Lack of Open Access for LNG Export Terminals

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An important factor in assessing the likely LNG options is an understanding of the limited role that federal and state regulation will play in the operation of an LNG terminal, including, in particular, the establishment of rates and terms of service. As discussed below, open access regulations generally do not apply to LNG import and export facilities. This could preclude subsequent explorers that discover additional North Slope reserves from gaining access to any LNG terminal.

The FERC initially regulated LNG import terminals in the same manner as pipelines, including by imposing cost-of-service rates and open access terms of service. *See Distrigas Corp*. v. *FPC*, 495 F.2d. 1057 (D.C. Cir. 1974), *cert. de*nied 419 U.S. 834 (1974); *Cove Point LNG Limited Partnership*, 97 FERC ¶ 61,043 (2001) (authorizing reactivation of LNG terminal and approving open access tariff). However, the agency changed course in 2002. In the *Hackberry LNG Terminal, L.L.C*. proceeding, 101 FERC ¶ 61,294 (2002), the Commission announced that, henceforth, it would confine its review of LNG terminal proposals to their safety, security and environmental aspects.[1] The *Hackberry* decision followed widespread complaints that traditional, so-called "heavy-handed" regulation of LNG terminals was discouraging the development of needed new LNG projects and supplies.

At a public conference held in October 2002 and in subsequently-filed comments, in a proceeding conducted during the pendency of the *Hackberry* proceeding,

[1] Pursuant to Section 301(b) of the Department of Energy Reorganization Act (Pub. L. 95-91, 42 U.S.C. § 7101 et seq.), authority over natural gas imports and exports under Section 3 of the Natural Gas Act was transferred the Department of Energy. However, the DOE has delegated to the FERC review authority over all issues related to the siting and operation of importation or exportation facilities. DOE Delegation Order No. 00-004.00A, (effective May 16, 2006). Before *Hackberry*, while the FERC typically took a hands-off approach to export terminals, as noted in the text, it regulated LNG import terminals in essentially the same manner as it did domestic pipelines.

representatives from virtually every facet of the industry urged the Commission to loosen regulatory restraints on LNG plants and operations, particularly those that required the application of open-access rules. Shell LNG NA, Inc., for example, then the largest shipper of equity-owned LNG in the world and owner of one-quarter of the world's LNG carrier fleet, argued that open-access requirements would seriously impede the development of LNG terminals in the U.S. Noting that assured access to terminal capacity was crucial for the large-scale investments necessary in connection with LNG projects, it asserted that open seasons and open access requirements undercut this required security of access. Shell accordingly urged that the Commission extend to LNG developers the option to construct "proprietary" LNG terminals whenever project participants concluded it was appropriate to do so. According to Shell:

> Developers of integrated international LNG supply projects need assured market access. Governments in foreign countries in which the gas that supports LNG projects is produced want market assurance before approving LNG projects. The Commission's open season and open access requirements are obstacles that make long-term planning of, and investment in, large-scale LNG projects extremely difficult, if not impossible. A policy that will permit access to new LNG import terminals on a reserved or proprietary basis will remove a significant barrier to development of LNG import terminal capacity in the U.S.

"Post-Conference Comments of Shell NA LNG, Inc.," *Natural Gas Markets Conference*, Docket No. PL02-9-000 (filed Nov. 15, 2002), at pp. 1-2.

Similarly, BP Energy Company asserted:

> Investors in an integrated, full-supply-chain LNG project need assured market access. That need can be met only with assured access to terminal capacity. Allowing proprietary terminals provides this assurance. In order to place large volumes of gas (which can be upwards of a billion cubic feet per day), LNG suppliers need access that cannot be guaranteed under open season bidding.

"Comments of Mr. Phil Bainbridge, Vice President, Global LNG - BP" (filed Oct. 25, 2002) at p.2; *see also* "Initial Comments of ExxonMobil Gas Marketing Company, a

Division of ExxonMobil Corporation" (filed Nov. 15, 2002) at p. 3 ("All elements of LNG projects must be carefully integrated to assure maximum efficiency, achieve production/liquefaction economies of scale and eliminate unnecessary cost. For example, the capacity of the terminal and shipping must closely match the capacity of the liquefaction facilities to avoid unnecessary costs associated with excess capacity at either end.").

