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Practice Group:

Liquefied Natural Gas

DOE Issues Second LNG Export License for Non-FTA Countries

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On May 17, 2013, the U.S. Department of Energy ("DOE") issued an order authorizing the Freeport LNG Terminal ("Freeport") in Quintana Island, Texas to export liquefied natural gas ("LNG") to nations with which the United States does not have a Free Trade Agreement ("non-FTA nations"), making it the second terminal in the lower-48 to secure such authorization. DOE Order No. 3282 ("Freeport Order") conditionally grants Freeport's application for long-term multi-contract authorization to export up to 1.4 billion cubic feet ("Bcf") per day of LNG by vessel to non-FTA nations for Phase I of its export project. This order was highly anticipated in particular since DOE issued its only other Lower-48 non-FTA export authorization, to Cheniere for the Sabine Pass project, nearly 24 months ago in May 2011.

Overall, DOE's Freeport Order is a net positive for the 19 pending applications at DOE seeking authorization to export LNG to non-FTA nations and likely for future applicants. The order demonstrates a firm understanding of the global gas market and, coupled with recent statements from DOE officials, appears to indicate a more accelerated pace for future orders. Importantly, DOE notes in the Freeport Order that significant LNG exports and the rapid reversal of the natural gas market are new phenomena that are very likely to change over time. Consequently, DOE intends to continue to monitor market developments that could tend to undermine the public interest in grants of successive applications for exports of domestically produced LNG to non-FTA nations.

Background

DOE derives its authority to grant or deny applications for authorization to export LNG from the Natural Gas Act ("NGA"). Pursuant to Section 3 of the NGA, DOE must grant applications for authorization to export natural gas to countries with which the United States has a Free Trade Agreement without modification or delay. By contrast, the NGA sets up a rebuttable presumption that natural gas exports to non-FTA nations are in the public interest.

Following its order authorizing LNG exports to non-FTA nations from the Sabine Pass terminal, DOE commissioned two studies on the impacts of LNG exports on the U.S. economy: a microeconomic study performed by the Energy Information Administration ("EIA") and a macroeconomic study performed by NERA Economic Consulting (collectively, the "LNG Export Study"). The stated intention was to determine, broadly speaking, the likely impacts of larger scale exports of LNG on the US economy. In December 2012, DOE invited public comment on the LNG Export Study, with an initial comment period ending January 24, 2013, and a reply comment period ending February 25, 2013.

The Freeport Order

In addition to providing an analysis of Freeport's application, the Freeport Order analyzes the results of the LNG Export Study, as well as the initial and reply comments on the LNG Export Study. The following is an analysis of several key points in the Freeport Order.

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The LNG Export Study and Continued Exports

The Freeport Order generally supports the conclusions of the LNG Export Study and continued exports. DOE explains that the conclusion of the LNG Export Study is that the United States will experience net economic benefits from the issuance of authorizations to export domestically produced LNG and that the LNG Export Study is fundamentally sound.

The LNG Export Study was challenged for its use of the EIA's Annual Energy Outlook Report ("AEO") 2011 data, which relied on 2010 information, rather than using AEO 2012 or the AEO 2013 Early Release Overview. In the Freeport Order, DOE explains that the use of AEO 2011 was necessary because it was the most recent, final projection available when DOE commissioned the EIA and NERA studies. Importantly for pending applications, however, DOE finds that there would have been no material change using post-AEO 2011 projections because, while AEO 2012 and AEO 2013 Early Release Overview forecast greater domestic natural gas consumption than AEO 2011, both also project much greater domestic natural gas production. We expect that DOE will augment its analysis as new projections are released, which is consistent with DOE's statement in its press release, that "[a]s further information becomes available at the end of 2013, including the EIA's Annual Energy Outlook Report, the Department will assess the impact of any market developments on subsequent public interest determinations."

The Freeport Order also includes language in multiple areas that supports continued exports and DOE repeatedly finds that comments opposing Freeport's application fail to establish that Freeport's proposed exports will be inconsistent with the public interest—the test required to overcome the rebuttable presumption. It is notable the DOE not only finds that the opposition did not adequately demonstrate that exports are inconsistent with the public interest, but essentially took the record so far that the agency affirmatively demonstrates that LNG exports are consistent with the public interest. This could seemingly positive approach furthers the prospect that DOE will move forward with other authorizations over the ensuing months of 2013.

The Public Interest Standard under the Natural Gas Act

As noted above, applications for authorization to export natural gas to non-FTA nations are measured against a public interest standard. The NGA does not provide specific criteria that must go into this analysis and DOE therefore has developed a flexible approach to applying this standard through its policies and case law. In its 1984 Policy Guidelines, DOE laid out three factors that it takes into consideration when assessing an application to import LNG into the United States. Since that time, DOE has applied the 1984 Policy Guidelines to export applications as well, including Freeport's application. Notably, DOE notes that it continues to subscribe to the principle set forth in its 1984 Policy Guidelines that the market is the most efficient means of allocating natural gas supplies.

