LOST OPPORTUNITY ON US LNG EXPORTS

IN A MOVE THAT COULD SIGNIFICANTLY SHAKE UP THE GLOBAL LNG MARKET, THE US DEPARTMENT OF ENERGY RECENTLY ANNOUNCED SEVERAL DEVELOPMENTS REGARDING NATURAL GAS EXPORTS, INCLUDING A PROPOSED RULE CHANGE FOR REVIEWING APPLICATIONS FOR EXPORTS TO COUNTRIES THAT DO NOT HAVE A FREE TRADE AGREEMENT WITH THE US, THE NON-FTA COUNTRIES. BY **LEE ALEXANDER**, PARTNER, **PHILIP ANGELI**, ASSOCIATE, AND **JAMES PICKLE**, SUMMER ASSOCIATE, **DLA PIPER LLP (US)**.

The proposed change would suspend the current practice of issuing conditional export authorisations. Instead, only those applicants with completed National Environmental Policy Act (NEPA) reviews would proceed to a final analysis by DOE of whether the export is in the "public interest". Since 2011, DOE has issued seven conditional approvals for liquefied natural gas (LNG) exports to non-FTA (free trade agreement) countries, only one of which has completed its NEPA review and received DOE's final export approval.

According to DOE, the intent behind the change – announced in late May – is to focus and prioritise departmental resources by addressing those projects further along in their commercial development, and to improve the quality of information for its public interest analysis.

In addition to the proposed procedural change, DOE announced that it will commission new studies to examine the economic and public interest impacts of LNG exports at volumes between 12bn and 20bn cubic feet of gas per day (Bcf/d) LNG. DOE also announced the release of two environmental reports: one on the environmental impacts of fracking, and the other on greenhouse gases (GHGs) and LNG exports. Interested parties have until July 21 2014 to submit comments in response to the proposed procedural change and the two environmental reports.

This proposal represents DOE's response to the many critics of its current approach for overseeing LNG exports. One camp of critics includes gas producers, LNG terminal operators and associated industry members, who argue that the permitting process is too slow and cumbersome and should be streamlined. In the other camp are those who would rather not see LNG exports increase; among them are US manufacturers reliant on low-priced natural gas for feedstock and environmental groups who are concerned that more increased overseas demand would result in more domestic fracking.

Unfortunately, DOE's efforts miss the mark. The proposal would not resolve these debates. Instead, the new procedure would simply changes the criteria for when DOE applies its public interest analysis to the applicant. In other words, DOE would essentially create a NEPA race, with applicants redirecting their attention to their NEPA reviews so DOE reviews their export projects in a timely fashion.

This misstep gives rise to a new problem. Industry participants generally agree that there will come a time when natural gas prices rise excessively due to previous export approvals, and pending applicants will be automatically denied or subjected to a prolonged moratorium as a result. If a company does not expect to conclude its NEPA review process before DOE's approvals reach the volumetric tipping point for price increases, the company has excellent reasons to oppose the proposed rule change.

The problem is that no one knows precisely when that tipping point will be reached (though many predict 12 Bcf/d)[1]. DOE's commissioning of further economic studies and possibly incorporating new environmental impact studies into its public interest analysis only add to the uncertainty. From a business and investor perspective, this level of uncertainty is unacceptable. LNG exports require significant investments of time and capital, as well as complex legal arrangements. The recent developments do not settle these uncertainties. If anything, they exacerbate them.

Most critically, DOE's proposed rule change does nothing to overcome the drawbacks inherent in employing a single-file queue. By subjecting each applicant to a case-by-case analysis, DOE disregards the relative public interest merits of all projects. Given the "public interest" mandate from Congress and the general recognition that a limited number of permits can be granted, a more logical and equitable approach would be to subject multiple pending applications to the public interest standard at the same time. DOE should comparatively evaluate which projects best serve the public interest. Investors are naturally more inclined to finance projects when the project can improve its odds of being approved; certainly, the inverse is true if a

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project has little control over its advancement in a queue.