The same points were made by LNG developers unaffiliated with major LNG producers/shippers. One of the commenters, Sempra Energy International, which has since purchased the Hackberry LNG project (of which construction is nearly complete) and is also developer of an LNG terminal in Baja California, argued that "[m]andated open access would impede the development of the LNG industry" and that "the Commission should decline to require LNG receipt terminals to charge cost-based rates for their services." According to Sempra, LNG should be viewed as simply another gas supply option and that gas-on-gas competition in the delivery market could be counted on to assure that price and discrimination problems were kept in check. "Comments of Sempra Energy International" at p. 6; *see also* "Comments of Dominion Resources, Inc. Following the Public Conference" at p. 9-10 (market-based rates should be authorized where LNG terminal lacks market power).

In its *Hackberry* decision, issued just two months after the public conference, the Commission expressly relied on the comments submitted at the public conference to announce its decision to abandon traditional, cost-of-service regulation of LNG import plants. In addition to noting the argument that investors in a "full-supply-chain" LNG project require assured access to terminal capacity, the Commission found that LNG

would simply be another supply option for the U.S. market and concluded that, like competing gas supplies, LNG should not be subject to price regulation nor to the requirement to offer open access service. 101 FERC ¶ 61,294 at P 22-27. The Commission accordingly granted Hackberry the authority to implement rates, terms and conditions or services as mutually-agreed upon by the parties to the import transaction and specifically held that Hackberry was not required to offer open access service or to maintain a tariff and rate schedule for its terminalling service. Id. at P 22.

Although *Hackberry* and the comments at the public conference dealt principally with import terminals, the need to assure terminal access seems clearly to apply equally to export facilities, as certain of the comments stress. *See, e.g*., Comments of ExxonMobil Gas Marketing Company, *supra* at p. 3. In fact, the Commission historically has exercised a significantly lesser degree of oversight with respect to export plants than in connection with import facilities. *See, e.g*., *Yukon Pacific Corporation*, 39 FERC ¶ 61,216 at 61,759 (1987). Moreover, the DOE, which retains authority to determine whether an import or export of the LNG commodity (as opposed to the LNG liquefaction plant, over which FERC has jurisdiction) is in the public interest, has found that the same energy policy principles that apply to natural gas imports are also applicable to natural gas exports. *See New Policy Guidelines and Delegation Orders From Secretary of Energy to Economic Regulatory Administration and Federal Energy Regulatory Commission Relating to the Regulation of Imported Natural Gas*, 49 Fed. Reg. 6684 (Dep't of Energy Feb. 22, 1984)

The facts associated with the Kenai LNG terminal in Alaska, operated by Conoco/Phillips and Marathon, are instructive in this regard. First approved in 1967,

Phillips Petroleum Co. and Marathon Oil Co., 37 FPC 777, the Kenai Plant has operated for 20 years as a proprietary facility, with apparently little or no third party access.[2] In connection with the recently-filed request to renew its export authority, the State of Alaska successfully negotiated with the plant owners an agreement to accept some third-party gas, on terms to be negotiated between the plant owners and the gas suppliers. *See* "Motion For Leave to File Supplemental Comments and Supplemental Comments of the State of Alaska" *Conoco Phillips Alaska Natural Gas Corp. and Marathon Oil Co*, before the Office of Fossil Energy, Department of Energy FE Docket No.07-02 LNG (filed January 2, 2008). It is significant, however, that the plant owners' gas supplies, on which they had been relying to meet their export needs, had significantly declined over the years, so that in the absence of third-party gas spare capacity apparently would have existed in the plant. Moreover, the plant's long-term contract with its Japanese customers is due to expire in 2009. Thus, the settlement did not involve the possibility that accepting third-party gas would interfere with an LNG sales contract for which major new investments would have to be made.

In 2005, the *Hackberry* policy was effectively codified into federal law. Although there had been no opposition to the new policy by the participants in *Hackberry*, it was nevertheless subject to change by a subsequent Commission. Further, the decision raised the possibility, particularly when applied to imports of gas that did not enter the interstate grid, that states would be able to rely on the FERC's diminished role to block import terminals of which they did approve. Issues were raised in other cases, moreover,

[2] *See* D.L. Andress, The Phillips Optimized Cascade LNG Process - A Quarter Century of Improvements, *located at*: http://lnglicensing.conocophillips.com/NR/rdonlyres/FBB538DA-256D-4B96-A844-5D147F4441CF/0/quartercentury.pdf, at 2 (1996).

regarding whether the Commission's authority over an import terminal was as broad as the agency assumed.

