Getting imaginative

Second-wave LNG developers are embracing new kinds of financing and contract models that will support both growing spot trade and a secondary, small-volume contract market.

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A growing number of second-wave LNG developers targeting startup dates in the early- to mid-2020s have been struggling to reach final investment decisions in recent years. A select few of the higher-capitalized projects have crossed the finish line.

Others are facing headwinds in securing adequate funding, calling into question the viability of projects that will be essential in meeting the anticipated growth in global LNG demand.

According to S&P Global Platts Analytics, LNG supply is expected to grow to almost 400 million mt/year by 2023, up from 320 million mt in 2018.

The market has witnessed a decisive shift in bargaining power toward buyers since the mid-2010s. The growth in flexible supply from the US and Australia has given end-users, utilities and portfolio players the leverage to exact shorter, more flexible buying arrangements.

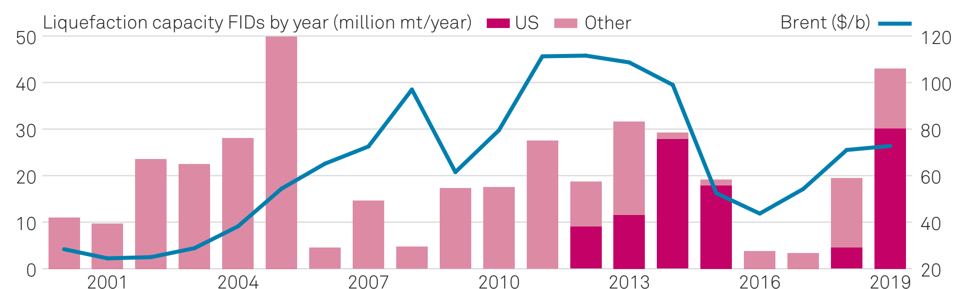
As traditional LNG contracts, underpinned by long-term sales and purchase agreements (SPAs), become a relic of the past, second-wave developers are embracing innovative financing and contract models to reach FID. Those new models will change how LNG trades in the future.

New strategies to reach FID

For a select group of highly capitalized LNG developers, firm offtake contracts are no longer a prerequisite for FID.

This development marks a sharp break with the past.

NEW CONTRACTING AND FINANCING SOLUTIONS, HIGHER PRICES SUCCEED IN ACCELERATING THE PACE OF EXPORT PROJECT FIDS IN 2019



2019 data above only considers January – June 2019.
2019 FID includes Golden Pass, Calcasieu Pass, Sabine T6 and Mozambique LNG.
Source: S&P Global Platts Analytics

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The acceleration of LNG trade in late 1990s and early 2000s was propelled by large-scale export projects built using borrowed capital tied to long-term SPAs.

These agreements required buyers to commit to long-term contracts that often included destination restrictions and even prohibited the resale or time swapping of cargoes.

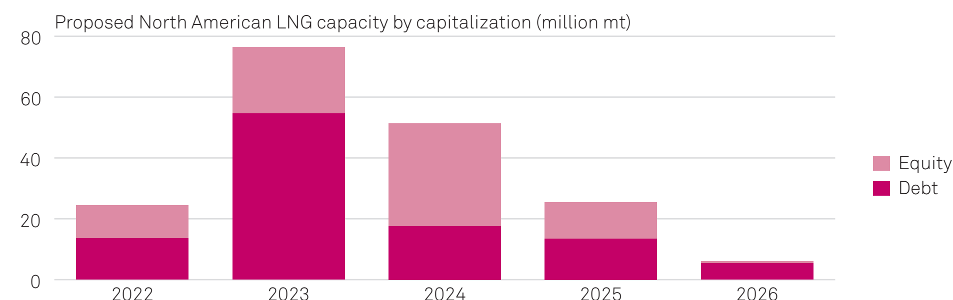
With the startup of exports from Australia and the US Gulf over the past few years, more liquidity has emerged in global LNG trade. Particularly for those with portfolio trading experience, the increase in short-term and spot market transactions has helped build confidence that new export projects can be successfully launched without significant debt financing and firm SPAs.

Since late 2018, the equity from deep-pocketed global majors, national oil companies and portfolio players has brought LNG Canada and Golden Pass — both large-scale North American export projects of 14 million mt/year and 16 million mt/year, respectively — into their construction and redevelopment phases.

For other equity-fueled projects, like the Shell and Energy Transfer backed 16.5 million mt/year Lake Charles facility, an FID is likely forthcoming soon too, regardless of any prior contracting activity.

