# MENA report: Spot the difference

01/04/2005

Small may be beautiful in certain quarters, but in the LNG market it pays to close large. Last December, Qatargas II did just that: a mammoth $10.65 billion in total costs, with 57 institutions involved at senior level. Amid the fanfare surrounding the project, industry sources are saying that the deal will be remembered not just for its size, but also for the way that bankers assess gas market price risk.

The deal is symptomatic of the growth of LNG across the MENA region and the burgeoning global offtake demand.

With forecasts predicting a further 10.9 million tonnes per annum (MMTA) on last year's record high of 134.8 MMTA coming on-stream this year, and increasing to 21.5 MMTA in 2006, the LNG market remains buoyant.

Qatar's latest flurry of LNG deals – including Qatargas 4 – will produce some 23 million tonnes per annum, once completed at the end of the decade. This will effectively make Qatar the largest LNG producer in the world.

These historic levels of supply reflect an increase of some 70% expected in power demand and security of supply expected over the next 25 years. Moreover, it is estimated that LNG will increase by between 4% and 4.5% over the next five years.

**Some spot market scepticism**

With a glut of projects coming on line, following Qatar's success in the market, there is concern in some quarters that oversupply may trigger a price collapse. Prices in Europe would be the most likely to suffer, while Gulf state suppliers, such as Qatar, would bear the brunt of the price collapse.

Fears look unfounded at present. The demand for LNG is so great that it is expected as much as 30% of global LNG will soon be trading trade on the developing spot market.

And although bank lenders have historically been loath to lend against any contracts other than those with a long-term tenure – post Qatargas II this looks set to change for good.

The appetite for Qatargas II was unexpected initially, given that once the sponsor construction guarantees fall away pricing has a look-through to the UK gas price with no guarantees or market floor price. Moreover, with 25-year sponsor SPAs in place there is no volume risk. The take-up reveals as much about the future for the UK gas spot market as the project model; and that confidence is reflected in the pricing for both upstream and downstream elements of the deal.

Even so, there are those in the industry who believe that Qatargas II is unlikely to set a new precedent for gas market-priced deals.

"I'm not entirely convinced about an 'emerging merchant market' for LNG. Certain of the players have moved away from tramline projects. And some of the players may be using market positions to get projects off the ground," says Nick Prowse, senior associate at Norton Rose.

The number of long-term contracts in the market speaks for itself. And it is doubtful whether the trend will change in the foreseeable future.

"For all the talk of a spot market for LNG, you do have to remember that it is not a major part of the industry – maybe less than 25%. In 2002, there were about 15 vessels on order that did not have a long-term charter. In the last few years, it hasn't changed that much. At the moment, over 60% of LNG vessels on order are based on long-term contracts," says M Chandrasekaran, head of Structured Finance at Gulf International Bank, Bahrain.

Furthermore, it is well known that export credit agencies have not looked on spot sales favourably, though projects have tended to be considered on a case-by-case scenario. Whilst it is unlikely that greenfield projects will be financed on a spot market basis, LNG projects with operating trains already in place to produce revenues are the most likely candidates. Nigeria LNG trains 3 and 4 – part financed by the UK's Export Credit Guarantee Department (ECGD) – comprised spot cargo sales.

It seems that, for those looking to enter the LNG market, the overriding problem is that LNG can often sell low on the spot market. LNG fuel is prone to dissipation the longer it remains out at sea, so carriers can find themselves in the unenviable position of selling at bargain prices in order to avoid spoilage.

**Tight margins despite spot**

Although questions over the tenacity of the LNG spot market remain unresolved, Qatargas II is in essence an outstanding deal. It is the first fully integrated LNG venture to include everything from upstream development to terminal ownership.

"Qatargas II will be the template for future deals in the region," comments a local banker. "It is interesting in how low the margins were on the corporate deal. But this is to be expected – there has been a tendency to really squeeze the banks. Therefore, the Qataris can afford good financing."

Now, the deal on everyone's lips is Qatargas 4: a project which will take committed LNG up to some 77 million tonnes per annum by 2010-2012, when deliveries are expected to commence.

In late February, Qatar Petroleum (QP) and The Royal Dutch/Shell Group of Companies (Shell) signed heads of agreement for Qatargas 4. The project – located at Ras Laffan City – will comprise the integrated development of upstream gas production facilities to produce 1.4 bcf/d of gas.

While the deal is expected to build on Qatargas II's success, there are concerns that Qatargas 4 may encounter difficulties securing the services of EPC (engineering, procurement and construction) contractors, for which there is a limited market. With a number of deals flooding the market across the region, the shortage of contractors may hit some deals hard.
Nevertheless, Qatargas 4 is not expected to suffer. Qatar Petroleum is expected to roll out plant contracts at intervals, so as to secure the best contracting services.

