

Cripps Sears & Partners in Partnership with Tellurian Investments

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How do you FID in this low price environment?

Liquefaction Projects

Liquefaction projects typically rely on having large long-term offtake contracts to secure capital, however the cheap LNG available on the spot market currently has disincentivised such agreements. Thus the only projects that will attract long-term buyers at present are those that can deliver LNG at a significant cost advantage over other potential supplies, which are predominantly brownfield sites like Tangguh and on the greenfield side, the US Gulf Coast. The majority of greenfield sites will have to wait until the cycle turns up again and for optimism to return, thus helping to perpetuate the cyclical nature of the market.

Vessels

The reduction in long-term purchase contracts, combined with the shipping length caused by supply delays, has also led to a reduction in the long-term charters that ship-owners used to rely on to underwrite investments in new vessels. The transition to shorter, 5-10 year contracts has placed more risk on ship owners and, in turn, has put further pressure on shipyards who are struggling not just to retain talent but to fundamentally stay in business. This could reduce shipbuilding capacity and thus help to rebalance the market, however some counter cyclical, speculative investment may be needed to prevent this happening to too great an extent.

What have been the effects of the growth of the spot market, and how will it continue to evolve?

After a period of strong growth in recent years, the LNG spot market is, none-the-less, still in its adolescence. New demand, incentivised by the low price environment and enabled by the advent of FSRUs, has bolstered the spot market and increased market efficiency, and is likely to continue to do so going forwards. Credit provision on a per-cargo level has become more common according to the needs of countries such as Egypt and Pakistan, and whilst this means their demand may appear sensitive to price, LNG often replaces very high cost alternatives making their demand less elastic. There may come a point, however, where internal pipeline infrastructure rather than regasification capacity becomes the factor limiting incremental LNG demand.

Further evolution of the spot market will likely be driven by the supply side, especially with the novel prospect of price-sensitive US supply entering the market. This increase in liquidity could lead to the disaggregation of supply chains as companies specialise further to maximise their competitive advantage. It will also likely lead to the development of a trusted pricing index, and in time an associated derivatives market as LNG continues to be driven evermore by its own fundamentals. Such a change has occurred in NBP, and this may serve as a reasonable example of how such a

market could germinate in LNG over the next 10 years. It is unlikely, however, that the depth of this liquidity will develop to the point where it can support the FID of a new liquefaction project in the foreseeable future, due to the vast amounts of capital typically at risk.

US shut-in

US shut-in is by no means a binary outcome, and the extent to which it occurs will be driven largely by Russia's influence on the HH-European gas spread. An efficient market would dictate that those with the cheapest feedgas will be able to export at the lowest spread, since the take-or-pay structure makes liquefaction a sunk cost. There are, however, other factors that may distort this. If long-term sales contracts are in-the-money then some exports may occur regardless of the spot prices at the time. Some companies are also trying to resell their liquefaction capacity at a loss rather than wearing the risk, but are struggling to find buyers. Regardless, companies with HH trading capability will be advantaged since they will be able to most effectively optimise their portfolios.

How can the LNG industry source and retain the talent required going forward?

The growth of the spot market has driven demand for LNG trading capability as even established long-term buyers try to optimise their positions. The industry, however, risks losing technical expertise on the construction side, both with respect to vessels and liquefaction capacity. The slump in prices has caused demand in these areas to fall off, causing an exodus of skills from the industry. Countercyclical investment may be required to ensure companies retain the skills to be 'FID ready' when the cycle turns. Along with this, the safety challenges posed by small-scale LNG require the development of a new skillset, since safety issues with small-scale LNG represent a risk to the reputation of the industry as a whole at a time when it is important to maintain a positive image, both to governments and the public, to help it compete with other sources of energy.