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Energy & Natural Resources

June 2012

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Does The Federal Energy Regulatory Commission Have A Role In The Shale Gas Revolution?

By Mosby Perrow



For several years, natural gas extracted from shale rock in several formations across the United States has driven energy policy and investments. While individual states currently have the lead in regulating the horizontal drilling and injections used to recover the natural gas (a technique known as “fracking”), the Federal Energy Regulatory Commission (“FERC” or “Commission”) jurisdiction over interstate natural gas pipelines and other infrastructure that takes gas from field to market gives the Commission substantial power over such investments.¹ Already, fights over potential environmental harm, rate hikes, and plans for exporting natural gas—an idea inconceivable by many just a decade ago—are playing out before the FERC. The results will shape the country’s approach to this newly abundant resource for decades.

Addressing Rates Established in the Pre-Shale Gas World

FERC regulates rates that interstate natural gas pipelines may charge pursuant to NGA Sections 4 and 5.² Rates must be just and reasonable for the pipeline’s customers (the “shipper”), but also must provide the pipeline with sufficient income to cover its costs plus a reasonable return.³ With abundant new gas being found in locations that years ago were not anticipated, rates that FERC approved before the shale gas boom may no longer be viable for pipelines designed to transport gas to population centres from the Gulf of Mexico or the Rocky Mountains. Several pipelines already have tried to restructure rates at FERC and similar battles will continue to play out in the near future.

For example, Columbia Gulf Transmission, a long-haul pipeline originally designed to take natural gas from reserves in the Gulf of Mexico to population centres in the northeast, had separate rates for its “Onshore Zone,” which extended along the Gulf Coast, and its “Mainline Zone” running north from the Onshore Zone. With gas from the Gulf

in decline or threatened by Hurricanes, and shale gas being drilled in East Texas and further north in the Utica and Marcellus Shale regions near the population centres where the gas is consumed, Columbia Gulf Transmission’s Onshore Zone has suffered from unreserved capacity while the Mainline Zone, useful for taking shale gas in East Texas north, was at near full capacity. Accordingly, after nearly 13 years of never seeking FERC authorisation to increase its rates, Columbia Gulf Transmission Company filed a general rate case seeking, among other things, to convert the Onshore and Mainline Zones into one zone with a single, postage-stamp rate.⁴

In support of its case, the pipeline argued that the change to a postage-stamp rate would allow it “to adapt to a rapidly changing natural gas market that has undergone a revolution in shale gas production.”⁵ But many shippers balked. They argued that the change would mean that Mainline Zone shippers would subsidize Columbia Gulf for capacity that the pipeline could not sell. They stated that this risk of unsubscribed capacity should be squarely on the pipeline’s shareholders and shippers in the Onshore Zone, not Mainline Zone shippers. Parties ultimately reached a settlement that allowed Columbia Gulf to establish a postage-stamp rate, but also exacted concessions from the pipeline such as capped maximum rates for certain shippers and separate transportation fuel retainage percentages based on the Mainline and Onshore zones. These types of rate cases, driven by the new shale gas reality, likely will continue. Several pipelines, such as Columbia Gulf and Rockies Express Pipeline (“REX”), were built to serve consuming regions from remote Gulf and Rockies reserves, but these regions now are capable of being served more cheaply by nearby shale gas reserves. Indeed, the President of the Natural Gas Pipelines Group for Kinder Morgan, which currently owns REX, indicated during a 2012 analyst conference that REX was experiencing up to 50% reductions in throughput this year with some gas staying in the Rockies.⁶

Such unsubscribed capacity puts pressure on the pipeline to request rate increases from FERC applicable to the remaining customers in order to recover costs. As current contracts expire, customers often have the option to go to other pipelines, creating the potential for a “death spiral” of ever higher prices leading to ever fewer customers. Pipelines must develop creative ways to sell capacity or repurpose themselves, and FERC approvals will be a crucial component to their success.



