LNG

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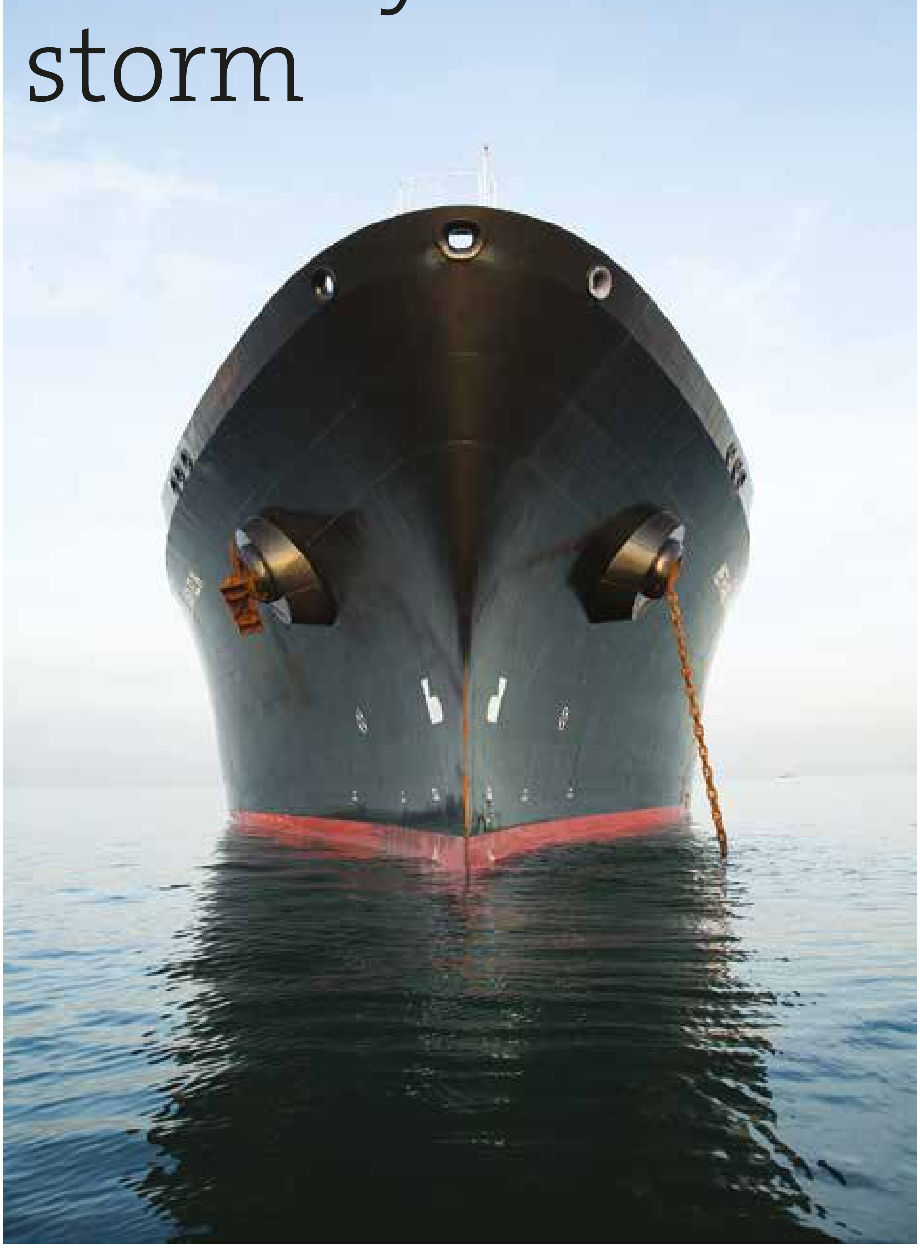
In the eye of storm



Bracewell & Giuliani's *Martin Stewart-Smith, Paul Jones* and *Nick Kendrick* review the changes to contracting strategies that are rapidly being deployed across the LNG market.

Methane Kari Elin LNG vessel, Singapore
Source: BG Group

The LNG market is in the process of rapid change. The current oversupply position is exerting considerable pressure on the traditional long-term contract model that has been so effectively used to underpin the long-term debt financing of LNG project development. In many respects, the current oversupply is not unexpected. Back in 2012 and 2013, many industry experts were predicting that the LNG market would be in an oversupply position by 2015. These predictions were based on the scheduled start-up dates of new liquefaction capacity which were either already under construction or had taken final investment decisions (FID). However, these predictions were made at a time when oil and gas prices were significantly higher than today.

The confluence of the predicted oversupply along with demand destruction in many traditional markets, coupled with the halving of oil prices have created a 'perfect storm' for the LNG industry – although this is unlikely to remain the case for long as the market finds a new equilibrium.

So, why are these storm winds currently blowing so many projects off course and what strategies can sponsors and developers take to navigate through them?

The winds of the storm

There are a number of different elements that, taken together, are proving challenging for many LNG expansion projects and new developments. Apart from the overall increase in supply of LNG generally, the extent of this oversupply is resulting in falling and shifting demand between the different LNG markets of Asia, the Atlantic Basin and the Pacific Rim.

In 2013, East Asian demand for LNG accounted for around 75% of global LNG consumption, with the three biggest end-user countries being Japan, China and South Korea. LNG is a key source of fuel to these economies, particularly in relation to power generation. Many players in traded LNG established operational centres in Singapore in response to this high level of Asian demand for LNG relative to other markets.