**Local interests**

Although opportunities in the region are manifold, it is questionable whether local players have the capacity or expertise to participate fully. Nevertheless, competition for projects remains rife.

Local commercial players are going to have their work cut out if they are to compete with the international houses. What many banks are looking for is the implementation of capital markets, in the form of a bond take-out clause, which would go some way in downsizing the risk.

According to Mark Westley, assistant director at ANZ, "Local banks don't tend to like long tenors, relative to say European banks, partly due to the mismatch between their deposits and loans. So, they'll be more comfortable with a 10- to 12-year ship or plant deal with a balloon at the end or other structure where refinancing is required or encouraged."

While European banks have been successful, US banks tend to be thin on the ground. It may be a case of post 9/11 jitters or more likely a general lack of expertise in lending.

"Currently there is increasing appetite from international banks than from local banks in relation to project finance in the Arabian Gulf. Very few local banks could compete with international banks on pricing: as the pricing gets finer and finer and the tenors getting longer and longer. Currently there are more international banks in the Gulf project finance market than ever before, though we don't see much of the US banks except in project advisory capacity, such as Citibank" adds Chandrasekaran.

Citigroup remains one of the only US players willing to re-enter the region, after exiting the market completely. Yet, whether others can re-establish themselves in a region that has a lengthy memory remains to be seen. At any rate, any US player looking to region will have to set its marketing machine into overdrive.

**Yemen LNG finally makes it to market**

Citigroup seems to have achieved just that. In mid-March, the US investment house asked banks and multilaterals to submit initial expressions of interest in the $1.863 billion financing of the long-planned $3.1 billion Yemen LNG (YLNG) project.

The debt package is expected to have a door-to-door tenor of 14.75 years including a 39-month construction period during which the loan will be guaranteed by the sponsors. The sponsors – comprising Total (42.9%), Yemen Gas Company (23.1%), Hunt Oil (18%), SK Engineering & Construction (10%) and Hyundai Heavy Industries (6%) – are expected to take a 60:40 debt/equity split. Financing will be finalized in the next few months, with financial close expected in early 2006. Export credit agencies and Islamic banks are expected to participate in the financing.

LNG from these deals will supply the US for a 20-year take, beginning 2009. YLNG will be able to divert cargoes should US pricing dive below a certain level for six months. Although negotiations have been ongoing since 1996, it looked like the deal would never hit the market. In 2002, ExxonMobil decided to drop the deal when the Yemeni government extended the project deadline. TotalFinaElf was placed in the unenviable position of having to deny that it couldn't drum up any appetite for the project. Others have since come and gone, including Enron, Exxon and Hunt Oil.

Even though the deal looks like it will succeed, there are still those who harbour concerns.
"It's been such a long time that Total have talked about this project. And the project is not an easy one either: it's inland and pipes to the coast. I'm not sure that ship owners and other parties will be that comfortable with the terrorism risks involved," says a London-based project finance banker.

**Iran next?**

While Yemen looks to be making ground in closing its first LNG project, Iran seems to be in a state of flux. Potential projects in the country have always aroused much interest, though industry experts expect there is much work to be done before any deal closes.

In early April, the National Iranian Gas Export Company (NIGEC) postponed bids for the project management consultancy on its first LNG plant. UK-based Costain and Sofregaz, in partnership with the local player Namvaran, are the only two bidders left in the frame. The Eu2.2 billion project is expected to be financed as an export credits-backed receivables package, rather than straight project finance. HSBC is acting as financial advisor.

In late 2003, Deutsche Bank led a consortium of 17 banks with a $1.75 billion financing for NIOC, for Phases 9 and 10 of the South Pars project. This included $1.23 billion with ECA cover, and another $525 million of commercial loans. The deal was notable for the fact that all the funding is being done on a structured finance basis, backed by revenue streams from the NIOC, whereas previous phases had all used buyback contracts.

Although industry sources have agreed that the deal is a step in the right direction, there is concern over the reliability of the Iranian legal structure. Structuring any deal under the laws of England and Wales or New York law would go some way to assuaging any fears that potential investors may have.

Iran has also been looking at the possibility of running a LNG pipeline to India, but through Pakistan. There are concerns that the transit costs and security risks incurred diminish any cost benefit that Indian buyers might be expecting. It is unclear whether the project will ever see fruition. According to industry sources, investment costs and lack of experience in multimillion-dollar projects should scupper this particular project.

**Price collapse a danger**

Although there is no danger of overcapacity at present, fears that it may lead to a price collapse are not unfounded.

It is unlikely, however, that the flow of projects will abate in the foreseeable future. Moreover, it remains to be seen what steps would be taken by the producers should there be a sharp drop in prices. There have even been rumours that LNG producers may form a cartel in order to protect themselves, though, given the broad range of producers, it is highly unlikely. What is for certain is that producers and buyers alike should remain vigilant: small ripples may have a lasting effect.

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