THE COMMERCIAL AND FINANCING CHALLENGES OF AN INCREASINGLY COMPLEX LNG CHAIN

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ABSTRACT

New countries and companies are seeking to develop new LNG supply projects; construct large numbers of LNG ships — some without firm charters; and develop new LNG regasification terminals. Patterns of ownership and project structures changing and the boundaries of risk allocation between buyers and sellers are shifting. This has a direct impact on the financiability of LNG projects, at a time when the availability of third-party finance could become squeezed with the implementation of Basel III bank liquidity limits. Any project seeking external funding must be financeable on terms acceptable to lenders or outside investors. Currently, all projects — LNG plants, ships and regasification terminals — require long-term 'take-or-pay' contracts for LNG with substantial buyers. The reliance on the buyer increases as new LNG project structures increase risks. This paper will look, from a commercial perspective; at the key features on which lenders will focus and examine how new LNG structures are being financed. It will also look forward to what LNG models might become financeable in the future and address issues including: Will all new supply project, such as those in Mozambique, Tanzania and USA, be able to raise finance and what new risks will have to be addressed? Will new commercial structures need to be developed? Will Basel III liquidity restrictions impact on the availability of funds to the LNG sector? Will we see a greater role for corporate debt in the future? Will LNG again become the domain of large companies?

INTRODUCTION

Since 2000, project finance has been a critical element in the development of over 100 million tonnes of new LNG capacity. Over this time the LNG industry has used project finance to raise around $97 billion of third-party debt to finance new liquefaction projects, which, by IHS CERA’s estimate, represents approximately 71% of total capital raised for new liquefaction projects during this period. The question is will this trend continue? Will project finance remain the mainstay of LNG project financings? IHS CERA estimates that gas liquefaction projects will be seeking $100-110 billion of new debt over the next ten years, while the industry will have to manage increasing tensions of rising costs and challenging project economics. With global lending liquidity constraints, the implementation of the new Basel III regulations and other complicating factors; the challenge is - will there be sufficient long-term debt available to support the development of this new liquefaction capacity?

Limitations in the availability of third-party debt could lead to greater use of shareholder funds, which in itself will limit the number of companies that can invest in the LNG sector. Projects need competitive lending as a means of mitigating debt costs and improving overall economics. Reduced availability of project finance debt may undermine some LNG project developments. It will also encourage the use of alternative financing structures and expand the role of export credit agencies (ECAs), which are already being used by energy consuming governments as a way of seeking a competitive advantage in sourcing LNG.

This paper examines the historical role, and speculates about, the future role of project finance in the LNG industry. To achieve this, the paper will also explain the looming Basel III regulations and their potential impact on long-term LNG project financing structures, and other factors that may impact on LNG project
financing. Based on this analysis, this paper concludes with an outlook for the financing of future liquefaction projects.

UNDERSTANDING PROJECT FINANCE AND ITS ROLE IN THE LNG INDUSTRY

Project finance is a form of long-term financing typically utilized for large infrastructure projects. It is different to other forms of finance because it is modeled off the projected cash flows of a project (i.e. LNG sales revenue) and not the balance sheets of the project sponsors - for this reason it is also referred to as off-balance sheet financing. In order to achieve a project finance transaction, project sponsors typically establish a project company or special purpose vehicle (SPV) that allows for banks, export credit agencies (ECAs) and other lending agents to lend money directly to the project company instead of to the individual project sponsors. By comparison in corporate finance, each sponsor would be required to finance its portion of the project, utilizing a combination of capital on hand and individual loans, which in the case of lower credit rated entities, would limit the amount of debt that can be raised. Project finance has played a pivotal role in the LNG industry. In LNG project finance transactions, the level of debt is determined by the structure of the project itself and the quality of the LNG offtakers, who ultimately provide revenue to the project. Lending institutions use the expected project income stream (in this case, the sale of LNG on a take-or-pay basis) to determine loan rates and default risk. Income is typically guaranteed for these projects through long-term (i.e. twenty-year) LNG sale and purchase agreements (SPAs). These agreements are usually signed ahead or in parallel with the loan agreements and other key documentation. Many financings also include shareholder loans, usually on the same terms as third party debt. Figure 1 illustrates the typical structure of a project financed LNG transaction.


