Liquefied Natural Gas Outlook: Industry Under Pressure

By **Monica Hwang and Silvia Smith** (March 8, 2023)

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The past year saw a remarkable turnaround in the liquefied natural gas market, with a dramatic increase in demand for development of U.S. LNG projects.

High LNG and gas prices in Europe, driven even higher by Russia's invasion of Ukraine, made clear to importing countries the need to boost their energy security by developing more LNG supply sources.

Developers of U.S. LNG export projects captured the majority of long-term LNG contracts concluded last year, making 2022 a banner year for the industry. But in 2023, the LNG industry is grappling with a few key uncertainties.

Arbitrage opportunities in Europe may become more elusive.

The current boom began in 2021 with the spike in European gas prices, then took off after the invasion of Ukraine focused attention on energy-supply security. LNG sellers responded quickly to higher European gas prices, shipping excess LNG and diverting other available cargos to the continent.

But several factors have now made it harder to capitalize on continued high prices in Europe. Chief among them is decreased demand, which has been reported and is expected to continue.

The rush to supply Europe with LNG may also be overwhelming the capacity of the continent's infrastructure. At one point this fall, more than 30 LNG ships were reported to be anchored off the Spanish coast, awaiting their turns at the few available LNG unloading terminals.

And once that cargo is unloaded, there may be issues with shortage or lack of downstream pipeline capacity to transport the natural gas to where it is most needed. In the year ahead, those seeking arbitrage opportunities will need to pay closer attention to location-specific import capacity and pricing differences.

Increased credit costs may deter new market entrants.

The growth of U.S. LNG projects and shorter-term, spot market transactions have brought new players into the LNG industry, which has historically comprised a small club of participants. But the recent spike in LNG prices could, paradoxically, push new entrants out, or make it harder for them to enter the market.

A cargo of LNG valued at $100 million or less just a few years ago can now be worth $200 million or more — and that jump in valuation means more onerous credit requirements for buyers. In the spot market, buyers often need to secure a standby letter of credit for 100% or more of the cargo value.

Creditworthiness is also paramount for any buyer in the long-term market, and buyers

without investment-grade credit ratings are facing even more stringent requirements. These requirements have the potential to reinforce historical barriers to entry, deterring or even preventing new players from participating in the LNG industry.

High prices may delay LNG conversions outside of Europe.

As exporters divert LNG cargos to Europe, where prices are highest, buyers elsewhere are having a hard time securing spot cargos.

That may slow the development of LNG infrastructure elsewhere. Potential buyers, who would have otherwise contemplated making the fuel switch to LNG for power generation, may rethink that strategy if they cannot secure LNG cargos.

And sponsors of LNG import terminals may have to shelve or scrap their plans, as European countries have secured all available floating storage and regasification units necessary to implement the fuel switch.

Construction cost increases may delay progress.

The front-runners among U.S. LNG project developers have started refreshing their construction cost estimates and finalizing engineering, procurement and construction, or EPC, contracts. As they do so, higher construction costs could affect contract negotiations with LNG buyers, and ultimately delay development.

For its Port Arthur LNG project, Sempra Infrastructure recently announced finalized contracts of $10.5 billion for 13.5 million tonnes of annual LNG production capacity. That is about $778 per tonne of annual capacity, up about 6% from the $733 per tonne of annual capacity that Sempra paid for its first-wave U.S. LNG project, Cameron LNG.

NextDecade Corp. has also launched debt financing, after refreshing its EPC pricing to a reported price tag of $11.4 billion for the first three LNG production trains.

To secure financing, developers need long-term contracts with expected revenues sufficient to cover construction costs. In the case of Port Arthur LNG, Sempra has started converting its announced heads of agreements into definitive long-term contracts, with pricing that takes into account the finalized EPC contract price.

Likewise, NextDecade has announced multiple definitive LNG offtake contracts, and is reportedly seeking to procure at least one additional long-term contract to support financing.

For U.S. project developers that have already announced definitive long-term contracts, they may need to renegotiate those deals if the contract prices do not cover EPC contract costs. As projects progress, industry watchers will be interested to see final EPC contract prices and whether buyers will remain committed in the face of price negotiations or renegotiations.

Multiple U.S. LNG export projects may reach the finish line.

After finalizing EPC contracts and long-term contracts with LNG buyers, project developers face one final test before they can start construction: finalizing financing. That is no small feat.

As recent project financing setbacks have demonstrated, developers need longer contracts to support financing. In fact, most definitive long-term offtake contracts signed for the majority of U.S. LNG projects in 2022 ranged from 15 to 20 years.

By all market indications, the financial markets are flush with capital seeking the right investment opportunities, and multiple U.S. LNG projects have announced their intention to finalize financing in the coming year. With appropriate structuring, the LNG industry might just see a repeat of the first wave of U.S. LNG, with multiple projects getting the green light in 2023.

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