In our view, DOE's proposal represents a lost opportunity to accomplish this important objective. Here is a closer look at this situation.

The current scheme

The existing export regulatory scheme is bifurcated, with controls over natural gas as a commodity and separate controls over the liquefaction and exportation facilities.

DOE has export jurisdiction over natural gas as a commodity, which derives from Section 3 of the Natural Gas Act. Section 3 requires a public interest examination of proposed exports to non-FTA countries (whereas exports to FTA countries are deemed automatically to be in the public interest). Over the last three years, DOE has conditionally approved seven applications, finding that each of the non-FTA exports would be in the public interest. DOE has explained that conditional approvals are appropriate in cases where there is a need for DOE to issue preliminary findings and conclusions, but more information is needed before it can make a final decision.

For its public interest analysis, DOE considers such factors as impacts on natural gas prices, domestic gas supplies and demand, economic benefits from the local to the national level, environmental effects, international trade, and national security.

Other federal entities have jurisdiction over the liquefaction and export facilities. The Federal Energy Regulatory Commission (FERC) has jurisdiction over the siting, construction, operation and expansion of the export terminals. The Maritime Administration (MARAD), a Department of Transportation entity, has authority over the ownership, construction, operation and decommissioning of deepwater export facilities located beyond US territorial waters (12 nautical miles offshore).

DOE and FERC/MARAD have independent review processes. DOE's approval of the export commodity and FERC/MARAD's approval of the export facility are both generally required for LNG exports, and each is subject to NEPA.

* *DOE and commodity exports* – The DOE approval process of a non-FTA export begins with submission of an application. Submitting an application is not a difficult task – it does not require a tremendous amount of information and is relatively inexpensive. DOE then places the application in a queue according to two factors: (i) when the DOE application was submitted and (ii) whether the applicant has already initiated the NEPA review process (the NEPA review commences when the applicant applies for approval to use FERC's "pre-filing" process). In December 2012, DOE determined that applications would be sorted into tranches and reviewed in order according to these two criteria. There are currently 26 applications pending for LNG export to non-FTA countries.

• *FERC and export facilities* – The typical review process under NEPA begins with FERC approval for pre-filing and ends with publication of an Environmental Impact Statement (EIS) or an Environmental Assessment describing the potential environmental impacts of the proposed export. Completing a NEPA review is not a simple task. It requires, among other things, an applicant to prepare project engineering and design plans and conduct detailed environmental studies, and these requirements are generally very costly and time-consuming endeavours.

Proposed rules

The new developments could substantially change the current export scheme. The proposed rule would alter LNG terminal developers' strategies because companies would need to invest heavily in their environmental reviews at the outset. As for the new economic studies and released environmental analyses, it is not yet clear how these would affect pending and future applications.

• *New procedures* – Under the proposed change, DOE would not conduct its public interest review until after the NEPA review process was completed – that is, after publication of a Final EIS or a Finding of No Significant Impact or DOE's determination that the project is categorically excluded from DOE's NEPA obligations.

DOE attributes the proposed change to an acknowledgement that, given the burdensome NEPA review process, applicants that have incurred the time and cost to complete environmental reviews are more likely to have commercially sound projects. Accordingly, DOE should devote its limited time and resources for public interest examinations to projects that are otherwise ready to proceed. The proposed process would also improve the quality of information for DOE's public interest test. Under the current system, DOE's public interest analysis can precede finalisation of the NEPA review by several years. By requiring a NEPA review to be conducted beforehand, the examination of impacts on natural gas prices and markets would be more accurate because much less time would elapse between DOE's approval and commencement of export operations.

Among the seven applicants with conditional approvals, only one has concluded its NEPA review and received final DOE approval. Another project conditionally approved by DOE earlier this year received FERC approval in the last several weeks, and is awaiting final DOE approval.