Figure 1 - Project Finance Structure

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1 Export Credit Agencies are government-funded bodies who advance funds and provide risk cover in return for selling their countries goods and services (e.g. US Exim, Japan Exim, SACE, Italy)

2 Take-or-pay is a common provision in gas contracts under which, if the Buyer’s annual nominated and received volume is less than the Annual Contract Quantity minus any shortfall in the Seller’s deliveries, minus any Downward Quantity Tolerance, then the Buyer pays for such a shortfall as if the gas had been received. The Buyer may have the right in subsequent years to take the gas paid for but not received, either free or for an amount to reflect changes in indexed prices (called Make Up Gas). Take-or-pay commitments are a critical element supporting the financing of LNG projects as they provide a guaranteed cashflow to the LNG project.
Benefits of Project Finance for LNG Projects

There are some key benefits to using project finance for LNG projects, which make it uniquely compelling to LNG project developers. These include the ability to:

Obtain limited recourse to project sponsors. Project finance is a form of “limited recourse” finance, this is because the loan is given to an SPV and not the project sponsors and so recourse on the loan is limited. As a result it is lenders, not sponsors, who take on the greatest share of project risk. Prior to completion, shareholders have to provide financial guarantees to the lenders in case the plant does not operate as planned. In turn, sponsors will aim to mitigate this risk by passing it on to the engineering procurement and construction (EPC) contractor. Once the project has started production and necessary completion tests have been carried out, recourse to sponsors falls away , and is then fully borne by the lenders. Comparatively, a balance-sheet financed loan has recourse directly to the total asset base or balance sheet of an individual shareholder and may preclude sponsors with poor balance sheets from participating in LNG projects. With the SPV structure, all sponsors will still need to pay their own equity shares.

Develop projects in higher-risk countries. Liquefaction projects are often developed in countries with low credit ratings, which includes the national government or a national company as a shareholder of the project. In this situation the national entity may not have the financial capacity to borrow money, or the international company investors may not wish to invest in the country or cover the portion of the local party’s debt. Project finance enables the project itself to be ring-fenced and to borrow money in its own name, on terms that may be more competitive than a national government or company could secure.

Generate large debt capacity. Projects utilizing this form of financing are generally highly leveraged, targeting a 70:30 debt to equity split It is therefore attractive to project sponsors who need to generate a large amount of debt while preserving their debt/equity ratio.

Include Export Credit Agency (ECA) Support. The lengthy and thorough due diligence process involved in a project finance transaction is well suited to ECAs and, since the mid-1990’s, ECAs have played a growing role in the financing of LNG projects either through direct loans, political risk coverage or loan guarantees. As set out in Chart 1, IHS CERA estimates that between 2008 and 2012, ECA’s have provided close to $30 billion in direct and covered loans3 to liquefaction projects utilizing project finance, or roughly 46 of all project financed debt for liquefaction projects.

Low default rates. The use of project finance for liquefaction projects is further supported by the low level of default in project financing transactions. The low level of default was confirmed by the rating agency Moody in its published a report on the default recovery of project finance debt4 which concludes that project finance is a resilient class of specialised corporate debt.

It is also important to note that project financing can have its drawbacks. Because banks lend to a project company, with limited recourse to the actual project sponsors, the due diligence requirements take time and cost money. While these drawbacks are significant, liquefaction project sponsors have historically found the benefits of project finance outweigh the drawbacks, but tend to use it only when it allows them to finance projects with weaker credit partners or at the insistence of National Oil Companies.

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3 Estimates are for direct loans only and do not include loan guarantees.
Project Finance and the LNG Industry: Historical Figures

The LNG value chain (liquefaction, shipping and regasification) is highly capital intensive particularly for the liquefaction portion of the chain, which typically constitutes roughly 70-75% of total midstream investment. Because the liquefaction part of the chain is the most capital-intensive portion, it is this part that project developers typically seek to project finance. IHS CERA estimates that since 2000, investment in the liquefaction portion of the LNG chain has exceeded $150 billion and $97 billion of project finance debt has been raised to fund new liquefaction projects. Taken together, this means that, since 2000, roughly 71% of the capital raised to finance new projects was in the form of project-financed debt. Chart 1 shows the Third Party Debt Raised for Liquefaction Plant Financings, 1985 – 2012. It is interesting to note that the $40 bn. Ichthys project financing that closed in December 2012 skews the graph by its size.