Certificating New Pipelines to Bring Shale Gas to Market

In addition to rates, FERC certifies interstate natural gas pipelines. Any person seeking to construct and operate an interstate natural gas pipeline in the U.S. must file an application with FERC and get approval. Shale gas currently dictates where much of the FERC certificated pipelines are being constructed. In 2011, for example, FERC certificated 324.8 miles of new natural gas pipeline projects, 234.9 miles of which were located in and around the Marcellus Shale region.⁷ On a capacity basis, 3,095.9 MMcf/d of the total 4,157.3 MMcf/d of new capacity approved by FERC was in that region of the country.

Some environmental groups opposed to current fracking methods have challenged FERC approval of pipeline projects that will be used to transport gas from shale regions to market as a way of slowing down shale gas development. This means that FERC, with no direct jurisdiction over the exploration or production of shale gas, has been asked to consider its environmental consequences.

In *Central New York Oil and Gas*, the Commission agreed with FERC Staff’s Environmental Assessment concluding that the widespread nature and uncertain timing of gas well drilling in the Marcellus Shale region made its environmental effects too difficult to identify or quantify to be appropriately considered as part of FERC’s review in certifying an interstate pipeline project.⁸ FERC’s order drew fire from groups such as Earthjustice as well as the United States Environmental Protection Agency. These parties argued that the pipeline would induce or accommodate Marcellus Shale natural gas development, including access roads, gathering lines, and other infrastructure necessary for development. In rejecting this argument, FERC held that protestors had failed to demonstrate the requisite causal connection between the proposed pipeline and Marcellus Shale development. Noting that as of October 10, 2010, 4,510 active permits had been issued for Marcellus Shale development in Pennsylvania, FERC found that development activities were ongoing and would continue regardless of whether the proposed pipeline was constructed.⁹ FERC also noted that, by linking two other pipelines, the challenged pipeline would do more than simply bring shale gas to market. In a summary opinion, the Second Circuit U.S. Court of Appeals affirmed FERC.¹⁰ In future FERC certificate proceedings, parties will have a difficult time challenging a pipeline based on the environmental consequences of fracking activities, but other concerns will continue to arise as more and more infrastructure is built to support the growing shale gas industry.

Certificating Facilities to Export Natural Gas

In addition to certifying interstate pipelines, FERC reviews applications for facilities used to import and/or export liquefied natural gas (“LNG”). By 2005, with natural gas prices at record highs, FERC had issued certificates to eight facilities to import liquefied natural gas to the U.S. to supplement depleted and disrupted gas supplies.

Once again, shale gas has changed the game, playing a key role in plummeting prices in the United States. Developers now seek authorisation from the FERC to convert import facilities into natural gas liquefaction and export facilities, and FERC is responding to growing concern by some who question the wisdom of exporting LNG.

FERC's role is to determine whether it is "not inconsistent with the public interest" to permit the construction of a facility that will be used to export LNG.¹¹ FERC focuses on three considerations: (1) whether it is good public policy to construct a facility that will allow U.S.-produced natural gas to leave the U.S.; (2) whether the environmental impact that the facility will have on the place where it will be built can be sufficiently mitigated to make the construction appropriate; and (3) whether the facilities will be constructed and operated in a safe manner once they are in service. To date, FERC has granted Cheniere Energy Inc. subsidiaries Sabine Pass Liquefaction LLC and Sabine Pass LNG LP approval to begin construction of the Sabine Pass Liquefaction Project for LNG exports at the Sabine Pass Terminal in Cameron Parish, La. Five additional applications for LNG export certification remain pending.¹²

Groups such as the Sierra Club are challenging FERC's approval of LNG export facilities. They have argued that exporting natural gas will increase its price and harm American consumers and businesses. Proponents counter that the export facilities will not drive changes in natural gas prices, will create new jobs, and will strengthen the U.S. balance of trade. Ultimately, it is uncertain what immediate impact, if any, approving U.S. LNG export facilities would have on natural gas prices given that, even if approved, most facilities are several years away from export capability. Moreover, other countries such as Canada and Russia also have large natural gas reserves that could provide stiff competition and potentially limit export opportunities. Further, it is possible that fracking technology could be "exported" faster to other countries with shale gas reserves than could LNG.¹³ Nevertheless, exporting LNG from the U.S. remains an enticing opportunity that already has garnered substantial interest and investment.

