Freeport LNG - Texas import terminal

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The road to the realisation of Freeport LNG in the US is one with many twists and turns - but with construction advanced and financing secure, the project will become one of the first of a new wave of LNG import terminals for the power-hungry US market in the first quarter of 2008

The project stands out for having secured more than 100 per cent debt coverage - meaning that some of the costs of future expansion plans have effectively been pre-funded.

Such a state of affairs was brought about by the participation of US major ConocoPhillips, which joined the project in December 2003. In return for two thirds of the terminal's capacity and a 50 per cent stake in its management, Conoco agreed to forward fund the costs of construction through two loan tranches.

However, the agreement with Conoco left the Freeport limited partnership (LP) with the leeway to arrange its own financing for US$203 million of the project's first phase costs plus more for expansion work to follow.

In December 2005, it secured this financing through the Royal Bank of Scotland by means of a US$383 million private placement to US insurers.

This deal put in place the last major piece in the jigsaw puzzle for Freeport besides the successful completion of construction itself. But it has been a long and winding road that has taken the project to this stage.

The first piece was put in place at the start of the millennium when a small Houston-based company called Cheniere Energy decided to look into the possibility of importing LNG into the Gulf of Mexico.

Freeport's chief financial officer Hugh Urbantke picks up the story: 'Charles Reimer, Cheniere's CEO at the time, called me in early 2001 to help create their business plan for LNG to the Gulf of Mexico. Previously I had worked for Charles in Indonesia in the Asian LNG business. After Charles and I completed the business plan and the initial review, we decided we had a project worth pursuing.

'So they started to go out and acquire the sites in Texas. Unfortunately, at the time Cheniere was a company of less than US$10 million in market capitalisation. Promoting the project was difficult - we were too much ahead of our time. Further, we thought it would cost around US$10 million to develop a terminal, but it turned out to be closer to US$30 million. The company was small and did not have enough money to do it alone.

'So we spent one-and-a-half years looking for investors. Then in 2002 Michael Smith came in and bought the project from Cheniere.'

Smith - a wealthy private equity investor - funded and managed the project prior to the sale closing and through to the submission of an application to the Federal Energy Regulatory Commission (FERC) in March 2003.

Then in June, Freeport's next door neighbour Dow Chemical signed a heads of agreement to take a third of the terminal's output on a long-term agreement along with putting an equity stake in the project.

FERC then gave its approval in June 2004 - allowing construction to begin in January 2005.

The Parties

Freeport LNG (FLNG) is a limited partnership (LP) owned by:

- Michael Smith (45 per cent)
- Cheniere Energy (30 per cent)
- Dow Chemical (15 per cent)
- Contango Oil and Gas (10 per cent)

Smith took control of the project using his share of the proceeds from the US$410 million sale of Basin Exploration to Stone Energy in 2000. He is chairman and chief executive of the LP and also owns 50 per cent of the general partnership (GP) that manages the venture.

Conoco owns the other 50 per cent of the GP and took on the responsibility for construction and operation of the facility when it joined the project in December 2003.

Cheniere is, of course, now one of the leading lights in LNG in the US - having made its plans much earlier than others when gas prices were much lower than they are now.

The company sold down its Freeport stake in 2002-3 because of a lack of finance. But the connection remains, not least in a management team which includes Charles Reimer - Cheniere's chief executive in its formative days - as president, in addition to several other former managers he recruited from the company.

However the biggest player in the room is Conoco, as 50 per cent owner of the GP, significant co-lender and off-taker with a long-term secured capacity of two-thirds of the initial capacity - one billion cubic feet of gas per day. Dow Chemical has the other 500 million cubic feet.

In 2003 Freeport took on Royal Bank of Scotland (RBS) as its financial adviser. Chuck Zabriskie, its head of project and export finance for North America, led the team. He was supported by head of midstream finance Adam Pettifer.

Pettifer says: 'They previously had another Wall Street bank advising them, but were now looking for core financial advice from people with real LNG expertise. We assisted then in their negotiations for the Conoco debt, especially focussing on the ability of Freeport to access the bank of capital markets for debt alongside the ConocoPhillips facility. We think that this is an area where were we added most value.'

As legal counsel Freeport employed Chadbourne & Parke, led by Houston-based managing partner David Schumacher and assisted by several associates, including Katherine Wich in the New York office.

The Project

Freeport LNG was set up to address the hole left by a combination of dwindling domestic supplies of gas in the US and the country's ever-increasing demand for power.

The plant is being built in the Gulf Coast industrial belt dominated by the oil and gas and petrochemicals industries. LP partner Dow Chemical has a huge facility next door to the site and has, according to Urbantke, been 'a huge supporter of the project'. BASF also has a plant nearby.