Looking Ahead: Why Future Liquefaction Projects May Seek Alternative Forms of Financing.

Despite the numerous benefits of project finance in the LNG industry, IHS CERA anticipates that in the years ahead a smaller proportion of liquefaction projects will utilize project finance. This change in status quo will be the result of complicating factors that will inhibit a project’s ability to secure project finance loans. Specifically, these challenges include: 1) the introduction of new liquidity ratios mandated by Basel III; 2) challenging locations for some of proposed liquefaction projects; and 3) the introduction and utilization of new technologies into the industry.

Basel III and Liquidity Contraints

New liquidity ratios introduced in Basel III standards will come into effect between 2013 and 2019 and are likely to impact project finance structuring. Specifically, there is a concern that the requirements for banks to meet the necessary net stable funding ratio (NSFR), which is planned to be adopted in 2018, could reduce the ability of banks to issue large, long-term loans – which is a key feature of a project finance transaction.

The NSFR, which is planned to be adopted in 2018, is meant to prevent banks from funding long-term assets with funds that have a short-term (less than one year) maturity and thereby preventing a maturity mismatch. The main goal of the NSFR is to limit a bank’s reliance on wholesale funding for long-term assets and force banks to find more stable, long-term funding options. There is speculation that the global banking sector may struggle to raise the capital required to meet the NSFR. There is also a view that the Basel III requirements...
may have to be adapted to the specific requirements of infrastructure project finance projects. Yet another concern about the NSFR is that it treats all ‘long-term loans’ the same and any loan with a tenor greater than one year will qualify as a ‘long term loan’. This means that a two-year fixed perm loan must meet the same liquidity standards as a 20-year term loan.

As a result, one possible implication of the NSFR is that project developers will use more mini-perm loans or medium term loans to finance the construction of a project, when the project development risk is the highest. The use of these medium term loans may however not be available without recourse to the project shareholders. This may result in smaller companies and low credit rated government entities not being able to invest in LNG projects without support from international companies or government-backed ECAs.

Many project finance bankers have called for the Basel III liquidity requirements to be relaxed for specific project finance classes. They cite the low historic level of default in past project finance deals and the high level of due diligence that is carried out before any loans are made. Indeed, the tighter lending requirements from Basel III could in theory favour LNG project financing debt vs. other industry sectors and forms of lending because it is a relatively safe.

If the rules are not relaxed, then the availability of long-term bank debt to finance future LNG projects on a long-term 15-20 years debt (10-15 years post project completion) could be challenged which would result in a tightening of liquidity and a rise in the cost of debt. Effectively, projects will have to compete for finance from a smaller pool of funds.

**Diverging Political Risk--Location of Proposed Liquefaction Projects**

A key advantage of project finance is that it allows developers to mitigate the risks associated with politically or economically unstable environments. Such projects face a risk of expropriation, political turmoil, labor strikes and other unforeseen disruptions. Today, the bulk of existing liquefaction projects are located throughout the Middle East, North & West Africa and South East Asia & Australia. Looking ahead, the proposed project pipeline suggests that the location of new LNG projects will be mixed with some in high investment risk countries in Africa and the East Mediterranean and others in lower risk countries such as the USA, Canada and Australia (see Chart 2 – IHS CERA Liquefaction Project Inventory). Because a key benefit of project finance is risk mitigation, project sponsors have been more open, to date, to considering balance sheet financing for projects in low-risk countries (such as Australia) in order to avert the due diligence process required in a project finance transaction, and thus reduce costs and speed up project delivery. The growth of new liquefaction projects in relatively high-risk countries, should lead to increased demand for project financed transactions with ECA support.

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5 Mini-perm is a form of short-term (3-5 year) financing that could be used to fund the construction of LNG projects ahead of LNG production and project income. A developer could use mini-perms ahead of accessing long-term financing or other permanent financing solutions
Introduction of New Technologies

Technology is a major risk in any liquefaction project and typically lenders prefer the use of proven technology. Projects deploying new or untested technology are often forced to accept tighter terms from lenders and undergo increased scrutiny. In recent years some of the proposed and developing liquefaction projects have involved reliance upon new and untested technologies, including floating liquefaction technology (FLNG). This again may encourage sponsors to consider non-project finance forms of debt financing.

