THE FORTNIGHT IN REVIEW

Over the last 10 years, the profile of Chinese commercial banks has developed significantly in international ship finance. Up until a few years ago, such banks were becoming more active in financing foreign shipping companies acquiring Chinese newbuildings. The global economic downturn in the last few years however appear to have taken its toll on the pace of such financings from Chinese commercial banks and resulted in a shift in the lending policies of these banks. Although Chinese banks show keen interest in extending financing to foreign shipping companies, they are generally more enthusiastic if a Chinese export credit agency (ie, Export and Import Bank of China (also known as CEXIM) or China Export and Credit Insurance Corporation (also known as Sinosure)) is involved.

CEXIM has responded to the increasing demand (in China and the rest of the world) for export credit agencies' participation in shipping finance transactions by remaining committed to extending financing to foreign shipping companies (either as participating as a lender or an issuer of standby letters of credit or guarantees). CEXIM has also recently vocalised its intention to increase its resources in its foreign branches thus expanding its global reach in order to maintain its support of the Chinese shipbuilding industry. CEXIM has noticeably, in recent months, demonstrated such continued support as we have continued to see them involved in international shipping finance transactions. Whilst doing so however, CEXIM remains justifiably prudent and cautious in selecting its counterparties and in determining its commercial terms.

Sinosure has come into the international ship finance scene later than CEXIM. For many years, Sinosure has been (and still is) actively involved in issuing its policies in project and trade financings. However, it has only been involved in shipping finance transactions in the last few years. Nevertheless, Sinosure has developed its expertise and experience very rapidly and has risen to become significant force in international ship finance. Sinosure provides a variety of products and services to assist foreign ship owners (purchasing Chinese built ships) in obtaining financing from Chinese and/or foreign banks. The two main Sinosure policies commonly featuring in ship finance are the buyer's credit insurance policy and the overseas lease insurance policy. The approval process and eligibility criteria vary for these polices depending on the facts and circumstances of each transaction. Our recent involvement in several ship financing transactions involving Sinosure leads us to believe that Sinosure continues to have a healthy appetite for shipping finance transactions. Like CEXIM, Sinosure remains supportive of the Chinese shipbuilding industry. In line with this, Sinosure has recently extended its buyer's default policy (which was previously generally adopted for trade financing transactions) to ship finance transactions. As far as we are aware, to date, this policy has not been utilised in any shipping financings however several international banks have shown an interest in this latest Sinosure policy.

Although Chinese export credit agencies presently are still keen to assist in international shipping financing transactions, whether they are able to sustain and/or grow their level of activity will depend on whether there are any changes to Chinese internal policies affecting liquidity and the availability of reliable and credible banks with whom the export credit agencies can collaborate with.

Recent Developments in LNG Market and Opportunities for PRC Players

Contributed by Fei Kwok

Of Counsel, Norton Rose LLP

An Overview of Current LNG Market

After more than 60 years of effort by innovative industrialists, liquefied natural gas (LNG) has become one of the dominant clean fuels in the global energy market. By the end of 2010, there were 12 LNG producing countries and 11 LNG importing countries. In 2011, however, the number of LNG producing countries increased to 18 and the number of LNG importing countries increased to 25, with Qatar alone supplying 26% of the LNG traded globally.

Asia is a major destination for LNG exports. In 2010, Asia consumed 70% of the LNG exported. According to a recent report, 60% of global LNG exports in 2011 was taken up by buyers in Asian countries, among which Japan remains the most important market, absorbing 50% of the LNG sold to Asia. Korea and Taiwan are currently the other two leading Asian LNG buyers. Each competes for LNG supplies and has been more successful than China and India because of their ability to afford relatively high LNG prices. China has increased its long-term LNG SPAs from one contract in 2004 to twelve by the end of 2010, although since 2010 Chinese buyers have been focusing on scooping up LNG spot cargoes.

Outlook of LNG Business

It is widely agreed in the LNG industry that Asia will contribute most to the growth of LNG demand in the next decade. Demand from the US will continue to

THE FORTNIGHT IN REVIEW

decrease due to relatively subdued economic activities and such demand is likely to be sufficiently met from domestic shale gas output. By comparison China, Singapore and India will ramp up their LNG demand by 10% by 2020. New entrants to the LNG import market such as Thailand, Vietnam, Bangladesh and the Philippines and other developing countries in Asia will represent additional LNG demand over the same period.

China will in the short to medium term overtake Korea to become the second largest LNG buyer in the region. Its demand for LNG by 2020 could be in the range of 320 to 400 billion cubic meters. To meet such growth in demand, China has accelerated its development of LNG receiving terminals, LNG carriers and other associated downstream facilities. The state-owned oil majors are also active in acquiring upstream gas assets in a bid to secure future supply.

A number of new LNG liquefaction projects will start production in the next few years, such that, in the longer term, total output will be sufficient to meet the global growth in LNG. However, in the medium term, the expiry of a number of existing contracts and the delays in the start-up of new LNG liquefaction projects is expected to lead to a gap between LNG demand and supply and so may assert added pressure on the already high LNG price in Asia.