The facilities being constructed in phase one include two above-ground LNG storage tanks with the equivalent of 6.9 billion cubic feet of gas capacity plus a send-out capacity of 1.75 billion cubic feet per day.

A new 9 mile pipeline will transport the gas to Stratton Ridge where there is a major interconnection point with the Texas intra-state gas pipeline system.

First phase construction of the terminal - costing an estimated US$780 million, though with 'significant contingencies' - began in January 2005 and is expected to be completed by January 2008, when Conoco and Dow will be able to start sending in shipments.

Where those shipments will come from remains open. Conoco has plenty of options, with liquefaction interests in Australia, Nigeria and Qatar as well as Alaska.

The private placement proceeds will also be used to fund the development of a 7.5 billion cubic feet underground salt cavern gas storage at Stratton Ridge and a portion of the cost of an expansion of the LNG terminal to include a second LNG unloading dock and an extra 500 million cubic feet of send-out capacity per day.

Phase two has been sold to MC Global Gas Corporation, a wholly-owned subsidiary of Mitsubishi Corporation and Conoco under long-term contracts. Expansion applications were submitted to FERC and other government agencies for approval in 2005 and should be received in mid-2006 for completion in 2009.

Future expansions of the terminal (which were included in last year's applications) to up to four billion cubic feet of send-out capacity are also planned and will be constructed as additional capacity is sold.

Financing

The first and most significant part of the financing process came when ConocoPhillips joined the project in December 2003, agreeing to lend the limited partnership financing in two separate tranches with first call on the physical assets.

It is estimated that Tranche A will be worth around US$620 million. It covers the first US$460 million of financing required plus 50 per cent of any more required. Debt service is covered by the terminal use agreement Conoco signed with Freeport.

Tranche B is worth US$160 million but has now been refinanced using the US$383 million private placement of loan notes through agent RBS Greenwich Capital that closed on 19 December 2005.

Pettifer says: 'Once the ConocoPhillips loan was closed we focused on whether to go with a bank loan, a public bond or private placement to provide the necessary supplemental financing.'

Urbantke adds: 'Originally we had intended to go out for a long-term bond financing. However, until early 2005, we didn't believe there was any appetite for a long-term bond deal with construction risk - there just was not any financing demand.'

'As the deal size went up due to increasing steel prices etc, and as the bond markets remained very favourable, we and Freeport became convinced of the benefits of a private placement,' adds Pettifer.

'Long-term fixed rates were very low and there was a clear appetite for LNG assets in the investing community. Further, the private placement investors are very knowledgeable and experienced so can get comfortable with the complexities arising from the co-financing structure.'

The notes were purchased by a group of nine insurance companies looking for long-term fixed rate assets.

Pettifer says: 'What is particularly interesting about this deal is that the cashflows from the project support more than 100 per cent financing. As a result, the proceeds of the private placement notes can be used to part fund a potential phase 2 expansion of the terminal.'

Urbantke says that the proceeds from the bonds should be roughly split between the two phases.

Conclusion

Freeport LNG is an excellent example of a project started by a small company that proved to be way ahead of its time, judging the market well and landing lucky on the price of gas.

Not only did Cheniere Energy pick up on the potential for LNG well before virtually anybody else, but it also picked an excellent site for the Freeport project, right next to one obvious potential off-taker in Dow Chemical and just nine miles from a connection to the pan-American pipeline network.

Cheniere may be relatively marginal to the venture now but there can be little doubt that ConocoPhillips is glad that it could parachute into the project as it did, thereby joining the first wave of new LNG terminals that are due to start cropping up on the North American coastline over the next few years.

As for the financing, Freeport obviously found an opportune moment to secure a large-scale private placement of bonds with interest rates low and interest in LNG projects high. RBS seems to have secured it a decent deal that could prove lucrative in the long term.

The project at a glance

Project Name	Freeport LNG
Location	Quintana Island, SE of Freeport, Brazoria County, Texas, US
Description	The construction and operation of an LNG importation terminal, storage tanks, regassification facility and pipeline infrastructure with an initial output of 1.5 billion cubic feet of gas per day
Sponsor	Freeport LNG Development LP
Limited Partners	Michael Smith (45 per cent) Cheniere Energy (30 per cent) Dow Chemical (15 per cent) Contango Oil and Gas (10 per cent)

General Partners	Michael Smith (50 per cent) ConocoPhillips (50 per cent)
EPC Contractors	Technip USA, Zachry Construction, Saipem
Construction Duration	3 years
Total Project Value	Around US$1 billion (about US$780 million for first phase)
Total equity	None
Total debt from ConocoPhilips	Up to US$780 million
Total private debt placement	US$383 million
Sole arranger - private placement	RBS Greenwich Capital
Legal Adviser to sponsor	Chadbourne & Parke
Financial Adviser to sponsor	Royal Bank of Scotland
Date of financial close	19 December 2005