Project Structures

Project finance has been used to source debt for projects developed using the three primary project structures, integrated, segmented and tolling. Under each of these structures the risk profile is slightly different:
<table>
<thead>
<tr>
<th>Structure</th>
<th>Description</th>
<th>Project Sponsors Risk</th>
<th>Lenders Risks (post start-up)</th>
<th>Risk Mitigants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integrated/Integrator</td>
<td>Shareholders in the upstream are the same as those in the LNG plant such that upstream and LNG plant economics are integrated. LNG is sold by the integrated company (to a third party buyer or to a shareholder). There is a direct linkage through the project back to discovered reserves.</td>
<td>Development of both the upstream and the LNG plant. To own or charter the LNG ships (in case of ex-ship sales).</td>
<td>Plant production risk. LNG offtake and market risk. Delivery risk (in case of ex-ship sales).</td>
<td>Plant and LNG chain due diligence and technology/construction guarantees. LNG market risk (inc. price &amp; payment). Gas supply, shipping and LNG offtake risk are mitigated through contractual take-or-pay, shipping contracts and supply obligation liabilities.</td>
</tr>
<tr>
<td>Segmented</td>
<td>The upstream shareholders are different to those in the LNG plant. Feedgas is sold to the liquefaction company, which builds and operates the plant and sells the LNG to the buyer (to a third party buyer or to a shareholder).</td>
<td>To secure the feedgas and sell LNG on economic terms. To build and operate the LNG plant and secure finance. To own or charter the ships (in case of ex-ship sales).</td>
<td>Plant production risk. LNG offtake and market risk. Delivery risk (in case of ex-ship sales).</td>
<td>Plant and LNG chain due diligence and technology/construction guarantees. LNG market risk (inc. price &amp; payment). (Gas supply, shipping and LNG offtake risk mitigated through take-or-pay, shipping contracts and supply obligation liabilities).</td>
</tr>
<tr>
<td>Tolling</td>
<td>The liquefaction plant is developed by a separate company (which may include some or all of the shareholders from rest of chain). Upstream gas suppliers “toll” through it, selling the LNG in their own name or through a reseller company.</td>
<td>Construction and operation of the LNG plant.</td>
<td>Plant production risk. Tolling fee payment risk.</td>
<td>Plant due diligence and technology/construction guarantees.</td>
</tr>
</tbody>
</table>
Lenders seek to mitigate their risk in a variety of ways and these are set out in the project’s security package. In summary the package will address the following risks:

| Sponsors | Selection of projects with sponsors who are experienced in the LNG industry and have a good credit rating. |
| Technology | Lenders will prefer projects where established technology is used, and will seek shareholder guarantees until project start-up and completion tests have been completed. Where new technologies are used (e.g. new liquefaction technologies or floating LNG) lenders will look for stricter shareholder completion and operations guarantees (which sometimes may preclude third party financing for some new technologies). |
| Buyers | Lenders will want to LNG buyers to be reputable, experienced and have a good credit rating. They will also want to make sure that, in the case of FOB sales where the LNG buyer arranges the shipping; the ships will be in place to lift the LNG. Lenders will also want to make sure that the buyers have sufficient regasification capacity or onward resale arrangements in place. Lenders will want all these terms set out in a binding LNG SPA with no, or acceptable, conditions precedent and, if required, suitable credit guarantees. |
| Export Credit Agencies | Lenders will like to see ECAs in place, giving necessary political risk guarantees and sometimes direct loans. These governmental lending organisations, give comfort to commercial lenders as well as financial support to the project. |
| Sponsors Completion Guarantees | Sponsors should be of sufficient credit standing to support completion guarantees along all segments of the LNG supply chain that are under their control. Where the sponsors are not of sufficient credit capacity, then third-party support may be required or shareholder crosses guarantees provided. |
| Experienced Shipper | Lenders will want to ensure that the shipping part of the chain is in place and reliable. |
| Host Government Support | Lenders will want to ensure that the host government is fully behind the project and that laws and regulations in place are appropriate and supportive to the project. |
| Host Government Stability | The country must be politically and economically stable to support the LNG project. If it is not the case, then extensive ECA cover will be required (e.g. PNG and Yemen LNG projects). |

