Questions remain as LNG Canada Phase 2 reaches FID

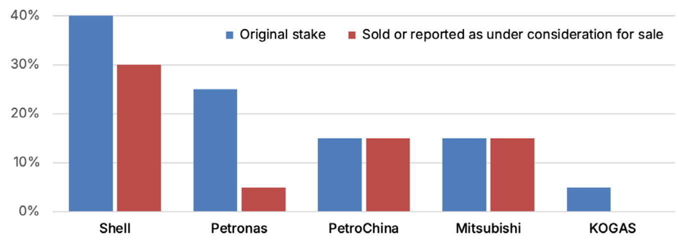
OVERVIEW

As Phase 2 of LNG Canada's export facility in Kitimat, British Columbia, reaches a final investment decision (FID), the investment case for this part of the project is noticeably different than for the first phase. LNG Canada Phase 2 is approaching FID with potentially 50% of the combined project for sale and possible new ownership. Phase 2 must also contend with greater uncertainty around construction costs, economic inflation, potential global oversupply, and a turbulent trade environment.

MORE RISK IN PHASE 2

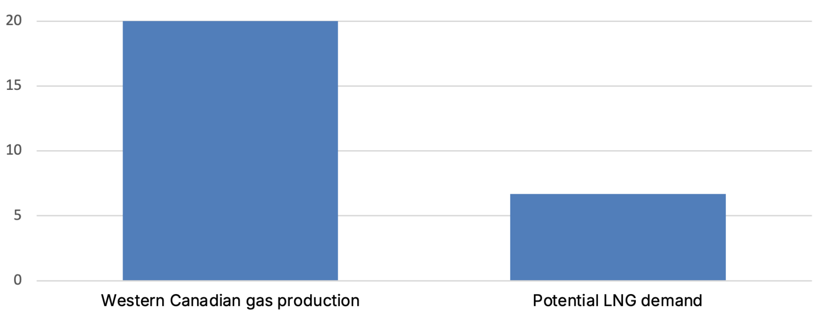
While both phases of the project share the same site and overlapping ownership, a lot has changed since Phase 1 reached FID. Construction of Phase 2 will have to contend with volatility and increases in prices of labour, steel, equipment, debt, and other input costs. Investors in Phase 1 were able to partially insulate themselves from the effects of cost overruns by transferring this risk to contractors via lump sum, fixed-payment contracts. Right now, it is unclear if Phase 2 can secure comparably favorable commercial terms in today's volatile cost environment. Notably, the project's ownership structure is also shifting, with some project sponsors looking to divest their stakes in the project.

LNG Canada ownership divestments



Sources: Shell; Upstream Online; Reuters IEEFA

Potential LNG demand vs. western Canadian gas production, Bcf/d



Source: Canada Energy Regulator (CER) IEEFA

Phase 2 also faces gas supply questions. The requirement for incremental feed gas must be assessed against expected production levels in western Canada. The Phase 2 expansion is likely to to double Phase 1's feed gas requirement. Even though western Canada has large gas reserves to pull from, the combined demand from Phase 2, other LNG projects under construction, and potential increases in data centre energy use may entail new drilling or higher utilization of existing infrastructure.

If incremental LNG demand grows faster than upstream production, this could tighten regional supply-demand balance, causing gas prices to rise. Higher gas prices would increase operating costs for both phases and pressure project margins.

Investors need to consider the cost and timing of expansion, the pace of upstream production growth, the development of demand drivers, and the risk of global oversupply.