For developers like Tellurian, however, the road to FID for its 26 million mt/year Driftwood LNG facility has been a bumpier one. In addition to intricate equity offerings, the project will likely be supported in part by smaller volume offtake agreements and significant debt.

EQUITY-FUELED PROJECTS LED BY MAJORS, NOCs MORE LIKELY TO REACH FID REGARDLESS OF PRIOR CONTRACTING ACTIVITY



Note: Capacity estimates include projects that are at various stages of development ranging from pre-FID to those currently under construction
Source: S&P Global Platts

In April, Tellurian announced its first successful $500 million equity investment from France's Total. Beyond the partial ownership sale, the developer offered attractive contract terms including a destination market price linkage to Platts JKM and an option that allows Total to take or leave up to 1 million mt/year from the Driftwood LNG terminal.

Tellurian's equity offering also gives investor-offtakers access to its gas resource in the Haynesville shale as well as midstream capacity from regional producing fields, including the Permian Basin.

Although the deal gives Tellurian a firm SPA from Total for 1.5 million mt/year, much more will be needed for the project to reach FID.

For an increasingly crowded field of low-capitalized developers, equity partnerships and offtake agreements from large portfolio traders remain elusive. For these projects, only smaller-volume and risk-averse buyers, and potentially less creditworthy buyers, are likely to sign the long-term contracts required to meet the lender's stringent requirements for debt financing.

Trading in the 2020s: spot vs contract

The emergence of equity-funded and portfolio-sponsored LNG export projects will continue to drive ongoing and much-anticipated growth in short-term and spot market trade.

As independents and small-scale developers continue to gain traction, though, the SPAs required to sponsor debt-financed construction of sub-10 million mt/year projects will also help to sustain a secondary, but vibrant, contract market well into the 2020s.

As the volume of contracted LNG held by portfolio players has continued to grow, these global aggregators have become a major force in LNG trade, helping to meet buyers' demands for shorter contract horizons, smaller volumes and even seasonally weighted deliveries.

By the early 2020s, the startup of equity-financed projects will bring even more flexible LNG supply to the market, supporting the trend toward commoditization that has allowed LNG to trade, increasingly, like crude oil.

As the market share of portfolio players continues to grow, though, utilities and

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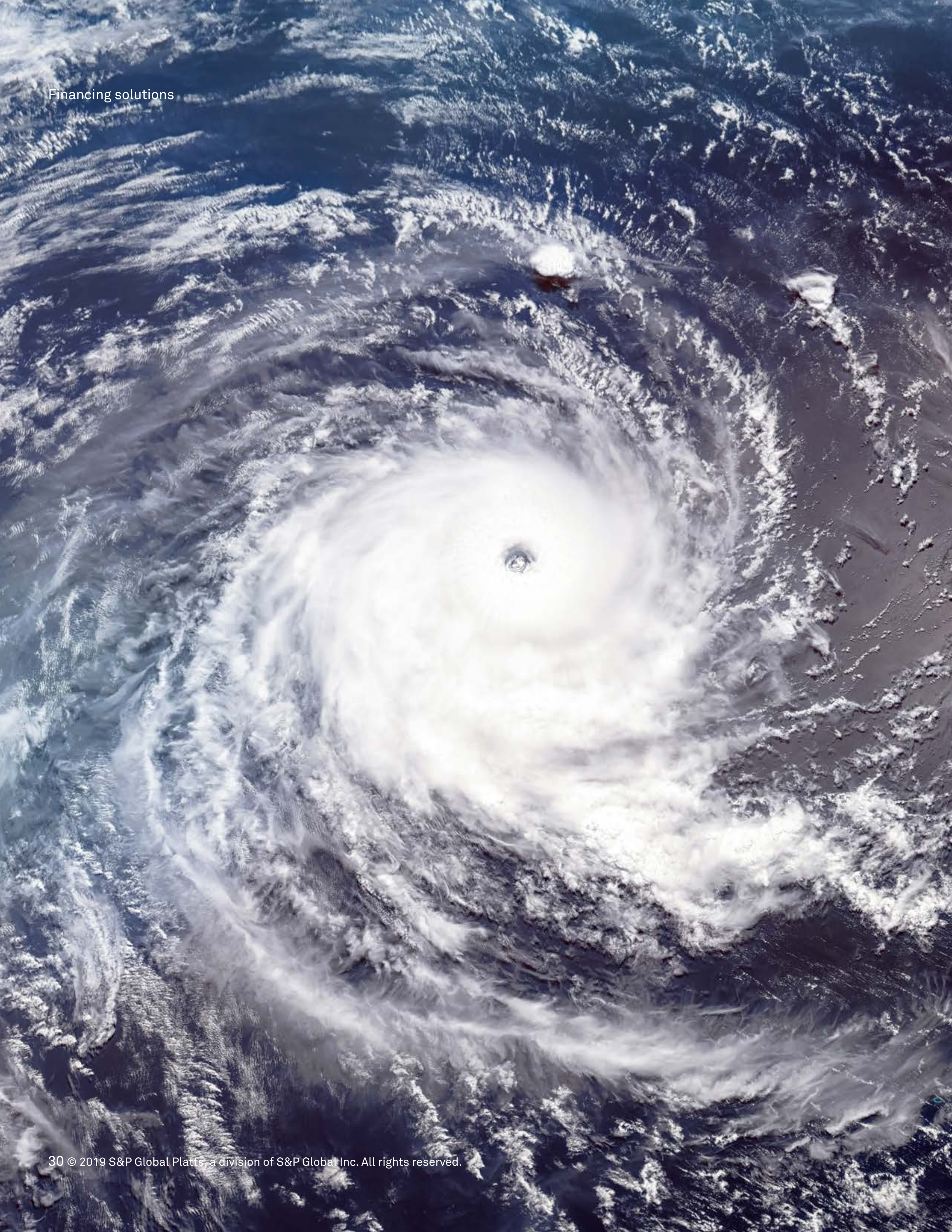