The last few years have seen changes in the risk distribution of project structures as new sources of gas are used for LNG projects, such as coal seam gas in Australia and where gas off the grid in the USA is used as feedgas. In the case of the first US Gulf LNG export project - structured as an LNG sale and tolling plant — the buyers have contracted to purchase LNG from Cheniere’s liquefaction SPV, which, in turn, sources feedgas from the grid — Cheniere then liquefies the gas. The LNG buyer is taking price and offtake risk, paying a fee to Cheniere to cover the liquefaction cost, regardless of whether the LNG is lifted. The offtaker is required to give notice to Cheniere when it does not want to take LNG. With such notice, the liquefaction fee reduces to a lower level that is sufficient to meet the financing and plant fixed operating costs. This structure leaves project sponsor, Cheniere, with a small element of price risk because it gets paid by the LNG offtakers for feedgas pipeline charges as a percentage of the Henry Hub price, while it pays a fixed pipeline fee to the pipeline operator. This tolling model being developed for the US Gulf projects therefore has a different risk profile to lenders that the integrated or segregated models described above.

As part of the changing global LNG business LNG buyers are also looking for greater flexibility in LNG SPAs (e.g. volume flexibility, price reviews, lower take or pay, relaxation of destination restrictions). Lenders will monitor these changes closely, as the debt capacity of an LNG project is usually determined by the lenders...
“banking models” which will be stress tested against the worst case contractual and pricing position. The more flexibility that the SPA includes, the lower the financial borrowing potential. The lenders will also be cautious on the basis under which LNG is priced under long-term sales and purchase agreements. Banks know and understand LNG priced against oil and have some experience of hub pricing in Europe. If Asian buyers purchase LNG on hub-related prices, and the revenue required to service project finance debt is related to hub prices (which in the main it is not for Sabine Pass LNG), then lenders will want to make sure that the LNG sales pricing formula includes a premium to Henry Hub. This premium must give an LNG price that is high enough to ensure revenues are sufficient to both service the debt and maintain profitability of the project. Whether a lender will accept LNG priced on a hub, therefore, depends on the pricing formula, contract terms and the structural arrangement of the project.

IHS CERA’S OUTLOOK FOR PROJECT FINANCE IN THE LNG MARKET

Since 2005 nearly 140 mt of new liquefaction capacity has entered the market and liquefaction projects with more than 450 mt of capacity are currently planned, but not yet committed. Worldwide liquefaction capacity amounted to 280 mt (37.3 Bcf per day) by Q4 2012 and IHS CERA expects that global capacity will exceed 420 mt (56 Bcf per day) in 2020 and 520 mt by 2030.6

IHS CERA’s Global Redesign scenario estimates that developers will take FID7 on around 200-210 mt new capacity between 2013 and 2025, which equates to an investment of $ 230-240 bn in new liquefaction facilities, see Chart 3 - The Capacity and Number of Liquefaction Projects Reaching FID 2013-2027. The key challenge, given the current economic environment, and increasing financial regulation, is how will all these projects be financed? For the reasons discussed above, IHS CERA anticipates that a smaller proportion of these new liquefaction projects will utilize project finance. While historically project financed debt accounted for roughly 71% of total capital expenditure on new liquefaction projects; IHS CERA anticipates that between 2013 and 2025 this figure could be closer to 40 – 45 % (equating to $100-110 bn. debt) as project sponsors and developers use more equity and the revenues from operating projects to fund expansions, particularly during the period 2016-2020; see Chart 4 - Expected Source of Funding for Liquefaction Projects that Reach FID 2013-2027.

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IHS CERA Global Redesign Scenario, October 2012

1 Final Investment Date (FID) - The date on which the project sponsors decide to make a binding financial decision to proceed with the project. Usually the key agreements related to the project are signed on this date (i.e. plant construction, gas purchase, LNG sales and financing agreements)

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Chart 3 - The Capacity and Number of Liquefaction Projects reaching FID, 2013 - 27

![Chart 3](chart3.png)

Source: IHS CERA. NOTE: Equity includes a) The equity portion when the projects in third party financed and b) all the finance cost when a project is shareholder financed.

Chart 4 - Expected Source of Funding for Liquefaction Projects that Reach FID, 2013 - 27

![Chart 4](chart4.png)

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While these figures suggest a contraction in the project finance market, this is actually not the case. Because numerous potential new and expansion projects will be taking FID over the next decade, the number of project finance transactions is likely to increase relative to the previous decade; while some will need to seek alternative financing options such as equity, shareholder loans and bond market financing.

