets, easing price pressure on Australian consumers. It is easy to see why this would be a welcome development for Australian governments, with Australian consumers having long suffered from high gas prices.

Australia could take advantage of weakened Chinese demand for gas by importing LNG to its east coast gas markets.

Australia's first LNG import terminal to be built in New South Wales was approved in April 2019. If such infrastructure were operational, Australian consumers could have access to LNG at much lower prices than usual due to the lack of demand, especially in the next few months.

To take best advantage of these opportunities, and limit the damage of weakened Chinese demand for gas, the Eastern Australian gas market needs policy reform. Pipeline capacity and its allocation, third party access, and gas hubs all need change if they are to encourage gas markets to allocate gas effectively between exports and the domestic market.

In order to turn this potential crisis into opportunities for Australia, action is needed, and the Australian business sector needs to be vigilant in its preparation too. Potential changes to current and future LNG contracts could be sudden and will be crucial, and companies must prepare contingency plans accordingly.

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