These issues were resolved, at least for the time being, in the Energy Policy Act of 2005, Pub. L. 109-58, 199 Stat. 594 (2005) ("EP Act"). In Section 311 of the EP Act, the Congress amended Section 3 of the Natural Gas Act to confer on the FERC "exclusive authority" over applications for "the siting, construction, expansion or operation of an LNG terminal." (The provision appears as new Section 3(e)(1) of the NGA.) The term "LNG terminal" was specifically defined to include all natural gas facilities "used to receive, unload, load, store, transport, gasify, liquefy, or process natural gas that is imported to the United States from a foreign country, *[or] exported to a foreign country from the United States*". Thus, the statute clearly embraces export terminals and removes any ambiguity regarding the scope of the Commission's authority over specific terminal facilities. 15 U.S.C. § 717a(11). Although the states were assured of the opportunity to provide input into the FERC's decision, they were effectively denied any veto over the approval of an LNG terminal site.

Importantly, the new statute also ensured that there could be no change in the FERC's decision not to regulate the rates or terms and conditions of service on which LNG projects would be undertaken, at least until January 1, 2015. For this purpose, Section 311 of the EP Act amended Section 3 of the NGA (now Section 3(e)(3)(B)) to provide:

> (B) Before January 1, 2015, the Commission shall not—
> (i) deny an application solely on the basis that the applicant proposes to use the LNG terminal exclusively or partially for gas that the applicant or an affiliate of the applicant will supply to the facility; or
> (ii) condition an order on—

> (I) a requirement that the LNG terminal offer service to customers other than the applicant, or any affiliate of the applicant, securing the order;
> (II) any regulation of the rates, charges, terms, or conditions of service of the LNG terminal; or
> (III) a requirement to file with the Commission schedules or contracts related to the rates, charges, terms, or conditions of service of the LNG terminal.

Finally, if a project sponsor does elect to offer open access service, the EP Act further provides that the Commission may not issue any order that

> result[s] in subsidization of expansion capacity by existing customers, degradation of service to existing customers, or undue discrimination against existing customers as to their terms or conditions of service at the facility, as all of those terms are defined by the Commission.

15 U.S.C. §3(e)(4). Although the latter provision presumably is intended to ensure that the economic risk of any expansions of LNG projects remain with the sponsor of the expansion, its interpretation and application remain unclear, but it is possible that it could have the effect of locking in any competitive advantage held by the original shippers.[3]

As a result of the foregoing provisions, the sponsors of LNG projects will have the ability to negotiate with their counterparties, without direct federal (or state) regulatory oversight, essentially any economic and service arrangements at LNG terminals that they find acceptable.[4] Applied to likely LNG alternatives, this regulatory regime would mean the project sponsors would not be required to provide open access service to other producers and explorers that may subsequently seek to gain access to the LNG facility. It would mean FERC regulation would not bar the project sponsors from preventing any parties other than the original participants from gaining access to the terminal. It would give the project sponsors the ability to fashion, without effective

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[3] It should be noted, however, that the provision appears to be a limitation on Commission authority and not on the ability of the project sponsor to negotiate a rate that would have that effect.

[4] Any such agreements would presumably still have to comply with other statutory requirements, such as federal and state antitrust laws.

oversight by the FERC, rates, terms and conditions that could prejudice the positions of other stakeholders, leaving injured parties only indirect remedies. And, due to absence of FERC rate regulation, it would enhance the abilities of these parties to allocate costs among parties and project segments to the detriment of royalty owners and taxing authorities.

The EP Act does not affect state authority over in-state facilities not associated with the LNG terminal. Under prior law, where an export project relied on state-regulated facilities to the move the gas to the border, the FERC and DOE had jurisdiction over the export itself and the facilities located at the border, while the state was free to regulate the upstream, instate pipeline facilities pursuant to state law. This ability to regulate in-state movements of gas, even where the gas is destined for export, is not disturbed by the new statute. This could be particularly important for potential LNG alternatives because of the likelihood that the pipeline from the North Slope would also serve in-state customers. But it also raises the possibility that the State would be required to play an important role in approving some aspects of the specific LNG alternative. In particular, implementation of the project may involve State approval of the pipeline route, rates to in-state customers, and other matters affecting State interests. It could also provide the State with the means to protect State interests associated with the gas to be exported in the event the LNG alternative were pursued. Such an approach may be less effective than State authority over the LNG terminal or than a federal proceeding affording a direct means of vindicating State interests, but, since federal law now confers substantial rights on private interests when pursuing LNG export projects, the residual

authority possessed by the State over in-state facilities could still be a significant factor in protecting State interests.