MIND THE FUNDING GAP: ALTERNATIVE FINANCING

In IHS CERA’s view, due to the potential tightness in project finance capacity, a proportion of projects will be forced to consider alternative financing methods including, and in particular, equity financing. Where a project is being funded from equity, without recourse to debt, it is likely to limit the number of companies who can take such a shareholding in LNG projects. These limitations may take the industry back to a time when only the “big players” could develop LNG projects. If projects are equity financed, then lower credit rated governments and companies may not be able to participate or they will have to reduce their equity share to a level that matches their financial capacity. This means that governments may not be able to meet their aspirations with regard to the degree of participation in projects, leaving only larger creditworthy companies involved, which could impact on their willingness to proceed with a project or their continued commitment to the project development process. This could therefore slow the rate of project development if NOCs/governments are slow to accept the “new” order.

Another possible outcome is that demand for project bonds could increase as projects seek alternative funding methods, and as project finance debt becomes squeezed, bonds may play a larger part on future financing of LNG facilities. This may also reduce the ability of NOCs/governments to raise finance and a country with low credit rating would find it difficult to raise the necessary bond finance at a reasonable cost.

For projects that wish to utilize project finance, the need for strong project sponsors, sound project economics (especially in an environment of rising capital costs) and competitive borrowing terms plus ECA support will continue to be vital while projects carrying additional risk may be difficult to finance. Projects developers need competitive lending as a part of their strategy to mitigate project costs and improve project economics and lenders will therefore have to be creative. The use of short and medium term debt to cover the risky construction period may become the norm, with re-financing once the plant is operational. In particular, ECA involvement will remain ever important as ECAs can deliver long-term debt in return for sourcing goods and materials, or selling LNG, to the loan country. This could restrict the companies that develop LNG projects, options of project developers as to where they can source engineering capabilities and equipment, and where they should sell LNG as they may need to target specific countries that have large available ECA funds.

Assuming that some of the proposed liquefaction projects that successfully secure financing in the years ahead are in the US, the portfolio of banks that seek to offer loans to these projects is likely to be similar to that of other liquefaction projects around the world. However, regional US and Canadian commercial banks are likely to play a larger role in these deals, thereby filling the funding gap left by European banks. It will be interesting to see whether local banks in other emerging economies of Malaysia, Thailand, Vietnam and South Africa take on a similar role in the development of LNG infrastructure.

In the years ahead, availability of finance is going to be tight, and even though project finance has a very good track record, there could be a shortfall of funds available for financing of LNG projects. This is due to both the pending liquidity constraints resulting from Basel III and higher premiums applied by many European banks. The key to financing, is therefore, the project structure – designing an LNG project to attract finance rather than vice-versa because, ultimately, poorly structured projects will not be able to secure the necessary third-party debt and will either not proceed or will have to be financed with equity or alternative financing sources.
CONCLUSIONS

Since 2000, 163 mt of new liquefaction capacity has started production; during the same period nearly $97 billion in project-financed debt has been raised for these projects. Project finance has been critical to liquefaction projects. Project sponsors have used project financing as a means to pass the project risk to lenders and secure competitive debt/equity ratios, enabling the development of LNG projects in countries with low credit ratings and with shareholders of varying investment grade. As a result, historically, the majority of debt raised to finance new liquefaction projects has been raised using project finance. IHS CERA estimates that since 2000, roughly 71% of the capital used to fund new liquefaction projects was in the form of project financed debt. However the implementation of the new Basel III regulations in 2015 and 2018, together with other complicating factors unique to the liquefaction industry, could impact the availability of long-term debt to support new liquefaction projects, and the terms under which debt is made available. This will lead to greater focus on project structure, more projects being financed through equity and other forms of debt and a greater role for companies with strong balance sheets. There is therefore a need for alternative financing and IHS CERA estimates that gas liquefaction projects will seek at least $100-110 billion in third party project financing between 2014 and 2024. While still significant, compared to historical averages, these figures suggest a gradual decline in the relative number of liquefaction projects that could utilize project finance in the future and will likely result in a funding gap that will be filled through alternative financing methods.