For those companies with pending DOE applications, the proposed change would essentially reorder the queue as it presently exists. Some companies high in the current DOE queue would find themselves farther back in the new queue. Others would be bumped ahead. Certainly, all companies would need to direct their focus toward completing the NEPA review

process. There would be new winners and losers depending on when an applicant finished the NEPA process.

More studies

• *Economic analyses* – In addition to the proposed change, DOE has also announced that it will be commissioning new economic analyses of the economic and market impacts of increased natural gas exports. These new studies will update the earlier two-part study completed by the US Energy Information Administration (EIA) and NERA Economic Consulting on the potential impact of increased natural gas exports on domestic consumption, production and prices, and the overall macroeconomic impacts of increased exports.

In its previous study, EIA contemplated hypothetical export volumes of 6 to 12 Bcf/d. The new study will contemplate export volumes of 12 to 20 Bcf/d.

Interestingly, in the May 29 announcement, DOE stated that it had granted final authorisation for non-FTA export of only 2.2 Bcf/d. This changes how DOE considers approved volumes as part of its cumulative market impacts analysis. In its most recent non-FTA LNG export conditional approval, DOE stated that the approved cumulative volumetric total was 9.27 Bcf/d. But 9.27 Bcf/d reflects only volumes that had been conditionally approved. It appears that DOE's analysis of volumetric totals in the future will be limited to final approvals, consistent with the proposal to prospectively stop issuing conditional approvals.

It may seem that by resetting the volumetric total from 9.27 to 2.2 Bcf/d, DOE is slowing the inevitable march to 12 Bcf/d – that is, the high export volume contemplated by EIA in its examination of hypothetical export scenarios and domestic consumption, production, and price – at which point, DOE would likely pause or suspend granting approvals pending completion of the 12-20 Bcf/d study. However, there may not be a significant reprieve. Several companies predict completion of the NEPA review in the next few months. We may be closer than we think to 12 Bcf/d.

• *Environmental reports* – DOE has also announced the release of two environmental reports to "better inform the Department and the public of the environmental impacts of increased LNG exports … beyond what is required for NEPA". Both of these documents, when finalised, will be included with comments in DOE's public interest analysis of future exports.

The first is a draft addendum to environmental review documents. This report is a discussion of potential environmental issues associated with unconventional gas production. DOE produced it in response to comments urging DOE to consider how higher levels of domestic production resulting from export authorisations will affect the environment.

The draft addendum is not new information, but a review of existing data and literature. DOE's purpose in releasing it is to better inform the public about fracking and the environment. Covering water resources, air quality, GHGs, seismicity and land use, it provides technical information along with examples of state and local regulations and best practices.

The second report is on GHGs and LNG exports. It examines the impact of US-exported LNG on European and Asian power plant GHG emissions, as compared with (i) the plants' use of regional coal or other LNG sources and (ii) the plants' use of natural gas sourced and delivered from Russia via pipeline.

This report concludes that European and Asian power plants' use of US-exported LNG would not result in higher life-cycle GHG emissions.

Uncertainties abound

The proposed procedural change would reshuffle the queue order, but DOE would still take a queue-based approach to evaluating applications. Indeed, DOE would examine applications in a single-file line, case-by-case, once the NEPA review process was completed.

Furthermore, although the recent developments show a clear interest to address environmental concerns associated with natural gas exports, industry consensus is that the public interest analysis will remain comprised of one primary consideration: the effect of export approvals on natural gas prices to the near-exclusion of other factors.

It therefore stands to reason that as gas prices rise with increasing exports, DOE will eventually determine that prices have become too high and additional approvals are not in the public interest. Those whose applications are in line to be reviewed after that point are likely to face an automatic denial or extended delay.

This is an unreasonable risk on project applicants. The fact that applicants would need to obtain final NEPA review before DOE's public interest analysis does not lessen the uncertainty. In fact, the proposed change could arguably put companies in a worse position. Under the new rules, applicants would be expected to invest heavily initially to complete NEPA review, and then wait possibly years until DOE examines their proposed export according to the public interest criteria. If an applicant forecasts that DOE will issue final volumetric approvals for 12 Bcf/d before that applicant's NEPA review concludes, the applicant has little reason to be confident about its outcome at DOE – when, or if, it gets there.