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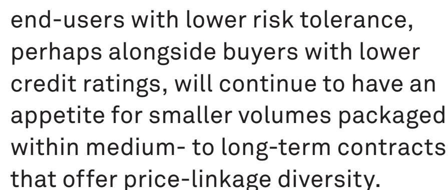

end-users with lower risk tolerance, perhaps alongside buyers with lower credit ratings, will continue to have an appetite for smaller volumes packaged within medium- to long-term contracts that offer price-linkage diversity.

This outcome seems especially likely in Asia, where utilities in countries like Japan and South Korea are well known for risk aversion with a preference for supplier and diversity of price indexation.

For around a half dozen proposed US LNG projects ranging in size from 1 million mt/year to about 9 million mt/year, debt-financed construction could be supported by small-volume SPAs with these end-users that include prices indexed to LNG, gas, crude and even coal, as recently seen under the supply contract signed by Shell and Tokyo Gas.

These kinds of deals should continue to support material market share for the small-volume contract trade through the 2020s, the aggregate volume of which should not be underestimated.

Financing, contracts and price volatility

The new financing and contract models now being tested by second-wave US LNG developers could inject more price volatility into the global LNG market heading into the 2020s.

For equity-backed projects, offtakers with ownership in regional gas resources and midstream capacity should have access to significantly lower-cost feedgas supply.

According to Tellurian, its equity offering should give offtakers access to LNG at a fully loaded FOB cargo cost of $3.50-$4.50/MMBtu.

By comparison, first-wave LNG developers are currently supplying offtakers at a fully loaded cargo cost above $6/MMBtu, according to Platts Analytics.

Access for US offtakers to cheaper supply will not only make the LNG market more competitive globally, but will also lower the threshold at which flexible supply shuts in, based on economic considerations.

New contract models are another factor that could increase price volatility in the 2020s. Destination-market price linkages in particular, like the JKM linkage offered by Tellurian and the coal-price linkage negotiated by Shell and Tokyo Gas, seem most likely to drive additional volatility.

Under existing Henry Hub-linked contracts used by US LNG pioneer Cheniere, and even the tolling models used by other US developers, fluctuations in the price of the producer's gas resource have the potential to make LNG exports uneconomic. Last winter, a precipitous spike in Henry Hub prices to the upper-$4/MMBtu range, combined with record shipping rates, briefly put many US LNG offtake contracts out of the money.

Under some of the newly proposed destination-market price linkages, contracted volumes could continue to pressure the spot market, even as the cost of feedgas from the supply source rises.

For contracts linked to crude oil prices, this has also been the case historically. In late 2014, for example, falling crude prices contributed at least in part to weaker spot prices for LNG. At the time, cheaper oil-linked contracts prompted many buyers to exercise upward tolerance on these contracts. As spot-market LNG buying retreated, so too did prices.

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