

# What's in the pipeline

Long-term LNG demand looks strong, but developers face tough conditions, and the shipbuilding boom for LNG carriers is on hold. There are a number of implications, good and bad, for risk management. **By Jerry Frank**

**G**rowth has been a byword for the liquefied natural gas (LNG) business since its revival in the mid-1990s, but the rapid lurch

of the global economy towards crisis is throwing up significant short-term challenges. Today, the sector is seeing supply-side problems from construction delays to investors holding back on financing decisions, and LNG projects face an increasing emphasis on quality control, contractor financial security, political risks and stricter criteria from lenders.

Worldwide LNG flows have doubled in the past decade and now meet 7 per cent of total demand for natural gas, according to the International Energy Agency (IEA) in its *World Energy Outlook 2008*. The volume of LNG trade is expected to rise to 340 billion cubic metres in 2015 and 680 billion in 2030, compared with 201 billion cubic metres in 2006.

Despite the recent overall investment in

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the LNG sector, according to the IEA there are not enough projects coming on stream to allow production to meet demand until around 2015. However, the amount of new construction is dwindling, and capacity pressures could build up in the future.

Tony Rastall, Partner at Jardine Lloyd Thompson's Construction Division, says that growth had already begun to flatten off in the last quarter of 2008, as the global economic crisis deepened, project finance availability tightened and oil and gas prices dropped. “The indications are that we are entering a period of hiatus,” he maintains. “We are going to see projects that have been planned for years started, but are unlikely to see new projects go into development. I expect the last quarter of 2009 will start to look dry for projects.”

## Current projects

PricewaterhouseCoopers estimates that around \$20 to \$30 billion worth of capital expenditure will be required each year to complete all the planned LNG projects. Although many projects are funded by governments, sovereign wealth funds and energy majors, there is still a need for external financing.

“In today's credit crunch environment the question is inevitably going to be whether people are going to lend to projects,” points out Spencer Banks, a Partner in Jardine Lloyd Thompson's Construction Division. “I can see a situation where banks such as Fortis or Société-Générale will lend, but they'll want to see stricter insurance criteria, such as top-rated securities and lower deductibles.”

Rastall is optimistic that most projects now in the final planning stages will still be



executed. He points out that cash-rich energy majors are heavily involved in the sector and that they have backed investment projects that are bigger than ever and located in increasingly widespread geographical locations.

## Shipping

There has been extensive investment in new tonnage that is expected to expand the LNG fleet to around 370 vessels by 2013, with 2008 a peak year for delivery with 56 units, followed by 46 in 2009. Thanks to this boom, there will be a ready supply of new and ever-larger tonnage, and few further orders are expected over the next five years.

Sean Woollerson and Richard Pierce, both Partners with Jardine Lloyd Thompson's Energy and Marine Division, say that with no new projects announced over the last 12 months, the LNG vessel newbuilding boom is coming off the boil.

By contrast the stability on the shipping side of the business – which is secure and in place – attracts quality investors with charters of up to 25 years and a guaranteed income stream. Therefore, the major challenges are faced by the construction projects served by the LNG tankers.

“Our clients are generally well-versed in reading market dynamics,” Woollerson says. “Over the past 18 months we have already seen a number of life extension work

projects being authorised, prolonging the trade of older vessels, instead of ordering new tonnage. That caution against an over-supply of tonnage has been validated recently as there has been a marked increase in the number of LNG tankers being laid up. It remains to be seen how long this blip in LNG's rampant growth will last.”

## Risk implications

The slowdown for liquefaction and regasification projects comes not only as finance becomes increasingly scarce, but also amid a deepening deficiency in skilled labour. “What concerns me from an insurance perspective,” adds Rastall, “is whether this shortage of skilled engineers will have quality implications in the medium term.” LNG project insurers are already reflecting this growing concern by putting more emphasis on monitoring on-site quality control and assurance, and contractors' safety and quality standards.

Quality factors have been an issue for the last five years because of this pressure on resources, but the reduction in new projects is likely to ease the problem, according to an independent consultant for Jardine Lloyd Thompson, Tony Froud, who is a chemical engineer. “It will be easier than before to get work done,” he says. “For supplies, that is already apparent. The time it takes to replace major equipment is likely to decrease.”

Another consequence of these economic conditions will be a closer scrutiny of the financial strength and solvency of contractors hired for existing LNG construction projects. With debt levels high in the construction services sector, financial distress could risk delays to existing projects and fan a further uptake of trade credit insurance cover.

A number of LNG projects also face substantial political risk, whether in Russia, where the government took control of the Sakhalin-2 project, or in Nigeria, where there has been civil unrest. However, Rastall points out that the larger the developer, the more ability it has to offset its own risk and the less interest it has in political risk cover.

Michael Hurley, Global LNG Leader with PricewaterhouseCoopers, believes that despite adverse developments for the world financial markets and economy, the fundamentals remain strong for the sector. “LNG is a tradable and flexible resource,” says Hurley. “There may be a short-term constraint on the number of new projects; however, the long-term future remains strong for LNG and big developments will still be needed.” **RS**

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## HALF FULL OR HALF EMPTY

### Opportunities

**Onboard technology** – shipboard regasification and liquefaction would reduce the cost of infrastructure.

**Trading** – unlike pipeline gas, LNG is flexible and can be shipped to different markets.

**Spot markets and arbitrage** – aspects of the LNG market present openings for 'spot' trade, including swaps and diversion arrangements.

### Challenges

**Price uncertainty** – unlike other energy commodities, there is no uniform global price for LNG.

**Regulatory risk** – the economic viability of a LNG chain can be influenced significantly by national or regional regulation.

**Infrastructure constraint** – there are limited numbers of market participants and specialist port facilities.