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The new economic studies and the release of the environmental reports compound these uncertainties. The environmental reports may be particularly worrisome. Although these reports consider impacts beyond the scope of what NEPA requires for environmental analysis, DOE will consider comments in response to the released reports as part of its public interest examination for final export approval. It is impossible to predict how such comments would influence DOE's decision-making process.

Finally, it is disconcerting that DOE would substantially alter the order applicants have relied on as they sit in the queue. Many of these applications have been pending for years. Some would be benefited by the changes; others would be harmed. None could feel confident that their spot in line was secure, however.

Lost opportunity

Although it is encouraging that DOE has recognised certain flaws in its current LNG export regulatory scheme, the proposed change does not adequately address the underlying problems. Investors, companies seeking export approval, critical overseas markets, and the American public all deserve an equitable and reasonable process for the approval of natural gas exports. Given the overwhelming importance of domestic gas prices to the public interest analysis, DOE's proposed export procedures are likely to result in the denial of some applications because of rising prices when the applications come up for review. Therefore, some applications will be mutually exclusive with others – and some of the applications will ultimately be disapproved. By simply changing the criteria by which the queue is established, DOE has lost a valuable opportunity to make fundamental changes to its process to ensure a rational and fair result.

There is a more sound approach, and it fits within the proposed procedural change to eliminate conditional approvals. DOE could evaluate pending applications according to the public interest factors by employing a comparative analysis.

DOE would determine the volumetric level of exports that would be in the public interest based on economic studies. Then DOE would conduct a comparative hearing where applicants can demonstrate how they best serve the public interest. Project merits could include those that would naturally emerge during the NEPA review process – such as environmental impacts and commercial viability – as well as those that might be dynamic – such as national security issues and particular destination markets.

DOE could consider geographic location, domestic supplies and price, and whether financing was secure for contract performance. DOE could also consider the project's ultimate destination for export and if it was a market where the US had a foreign policy or national security objective in diversifying the energy supply (Eastern Europe would be a good example of such a market).

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DOE would conclude the hearing process by issuing export approvals to those projects that best served the public interest, up to the volume contemplated by the economic studies. After additional studies were conducted, another comparative hearing would be conducted to determine which additional projects should be approved.

Fair solution in reach

By initiating its recent proposed rule-making, DOE signalled that it recognised there were problems with its current LNG export approval process. Unfortunately, these new rules do not resolve the critical deficiencies with any queue-based approach. The new rules will lead to another single-file queue, with DOE evaluating applications one by one according to the "public interest" (read: price impacts). The main difference will be that companies will be expected to have invested heavily in their NEPA review before they get to this point.

The same question will loom over the new process: When will we reach the point when DOE determines that exports must be limited to preserve domestic price stability? And now a new question: How much time and investment will some companies sink in their NEPA review, only to be told by DOE when they get to the front of the queue that they must wait for lower natural gas prices before further export approvals can proceed?

A comparative analysis of similarly situated applications would fairly and logically allow applicants to hedge against these concerns, and allow the US to authorise only those projects that were most consistent with the public interest, rather than those simply in the front of an arbitrary queue. There is legal precedent supporting the point that DOE should grant comparative hearings for mutually exclusive applications as a matter of law and due process. During the notice-and-comment period, DOE has an ideal opportunity to address these issues with a straightforward, rational, and fair solution.

Footnote

1 - In a previous article, the authors discuss the speculation that once DOE has conditionally authorised 12 Bcf/d volumetric total, DOE will pause or suspend the review process to assess the market impacts of the approvals thus far. See Philip Angeli & Lee Alexander, Cracks in DOE's LNG Approval Process, Project Finance Int'l Global Energy Report (2014).