Q&A with Joseph A. Bevash & Stephen P. McWilliams

The Canadian LNG Projects Revolution

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Canada's liquefied natural gas (LNG) market is at something of a turning point. With expanding shale reserves, an amenable regulatory environment and a general comfort with foreign investment in its oil and gas industry, Canada's LNG market stands ready to expand significantly. However, with the United States, previously the principal importer of Canadian natural gas, now self-sufficient thanks to its own expanding reserves, Canadian LNG projects must turn their focus toward the larger global export market.

On August 27, 2014 Latham & Watkins partners Joseph Bevash and Stephen McWilliams were joined by Paul Cassidy and Gordon Nettleton, partners at Canadian law firm McCarthy Tétrault, to lead a seminar in Tokyo on the key issues related to the development and financing of Canadian LNG projects in this evolving environment.

In this Q&A interview, Bevash, McWilliams and Cassidy provide an overview of the topics covered during the seminar and discuss what they expect the future of the Canadian LNG market to look like.

How would you characterize the current natural gas market in Canada? How is it changing?

Cassidy: I would characterize the current natural gas market in Canada as being very prolific. It is very large — there is an extensive resource available for exploitation primarily because of major advancements in shale gas exploration and drilling. As a result, Canada is faced with a changing market because, at the same time as the proven reserves in Canada are expanding to some 238 years' worth of domestic supply, the major export market for Canadian natural gas, the United States, is also experiencing a major shale gas revolution, such that their reserves are massively expanding. This is causing a decline in the export market for Canadian gas to the United States. The market is changing in Canada such that new gas markets have to be found for Canadian gas, or it becomes, in essence, a stranded asset because the Canadian consumption and demand is still so low. As a result, you are seeing a significant effort by the Canadian government and the various provincial governments in Canada to seek out new markets. Hence the focus of the Canadian government and Canadian gas industry on the Asian market.

Bevash: In summary, you've got a supplier whose sole buyer has now become self-sufficient, a motivated host government and a continuing big appetite among Asian and other world buyers for the gas. So, it is a natural opportunity to switch gears and target the global export market.

What is the appetite for major new capital LNG investment in Canada versus other jurisdictions?

McWilliams: I think the main thing to note here is that the Canadian projects are competing in a global market. There are very significant numbers of projects that are in the planning stages in many countries. The US obviously, Africa — places like Mozambique and Nigeria — Yamal in Russia, the Far East, Australia and Indonesia. There are many projects searching for capital and searching for buyers. The advantage that the Canadian projects have the potential to capture is a cost advantage. They are closer to the markets than the African projects, for instance. They have the advantage of being in a predominately cold weather climate, unlike the Australian projects, for example, and this makes them more efficient. Because they are starting from scratch, they also have the opportunity to think about the government policies and infrastructure sharing arrangements that could dramatically reduce their cost to make them more competitive than the Australian projects, for instance, which have all been done as standalone massive projects. They can compete in the global marketplace and they have a choice to make, I think, about how competitive they want to be. That choice is going to be driven partly by government policy and partly by how these projects manage to cooperate and share things like pipeline infrastructure.

Are the Canadian government's policies amenable to LNG development in Canada?

Cassidy: Yes. Canadian government policies are created at both the federal and provincial level. Both of those levels of government have recognized the importance of creating a favorable investment climate for capital LNG investment in Canada in order to ensure that the assets and reserves are exploited appropriately for use in the Asian markets. This extends to foreign ownership presence in the markets — Canadians are very used to foreign ownership in their natural resources and have developed favorable policies for that, particularly with regards to natural gas. There is a very favorable government attitude toward foreign investment in the gas industry in Canada and that is primarily because Canada is very much an export oriented country when it comes to its natural resources. It has huge natural resources and a small domestic load, so you'll find the Canadian government's policies are amenable to LNG development in Canada.

There are some policies that are being developed as we speak, particularly tax policies and labor and employment strategies, that are the subject of a lot of current discussions right now to ensure they are formulated to be consistent with that open market approach. We look forward to seeing these policies developed by the end of 2014 with more detail, but our expectation is that those policies will be an extension of the favorable government position toward LNG development in Canada.

McWilliams: Generally, most governments around the world are struggling to catch up to a rapidly changing marketplace for LNG. If you go back five years or so, demand for LNG far outstripped supply. Now, we've moved into a different marketplace where there are a host of supply sectors, not just LNG, but piped gas — Russia just announced a big contract to sell piped gas directly into China — coal prices are also very, very depressed at the moment, and that competes for power projects with LNG and gas, so this has created a very big shift in the market for LNG from a seller's market to very much a buyer's market. I think governments generally are playing catchup to develop policies and encourage investment that matches this new reality.

Bevash: Most governments can no longer just count their chickens and try to figure out how best to extract the maximum tax revenue from the development of LNG. Now, governments actually have to put themselves more in the role of motivators and grantors of tax concessions in order to encourage their exports of LNG.