Some LNG experts predict a shift from the long-term and inflexible LNG trading model to a short-term and relatively flexible model. It is believed that such change would arise from a combination of the following three factors:

- the increased number of players in the LNG business has led to more competition;
- the market is overshadowed by a pessimistic view of global economic environment; and
- the LNG price in Asia will continue to represent an attractive premium over the LNG price achievable in the Atlantic Basin.

In view of this outlook, both LNG sellers and buyers have adopted wait and see strategies and prefer medium or short-term LNG purchase contracts. As a result, spot cargo trade seems likely to remain popular. More LNG trading houses will be established in trading hubs such as Singapore to capitalize on the rapid development of the LNG spot cargo business.

Opportunities for PRC Players

China will need to increase its natural gas supply to 450 billion cubic meters according to the preliminary report of its 12th five-year plan. It is estimated that China's LNG supply will increase from 5% of its total gas supply from today to 16% by 2020. The long-term LNG contracts China has secured are able to provide up to 2.85 million tons of LNG per annum to the domestic market. It was reported that secured LNG supply to China will be increased to 30 million tons per annum by 2015.

The three state-owned oil majors (PetroChina, Sinopec and CNOOC) have invested heavily in developing LNG receiving terminals. Currently, CNOONC and its partners own and operate three LNG receiving terminals and have another six under construction. PetroChina and its partners own and operate two LNG receiving terminals and have another two under construction or planned. Sinopec is slightly behind, with four LNG terminals under construction or planned.

The rapid growth in LNG importation and the development of LNG receiving terminals in China offer many exciting opportunities for international and domestic companies. LNG importation will also encourage the onshore LNG trade. Recently Shenergy, a leading utility group, has included LNG as one of the products which can be traded via its oil products exchange. After registering with the exchange, city gas companies, suppliers to gas-fuel vehicles and other small/medium LNG marketers will be able to participate in LNG trading. According to statistics recently published by CNOOC, the use of gas-fuel vehicles will increase substantially in the next few years. By the end of 2011, approximately 500 LNG vehicle refill stations will be introduced in China, the number will be doubled next year and increased four-fold by the end of 2013.

As many as 12 LNG receiving terminals are to be built in China in the next five years. Work and financing needs arising from the development work are sufficient to keep EPC contractors, engineering companies, manufacturers, design institutions, and banks busy for a while.

To transport and store the quantity of LNG that has been contracted by PRC companies, more LNG ships and storage tanks are to be built. According to various industry studies, by 2020 China will own more than 20 LNG carriers and up to 93 LNG storage tanks.

CNOOC has signed a cooperation memorandum with GDF Suez to charter a floating LNG storage and regasification unit, which may become the first FSRU parked along the Chinese coast.

Challenges

Despite the overwhelmingly positive outlook for LNG business opportunities in China, a number of constraints and challenges may dampen the optimism promoted by industry forecasts.

In China, the natural gas price is heavily regulated and subject to a series of guide prices set by the relevant regulatory authority according to its use. Such a pricing system leads to a constant mismatch between the price of LNG and the retail gas price. Recently, the central government extended the VAT exemption granted to the major LNG importers by an additional ten years. Different views on how the VAT rebate should be calculated (under the extended exemption system) between the tax authorities and the industry may diminish the positive impact which would have been

THE FORTNIGHT IN REVIEW

introduced by such an extension. According to Mr Mao Jiaxing, a Chinese expert, the reform of the gas pricing system in China will happen, but its pace and progress will be subject to the reform of the petroleum products pricing system.

Currently, all PRC LNG receiving terminals in service are controlled by a handful of companies. Although no written rules restrict third party access to these terminals and the capacity of these terminals is not always fully utilised, other national, regional or international companies find it virtually impossible to gain access to and secure capacity at these terminals. Some regional players such as city gas companies or non-state owned energy companies plan to build their own receiving terminals. However, they have found it challenging to identify suitable sites and to obtain approvals and financing for their proposed developments.

Technical standards for LNG down-steam facilities in China are not developed in a consistent manner. Some standards were developed over ten years ago and are urgently in need of revision. The fast-track development mode adopted by Chinese companies may lead to long-term environmental and quality concerns. The industry has seen a great shortage of experienced and properly trained staff to ensure safety management and proper operation of the LNG carriers and LNG receiving and regasification facilities.

Conclusion

There is no doubt that the development of the LNG industry and the increase of LNG use in China offers many opportunities to international and domestic companies. However, uncertainties about gas price reform, trends in long-term and short-term LNG prices and the availability of sufficient LNG supplies in the medium term may slow the progress of the LNG business in China.

The market is calling for a more open and transparent regulatory environment. This would permit a market-oriented pricing system, encourage healthy competition and lead to continuing innovation in technology, whilst promoting a long-term sustainable development of the LNG industry in China.