The Evolving State of Today's LNG Spot Market - "Where we are and how we got there"

Author: John Varholy, Partner, London
Author: Amir M. Hussain, Associate, London

Publication Date: November 14, 2011

The evolution of the global LNG market continues apace, influenced at a macro level most recently by the need for ever greater quantities of LNG in a post-tsunami, nuclear-power-short Japan, faced with massive reconstruction-related energy requirements. What follows in this first of a series of LNG-focused *Client Alerts* is a snapshot of the current status of this market, focusing on its evolution and in particular on emergence of the sub-market for spot LNG trading. We will identify a few interesting aspects of the market's evolutionary process, make some educated guesses about how it will develop from here, and finally, flag as a heightened risk factor, the potential for non-compliance with anti-corruption requirements of very broad applicability.

Market Evolution

Today's LNG market has come a long way in a relatively short time from its early days of large, long-term, capital-intensive projects dominated by an elite list of very large players residing on the production and consumption ends of the natural gas value chain. Going forward, some things will clearly remain the same, as ever-larger in scale new LNG producing projects will likely continue to be brought on line by the major international petroleum companies, together with the sovereign gas producing nations who are their natural partners in such ventures. These types of projects will clearly continue to find their funding from both the majors' cash flows attributable to prevailing strong oil prices, and external financing secured by the types of traditional long-term LNG purchase commitments historically made by the large utility and industrial concerns resident in countries lacking in sufficient domestic energy resources. Such traditional projects and long-term commitments, however, will no longer represent the entirety, or at some future stage may no longer represent even the majority, of the overall global LNG marketplace.

Recent Market Developments

Availability of Uncommitted LNG Supplies

A number of interesting elements are currently manifesting on the supply end of the LNG value chain. Uncommitted LNG supplies are increasingly becoming freed for spot sale by the expiration of prior dedicated term sale commitments. Similarly, uncommitted incremental quantities of LNG are being coaxed from existing liquefaction capacity after years of experience gained in operating and optimizing the utilisation of underlying LNG supply trains, delivery terminals and load port facilities.

Growth in LNG Market Participation

In addition, on the horizon are new categories of LNG project development entities, from small to mid-sized oil independents, venture capital and dedicated LNG funds, to investment banks, all now able to draw upon and utilise established and proven technologies which were only being pioneered a short while ago by a highly exclusive list of oil majors. Finally, historic LNG purchasers, particularly those who have invested in fuel switching capabilities to meet their own requirements, are increasingly entering the LNG resale markets when opportunities present themselves, to capture arbitrage profits by reselling their own previously contracted purchase volumes.

Correspondingly, at the market's consumption end, a host of new LNG receiving terminals have come on line and been commissioned in recent years. These assets are connected into liberalised gas pipeline networks, in many cases recently reregulated as common and contract carrier systems. Consequently, access to berthing, regas, system entry and even storage capacities and infrastructure located at and appurtenant to these LNG terminals is increasingly offered on open, competitive and non-discriminatory terms to anyone prepared to contract for them.

State Energy Policies

Further, government policy on security of energy supply has manifested itself in regulatory models encouraging the integration of LNG into the domestic energy supply portfolios of many nations. And in the interests of fostering increased market liquidity and competition, a diversification of participants in the LNG and underlying natural gas markets is often also being promoted. Finally, as noted previously, numerous entities traditionally participating exclusively in the consumption end of the market have now begun to enter the supply end of the market as economically opportunistic LNG re-sellers.

Spot LNG Market?

Linking these developments at these diametrically polar ends of the LNG value chain are a number of related developments in what is now commonly referred to as the LNG midstream market. A whole new class of pure trader or middleman entity has in recent years begun to enter this new and rapidly expanding link in the LNG market. These new entrants are providing liquidity, taking on and managing a host of logistical risks and challenges, and thereby further facilitating the emergence of a truly traded spot market in LNG itself. The activities of these traders in this regard are generally a natural extension of their existing capabilities and activities in trading and marketing natural gas in numerous competitive gas markets around the world.