The three factors in the 1984 Policy Guidelines are: the competitiveness of the import, the need for the gas, and the security of supply. In addition, in the Freeport Order, DOE took into account the results of the LNG Export Study, the initial and reply comments on the study, and the following factors:

- <u>Benefits of international trade.</u> This factor encompasses the United States' commitment to free trade, including diversifying international supply options and improving energy security for our allies and trading partners.
- <u>Economic impacts of higher natural gas prices and potential increases in gas price volatility.</u> These are two factors that DOE notes it will view very seriously. However, it also explains that it took into account factors that could mitigate such economic and price impacts, including the current

oversupply of natural gas and data indicating that the natural gas industry would increase natural gas supply in response to increasing exports.

- Cumulative impacts. DOE states, not surprisingly, that it will assess the cumulative impacts of each succeeding request for export authorization on the public interest with "due regard" to the effect on domestic natural gas supply and demand fundamentals.
- Viability of proposal. DOE notes that it will attach conditions to authorizations to ensure that the authorizations are not issued except where the applicant can show that there are or will be facilities capable of handling the proposed export volumes and existing and forecast supplies that support that action. This reference highlights two key points: namely, that DOE may prioritize those projects that are (1) brownfield (existing import) terminals, and (2) proceeding through the Federal Energy Regulatory Commission ("FERC") process for authorization to site, construct, and operate the export terminal.

Revocation Authority

In its order authorizing LNG exports to non-FTA nations from the Sabine Pass terminal, DOE cited authority under the NGA to revoke an export license if there are unforeseen developments of such significant consequence as to put the public interest at risk. In the Freeport order DOE reiterates that text from the Sabine Pass order, but does not provide any additional analysis of its purported authority, despite the ambiguity in the NGA with regard to DOE's revocation authority. DOE has repeatedly stated that it will not use this purported authority as a price control mechanism and that it respects the sanctity of contract. While this should provide some comfort to export project participants, there is no guarantee that future administrations will abide by this principle.

Order of Precedence

We believe that DOE will continue to process at least the next few pending applications in the order of precedence the agency announced in December 2012, and refreshed in January 2013. As DOE noted in its press release, it will continue to process the applications on a case-by-case basis and in the order of precedence established. In recent comments, DOE Acting Assistant Secretary Chris Smith hinted that DOE will retain the currently established order of precedence in the short term, but that the agency may consider changes to its approach in the future. The next several projects in the queue in the order of DOE's stated consideration are Lake Charles, Dominion Cove Point, Freeport Phase II, and Cameron LNG.

Current Market Information: Supply, Demand and Prices

In the Freeport Order, DOE finds that there are adequate natural gas resources to meet demand associated with the Freeport applications based on EIA's AEO natural gas estimates, proved reserves of natural gas, and technically recoverable resources. However, DOE emphasized that these supply estimates change over time and the agency will continue to monitor them to inform future decisions. Given the likely increases in technically recoverable reserves for the next few years at a minimum, this factor likely will continue to be a check in the positive column for LNG exports.

DOE disagrees, on balance, with arguments from a few vocal energy-intensive manufacturers that LNG exports will substantially increase the volatility of domestic natural gas. It explains that when domestic wholesale gas prices rise above the LNG netback price, LNG export demand is likely to diminish, if not disappear altogether. Also, in light of DOE's findings that natural gas reserves are adequate to support Freeport's proposed export, DOE sees no reason why LNG exports would interfere with the market's supply response to increased prices.

Environmental Review

Under the National Environmental Policy Act, DOE is required to conduct a review of the potential environmental impacts associated with its decision to issue an LNG export license. However, FERC is the lead agency for this environmental review and DOE generally adopts and conditions its orders on FERC review. DOE makes a point to note its position as cooperating agency in this environmental review. It explains that parties who wish to raise questions regarding the environmental review must do so in the FERC proceedings, although it also specifically notes that it independently will review FERC's environmental analysis and if DOE disagrees with FERC's environmental review, DOE will adjust its order on the commodity export accordingly. Notably, DOE made little or no mention of environmental groups' attempts to link upstream unconventional production and hydraulic fracturing to LNG exports.

The Path Forward

DOE repeatedly has recognized that its orders on the applications for authorization to export LNG to non-FTA nations will be highly scrutinized and are susceptible to legal challenge. Its Freeport Order reflects this belief, with a methodical and careful approach that can be viewed as preparation for defense of an appeal. Under DOE's regulations, requests for rehearing on the Freeport Order are due Monday, June 17, 2013. Once DOE issues a final order on rehearing, parties will have sixty days to file an appeal in federal court.

In terms of how DOE moves forward with the rest of the pending non-FTA applications, DOE has been reluctant to provide any specific timeline, and this week new Energy Secretary Ernie Moniz noted that he needed to review the pending applications prior to issuance. Nonetheless, we think that based on the rigorous legal and regulatory assessment conducted by DOE in the Freeport Order, DOE can move forward on a more expedited basis—at least for the next three or four pending applications.

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