LNG importing terminals: future targets with risks not found in the data room

BY DAVID GHIGHI AND SOPHIE GUINY

By 2020, as many as 15 highly specialised port facilities could be built on or near US shores at a cost of about $10bn. These assets will be critical links between the US natural gas consumer and the distant gas-exporting countries like Qatar. As liquefied natural gas becomes a commonplace feature in the country's energy mix, M&A buyers may be tempted to consolidate these assets. But hopefully not without full knowledge of the risks therein.

Despite a dramatic price increase of natural gas in the US over the past 10 years, demand for this commodity has continued to march higher, primarily driven by its environmental benefits over competing fuels for power generation. Domestic production, however, has been unable to keep pace with the increased demand, notwithstanding the apparent investment incentives offered by forward prices. Imports by pipelines from Canada are now being supplemented by ever-larger amounts delivered by ship in the form of liquefied natural gas or "LNG" from places as near as Trinidad & Tobago and as far as Qatar.

In the US, the high-price supply-constrained scenario is driving more than a few multi-billion dollar LNG liquefaction projects in Africa, the Middle East, Russia and elsewhere. Shipments from these plant sites, in turn, are driving the US LNG importing business into its growth phase.

Estimates indicate that LNG could satisfy up to 20 percent of US natural gas demand by 2020, up from about 3 percent today. This would require the construction of about 15 terminals, a three-fold increase over today's terminal count. (It is interesting to note that today Japan has 23 importing terminals in operation.) The size of each investment, between $500m and $800m, and the uncertainty of obtaining the necessary permits result in a diverse and fragmented field of owners with access to risk capital, from pure development companies to affiliates of major oil companies.

As the industry evolves over the next 15 years, with today's uncertainties becoming part of tomorrow's history, an M&A consolidation period will likely emerge. Major industrials, gas marketers and private equity funds could all compete for assets, the latter increasing their knowledge in recent years of this sector via acquisitions of gas-fired power generation businesses.

Buyers may be tempted to seize opportunities in the LNG importing sector, but a cautious approach is necessary. A team of experts would be hired to conduct financial, legal, and environmental investigations, inspired by the best practices in the field. Such due diligence is important, but not sufficient to avoid or value properly the risks specific to this business.

Unlike many M&A deals in the energy sector, not all LNG re-gasification terminals will have abundant long-term contracts for supply and offtake underpinning their fundamental economics. The nature of LNG sales and purchase agreements ("SPAs") is evolving towards more uncertainty. Traditional SPAs were long-term contracts, often over twenty years, with fixed volumes and, frequently, pricing formulae that offered effective price risk mitigation. The trend today is towards short-term contracts with prices that are not indexed to crude oil. Spot cargos, seasonal contracts, tradable cargos and buy-or-pay features are becoming increasingly common.

Uncertainty is also increasing on the demand side of the market as the share of large public utility customer's declines as a percentage of natural gas buyers. LNG terminal owners will no longer have a handful of large utility customers or other major buyers. They could rather have portfolios of customers including any number of power generators, local gas distributors or energy risk management firms. Their revenue streams could thus be blends of contracted and un-contracted sales.

The physical dynamics of the pipeline network into which the LNG terminal injects could also add to the risk. Bottlenecks, which may have been upstream of the terminal (and could have formed the rationale for the terminal's site selection when it was built), could develop downstream of the terminal due to the supply/demand forces of the region. Alternatively, bottlenecks could be eliminated by looping or compression, perhaps to create pipeline capacity for a competing LNG terminal.

Even the geography and meteorology of a terminal could present significant risks that may go unnoticed following less industry-savvy due diligence practices. Unfavourable weather patterns, difficult approach conditions, increasing traffic and congestion in shipping lanes can constrain the operations of a terminal and reduce its profits.

The LNG business is one of the fastest growing segments of the energy sector worldwide. In the US, LNG importing terminals represent a high-growth, high-risk investment area in an otherwise mature industry. It is reasonable to assume that a period of consolidation will follow the current growth phase. Potential buyers should, however, be aware that forces at work in countries far away from the US will be changing the risk profiles of these domestic terminals and these changes are not likely to be evident in the data room. ■

David Ghighi is a Director and Sophie Guiny is an Analyst at Taylor-DeJongh, Inc.