Written By: Ivie Ehanmo

Email: Ivie@geplaw.com

What is the role of long term sales contracts in ensuring the bankability of Liquified Natural Gas projects?

Liquified Natural Gas [LNG] projects are highly capital intensive and are typically developed as an integrated chain of dedicated elements (production-liquefaction-transportation-regassification), each of which is necessary to implement a successful project. The cost of financing each chain requires significant up-front investments that may outweigh a project company's corporate capital. The capital intensive nature of LNG projects therefore gives rise to the need for the use of long term sales contracts in ensuring the bankability of such projects. Bankability is the term typically used to signify the capability of a particular project to attract project finance.

The use of long terms sales contracts are of crucial importance because not only is the gas market highly unpredictable with fluctuating demand for gas, each LNG chain has to be financed over long periods varying from 15-25 years, owing to the fact that there is no exchange which trades LNG and everything is done over the counter, unlike what obtains in the stock market. Financiers therefore need some form of guarantee with regard to the creditworthiness of the parties, in order for the project to be made bankable.

Long term sales contracts assure predictability of cash flow by hedging long-term risks therefore acting as a guarantee. The take or pay obligation (clause) under the contract, is the main instrument used or employed as a basis of security as the buyer is required to pay for contractually specified quantities of gas, even if delivery is not taken. The buyer is in effect taking the volume risk and the seller bears the price risk.

Sellers in an LNG project would prefer to enter into long term take or pay contracts, rather than leave it to the unpredictable and fluctuating gas market because of the high cost of producing gas; sellers need to reassure the financiers that costs will be met by assuring their income over a period of time. These contracts therefore, act as a means of buying certainty, guarantee and security of supply by securing the investments of sellers who are then able to repay the lenders.

However, the use of long term sales contracts may be limited because of the rising growth of spot trading in the industry, thus creating competition and flexibility in the market. Although the short term LNG market is growing, it has not developed to a point where long term sales contracts will be eradicated as producers use them to help underpin their market position, project sponsors depend on them to assure off-take and thus justify large investments in production and transportation, project developers and financial institutions need them to provide security both for project and corporate finance, primary buyers rely on them to provide certainty and stability of physical supply and as a price hedge and more importantly, a strong long-term portfolio acts as a powerful marketing instrument that helps both primary and secondary buyers to sell their gas.

Ivie Ehanmo