What are some of the regulatory and environmental hurdles new LNG projects may face in Canada? What strategies can be used to help overcome them?

Cassidy: There are some issues that have to be resolved, but the provincial and federal governments in Canada have been working to remove or resolve as many of the regulatory and environmental hurdles facing the new LNG projects in Canada. The government's intentions are to avoid being the cause, through their regulatory regimes, of any impediments to LNG investment in Canada. For example, the federal legislation governing the export licensing of LNG to export out of Canada has been significantly reformed and has been streamlined into a simple process. Given the huge resource that is available in Canada, it is now a relatively straight-forward process to demonstrate that there is sufficient resource to satisfy the local domestic market and that there is a benefit to Canada from the exports. Hence, export licenses are becoming relatively straightforward to obtain for viable projects.

Similarly, there has been reform of the process for deciding whether or not investments in Canada are of net benefit to Canada. Under the Investment Canada Act, investments are reviewed, but given the value of exports to Canada, that process recognizes that it is generally a net benefit to Canada for LNG investment to take place. Similarly, there has been reform of the process for deciding whether or not investments in Canada are of net benefit to Canada. Under the Investment Canada Act, investments are reviewed, but given the value of exports to Canada, that process recognizes that it is generally a net benefit to Canada for LNG investment to take place.

The fiscal regimes in place are currently the subject of intense discussion between the major LNG proponents and the relevant government to determine what the appropriate fiscal regime is — the appropriate tax, if any, that could be applied to the LNG developments. The government has made proposals that the industry has reacted to such that the conversation is continuing and we expect that by the end of this year there will be some resolution of what the appropriate fiscal regime is to ensure it doesn't become a regulatory or cost hurdle to the development of LNG in Canada.

Further, there has been significant reform in the environmental permitting regimes in Canada, and that reform has led, for example, to a consulting firm doing a comparison of the environmental permitting regimes between Australian LNG and Canada and they concluded that the Australian LNG was a lengthier process by some three months, which is a significant amount of time in the permitting life of a project. So, Canada has made real progress in the streamlining of its environmental permitting regime.

Finally, there are issues with regard to Canada's aboriginal peoples, the First Nations, which we don't believe are hurdles but, in fact, present economic opportunities for First Nations and economic developers to come together.

When LNG and First Nations reach agreements and accommodations they can actually work together, and when First Nations become participants in LNG projects they become powerful economic and community allies and that helps to reduce regulatory and environmental hurdles as well.

What do you expect to see in terms of LNG development in Canada in the next five years?

Cassidy: Within Canada, we are seeing a lot of interest and we are seeing a lot of major industry players — major companies in the oil and gas industry as well as investors — demonstrating interest in LNG developments. We would expect that within the next two to three years we will see final investment decisions taken with regard to three to five LNG developments in Canada, assuming that all of the regulatory issues and all of the cost issues are resolved. That would then lead to three to five projects being developed or substantially started in Canada within the next five years.

McWilliams: It is not just a domestic question, it is also a question of how those projects compete with the Australian projects and the African projects. Australian projects are generally seen as having priced themselves out of immediate development for several reasons, the primarily one being labor costs. As some of these projects in Canada gather steam and begin construction they will start to exhaust the Canadian labor supply, and Canada will need to be careful that they don't experience the same wage cost inflation that Australia did over the last five years or so. If they manage to avoid that, the prospects of more projects being developed in Canada is higher. If they do experience the same wage cost inflation, then eventually they'll match the Australian projects and less projects will be developed.

The other thing that factors into this is the financing — the capacity of the market to finance a large number of these at a similar time. Canadian projects have the advantage in North America of being almost part of the US domestic financing market. There are bond investors, high yield bond and investment grade bond investors, and a term loan B institutional lending market that are accustomed to lending to US projects in the oil and gas industry, and they are probably equally comfortable doing so in Canada, whereas they might not be on an African project, for example. So that ability to tap a different type of financing in addition to the traditional project financing model or balance sheet financing model, which are the two other options, give the Canadian projects a bit of an advantage over some of the projects being developed in developing nations.

Bevash: It is a more complicated projection than the US shale projects, which have the definite advantage of being able to build on the footprint of existing former regas facilities as well as the very significant advantage of being able to tap into a thoroughly developed gas pipeline network. Canada's gas pipelines all point in one direction: toward the United States. Canada is going to need to invest in significant new east to west infrastructure to bring the gas to the coast to be able to ship it to Asia and other world destinations. Those projects will necessarily be higher cost at a time when US production is really switching into high gear on a lower cost platform. Also, Russian gas possibly may become available to parts of Asia through pipeline and avoid all the liquefaction and transportation costs associated with LNG. There are a lot of factors at play that complicate the analysis, but make it very interesting.

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