Of course essential to the development of a spot LNG market is access to transportation capacity, which in the case of LNG means the ability to charter a relatively finite class of floating stock designed to meet the unique requirements of moving a highly refrigerated and pressurised commodity safely from liquefaction facilities to regas terminals around the world. Historically, LNG vessels were constructed for specific liquefaction projects and employed almost exclusively to service delivery of term sales commitments from those projects. However, as has become the case with LNG supplies, the expiration of long ago contracted term LNG sales contracts has in many cases brought with it an increasing availability of a number of older LNG vessels for use by spot traders on generally trip and short-term charterparty basis. Furthermore, certain vessels constructed for liquefaction projects which were subsequently delayed (or were casualties of Shale Gas) have been chartered to meet demand for spot LNG. In addition, many companies with spot LNG supplies for sale today own or control vessels which they can provide on a bundled basis for delivery of their own spot cargos. Indeed, the current state of the VLCC market may also create spare capacity in coming years as some shipyards have offered their prospective buyers of VLCC the option of transferring their commitment to the building of an LNG vessel.

These elements collectively contribute all the essential building blocks required for the long-anticipated development and rapid growth of trade in spot LNG cargo trading. Factoring Japan's increased demands for both incremental LNG supplies and delivery vessels into a market already featuring very finite available spot LNG supplies merely raises the stakes driving spot market development. Together, these elements offer potentially greater margins and therefore incentives for new participants to enter the emerging spot LNG market. Stakes are high, as are potentially available profit margins for the nimble and creative.

Increased Incentive for Non-Compliance

It is worth noting that the significant potential upside of early participation in the emerging LNG spot market brings along with it a few additional categories of fairly unique risks. One such risk which may not have previously made it onto your radar is the potential for exposure of your company to some quite draconian legal penalties imposed by the laws of at least two countries in which many global trading companies are either based or maintain sizeable operations.

To understand this risk, it is helpful to first consider practices commonly employed in spot LNG sourcing. Companies trying to establish a foothold in the world of spot-traded LNG, and even long-term LNG participants looking to grow the traded side of their businesses, will all require prompt access to accurate information regarding the availability of uncommitted LNG production and loading at numerous liquefaction projects located around the world. As even the largest traders in many cases do not maintain a formal presence in all such locations, a fairly common practice is to seek out and employ local agents for these purposes. The engagement terms for this category of agent are often heavily weighted toward success-fee components. With Japanese demand tightening an already constrained supply market, competition for the award of, or even the opportunity to attempt to bid for, available LNG cargoes will be particularly intense for the foreseeable future.

Now consider the fact that in many LNG producing nations, the persons possessed of the most valuable categories of both information and decision-making authority are in many cases employees of the national petroleum company - in most cases classifying them as some form of government official. Therein lies the potential risk which we believe will require active management by many of the readers of this note.

The legislative framework relevant here is created primarily by the US Foreign Corrupt Practices Act and the UK's recent Bribery Act 2010[1], and similar legislation in numerous other jurisdictions. These laws have far-reaching extraterritorial implications for companies interacting with foreign government officials. This remains the case regardless of whether such interaction is through actual employees or merely contracted agents. The penalties that can stem from violations of these types of laws are very severe, from financial fines and penalties, to blacklisting from approved vendor, supplier and contractor lists with all of the arms of the relevant government. In addition, further downside of even allegations of violations here will involve the quite significant costs of internal investigation, legal defence, and related diversions of management and company resources, as well as negative public relations considerations.

The general focus of these laws is payments made to, or other benefits bestowed upon, officials of foreign governments, generally with the objective of being granted special treatment, although proof of the latter is not always a necessity to establish a violation. It should be easy to see that the current conditions prevailing in the spot LNG market lend themselves quite well to the types of incentives to wrongful actions that most companies try to mitigate to avoid problems under these laws. The Japan effect has in many ways merely increased these incentives.

As a result, compliance training in this area for key personnel and agents in your LNG operations is a necessity. Further, the terms of engagement for local promoters and agents in producing countries should be carefully reviewed in order to see that sufficient safeguards are being employed and improper incentives are avoided. While even the best training cannot always guarantee 100 percent compliance, we also note that in the event of an alleged violation, evidence of efforts by the company to discourage and prevent such practices can often serve to mitigate penalties that might otherwise apply.

____?

1. For some recent guidance on the Bribery Act 2010, please see our Client Alert published 31 March 2011 (Client Alert 2011-075).

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

This Client Alert was compiled up to and including November 2011.