Europe is the second most important LNG regional market after East Asia, but the rapid growth of renewables and the lingering economic malaise post-credit crunch has continued to suppress demand. Nevertheless, the race is now on to exploit new niche market opportunities where there is potential for relatively greater value compared to the traditional regional markets where, for example, there is a rapid movement away from Brent linkage.

The rapid rise of the use of floating storage and regasification units (FSRUs) to bring early gas into new markets has become an important part of this equation. Recent examples include Pakistan, Jordan, Egypt and now Ghana, to name only a few. This move to new markets where there is either no, or limited, gas is driven by the push for entirely gas hub indexed pricing (NBP; National Balancing Point, or TTF; Title Transfer Facility) where the traditional utility buyers wish to de-risk their purchasing by eliminating floor pricing and lowering the index price percentage or taking a higher fixed deduction (or in some cases, a combination of both).

Where hybrid formulae are still being considered, the constructs show a markedly reduced slope in terms of the percentage of Brent, made vulnerable to early elimination through wider ranging price review provisions. But this move is also driven by the pull effect of these new markets where the alternative fuels with which LNG competes are more expensive, allowing LNG to be sold at some discount to the competing fuel but at a decent margin over NBP or TTF indices. The effect of these forces on the market, as it struggles to find its new equilibrium, is a rapid shift to spot sales and shorter term contracts.

Regional interdependencies

In an integrated (yet historically price-delinked) global market, specific regional factors are growing in impact on global pricing and contracting strategies.

- *Japan* – The average price of spot LNG cargoes imported into Japan in September 2015 was \$7.7/mn Btu compared with \$11.3/mn Btu in September 2014 as the country focuses on cheaper heavy fuel and thermal coal purchases.
- *US* – Wood Mackenzie recently observed that a spot natural gas floor price of \$5/mn Btu in Europe and Asia would have to prevail in the current LNG over-supply environment for new US LNG production to avoid being curtailed.
- *Yemen* – The shutdown is likely to leave the overall 2015/2016 winter surplus just above last year's levels, providing some counterbalance to the explosion in Australian liquefaction capacity.
- *China* – The uncertainty around future Chinese gas supply, level of reliance on LNG imports and indeed economic health and growth potential more generally is enough to move the needle on global pricing.
- *Russia* – Russian supply activity has a significant impact on gas prices in Europe and as far afield as Asia and the US.

One effect of pricing interdependency identified by analysts is the increasing potential for destination flexibility in LNG contracts, increasing diversions of cargos between markets and re-exporting of cargos, all of which increase market liquidity and contribute to greater conformity between regions and markets. Over the medium- to long-term, there is a general feeling that migration away from oil linked pricing is likely, with a shift to more spot sales or hub-based pricing.

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Navigation strategies

A number of financing strategies are being used in the LNG sector:

Debt financing

As lawyers and bankers advising sponsors and developers seek to capture these changes through financial modelling, documentation and views on 'bankability', it is clear that until a new equilibrium is found between project development and construction costs that feed into the costs of production per mn Btu of LNG on the one hand, and the price at which that LNG can be sold on the other hand, the project financing textbooks have to be closed, put back on the shelf, and instead creative thinking has to be deployed. The traditional approach of fully de-risking the SPV (special purpose vehicle) in every respect through long-term LNG SPAs (sale and purchase agreement) with floor pricing and indexation is giving way, at present, to shorter term, fully market-based contracts which have sellers bearing more risk than they have been used to over the last decade.

As sponsors cancel or defer FID on more and more projects, construction costs are rapidly falling as contractors are increasingly hungry for new work. At the same time, cancelled or postponed capital spend will mean deferral of new LNG coming to market and therefore the potential for a pricing recovery in the next three to five years. In a best case scenario, the pervading gloom of the current LNG overhang will correct itself, particularly given the propensity of the LNG industry to over-react to swings in the market.

The factor that will separate the winners from the losers in the current market will be those who are able to combine short- and medium-term contracts sufficient to get the production capacity developed, built and operational on terms that can access the new niche higher value markets, but leaving sufficient flexibility to remarket the volumes in the medium-term in order to capture the benefit of the inevitable tightening up of the LNG market.

What does this mean for project financing then in the short- to medium-term? In the short term, project financing is likely to be difficult, as lenders will see this approach as a departure from the text book that makes the deal 'unbankable'. However, the combination of alternative funding structures such as pre-pays, mini-perms and hybrids alongside commodity hedging are just some of the tools that can be effectively deployed to weather the current storm.

Equity financing

As access to project financing proves difficult in the short-term, sponsors and developers are likely to look to dilute their exposure to significant capital costs through farm-down processes and other strategies to introduce new equity participants into LNG projects which may spark a higher volume of M&A activity in the LNG sector (though with a cautionary note that such M&A is likely to be on weaker terms for sellers in the light of lower prices and more limited short access to project finance).

In Chile, for instance, Gas Natural Fenosa recently increased its stake in Metrogas (the main gas distributor in Chile and 20% shareholder of the Quintero LNG import terminal), while in Mozambique, Sasol has entered into a consortium with Area 4 operator Eni to acquire fresh acreage that could form part of Mozambique-LNG feed gas supply. Capital intensive projects on the east and west coasts of Africa, and in the Mediterranean, are also likely to see changes in their equity make-up as projects move closer to development. On a much bigger scale, the imminent closure of Shell's takeover of BG will see it acquire a range of LNG assets and place those projects on a new financial footing.

A 'new normal'

Alternative contracting strategies are enabling project sponsors and developers to take projects forward in the midst of a perfect storm of oversupply and demand destruction. This innovation is set to continue for the foreseeable future as buyers and sellers alike adapt to a 'new normal' away from fixed long-term contracts. ●