Preparing for the Growing Gas-Fired Electric Generation Fleet


A cold snap in the Southwest in 2011 led to major power outages. FERC estimated that 1.3 million electric customers were out of service at the peak of the three-day event, and a total of 4.4 million were affected overall.¹⁴ FERC initiated an investigation and determined that the blackouts occurred in part because of a growing dependence by utilities on gas-fired generation due to shale gas dramatically reducing the cost of gas. This growing reliance has gotten the attention of regulators, especially with growing pressure on an aging coal-fired generation fleet.

Recently, FERC sought comments on whether it should have a role in better coordination between natural gas and electricity markets, and what duties, if any, should be delegated to the North American Electric Reliability Corporation ("NERC"), the North American Energy Standards Board ("NAESB"), or other entities.¹⁵

Responses to FERC's inquiry have been robust, and the interconnection between the electric and natural gas industries will only grow more significant. Moody's recently predicted that by 2020, natural gas volumes will grow to approximately 32% of total U.S. generation, up from its 24% share in 2010.¹⁶ Indeed, FERC recently certificated a lateral pipeline to support a \$1.091 billion, 1,329-MW natural gas fired generation and transmission project that Virginia Electric Power will be constructing in Virginia.¹⁷ Whether FERC will carve out a larger role for itself remains to be seen.

FERC Commissioner Philip Moeller recently intimated that FERC's next step in exploring gas/power industry coordination issues will be to hold a series of regional technical conferences.

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- 1 - 15 U.S.C. § 717 (2006).
- 2 - 15 U.S.C. §§ 717c, 717d (2006).
- 3 - *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
- 4 - *Columbia Gulf Transmission Company, Filing to Revise Rates and Tariff*, FERC Docket No. RP11-1435-000 (Oct. 28, 2010).
- 5 - *Columbia Gulf Transmission Company, Initial Comments In Support Of Stipulation And Agreement at 1*, FERC Docket Nos. RP11-1435-000, RP11-24-000 (Sept. 29, 2011).
- 6 - Mark Passwaters, *Coal-to-gas switching could fuel Rockies Express backhaul*, Kinder executive says, SNL Financial (January 25, 2012).
- 7 - See <http://www.ferc.gov/industries/gas/indus-act/pipelines/approved-projects.asp>. *The Marcellus Shale region stretches from West Virginia through eastern Ohio and western Pennsylvania and into lower New York.*

- 8 - *Central New York Oil and Gas Co., LLC*, 137 FERC ¶ 61,121 (2011) ("Central New York Oil and Gas"), order on reh'g, 138 FERC ¶ 61,104 (2012).
- 9 - *Central New York Oil and Gas at PP 89-90.*
- 10 - *Coalition for Responsible Growth & Resource Conservation, v. FERC*, No. 12-566, slip op. at 4 (2d Cir. June 14, 2011) (finding FERC reasonable in concluding that "the impacts of [Marcellus Shale] development are not sufficiently causally related to the project to warrant a more in-depth analysis.")
- 11 - See 18 C.F.R. § 153.7(c)(1) (2012); 15 U.S.C. § 717b (2006).
- 12 - <http://www.ferc.gov/industries/gas/indus-act/lng/LNG-approved.pdf> & <http://www.ferc.gov/industries/gas/indus-act/lng/LNG-proposed-potential.pdf>
- 13 - *But See, Liam Denning, Shale is Hard to Crack Outside U.S.*, Wall Street Journal, at C10 (June 19, 2012) (noting that abundant open access pipeline infrastructure and individual mineral rights that have lead to shale boom in U.S. difficult to replicate elsewhere).
- 14 - *Staffs of the Federal Energy Regulatory Commission and the North American Electric Reliability Corporation, Report on Outages and Curtailments During the Southwest Cold Weather Event of February 1-5, 2011 at 1* (Aug. 2011), <http://www.ferc.gov/legal/staff-reports/08-16-11-report.pdf>.
- 15 - *Notice assigning docket no. and requesting comments re Coordination between Natural Gas and Electricity Markets*, Docket No. AD12-12-000 (Feb. 15, 2012).
- 16 - Dan Testa, *Moody's: In US energy mix, displacement of coal by gas is permanent*, SNL Financial (June 7, 2012).
- 17 - *Columbia Gas Transmission, LLC*, 138 FERC ¶ 61,205 (2012).