

# LNG Development in Canada: Evolution of the Gas Business



by Janice Buckingham and Gord Nettleton

The Canadian LNG export industry has undergone considerable evolution in 2012. Five projects have been proposed for BC's west coast. Each project is at a different stage and has taken a different route toward feasibility analysis. Market factors and recent revisions to Investment Canada guidelines applicable to state-owned enterprises will continue to influence the emergence of this industry in 2013.





### The Race is On But Has the Finish Line Moved?

The Apache-led Kitimat LNG project has access to significant upstream reserves, secured a pipeline route, local stakeholder support, and obtained environmental and NEB export approvals while working to finalize marketing arrangements. The Royal Dutch Shell-led LNG project (also at Kitimat), is believed to have secured marketing arrangements through joint venturing with CNPC, Kogas and Mitsubishi and has announced a pipeline route with TransCanada Pipelines, but has yet to obtain local stakeholder support, environmental or NEB export approvals. Progress, with a site at Lelu Island near Prince Rupert, its significant Montney reserves and its recently approved take over by Petronas (a global LNG player) has announced plans for an \$11 billion plant. BG Group has announced its pipeline route with Spectra to a proposed LNG terminal on Ridley Island near Prince Rupert, but has not made any further announcements. The fifth project, a cooperative between LNG Partners and the Haisla Nation for a floating LNG platform in Douglas Channel, has secured its NEB export licence and is working toward providing a market alternative to smaller producers who are not yet aligned with a major export facility. ExxonMobil, with its recently announced take-over of Celtic Exploration, has also announced that it is looking at options.

The boom in U.S. gas discoveries has increased competition for Canada's LNG industry and driven down prices to the point where some industry players expect a convergence in gas prices. Japan has expressed a desire to revisit the oil-indexed link for LNG prices. Moving to "hub pricing" will cut the cost of natural gas imports, but will also increase the pressure on project proponents who rely on the oil-indexed price to finance the massive cost of building such projects. As North American competition increases to meet Asian import demands, the timing required to render costs certain and to move these projects toward a positive final investment decision, coupled with the congestion of projects proximate to each other, may mitigate against development of all of these projects, and in favour of consolidation of some of them. Such consolidation may also be unavoidable if state-owned enterprises rethink potential investments as a result of the revisions to the federal government's framework for direct foreign investment. Please see "Asian Investment in Canada's Resource Sector in 2012".



**OSLER REPRESENTED THE FOLLOWING CLIENTS IN 2012:**

**Apache Canada Ltd. and KM LNG Operating General Partnership** in all commercial and regulatory matters relating to the Kitimat LNG Project and the Pacific Trail Pipelines Limited Partnership.



### The Road to an NEB Export Licence: Paving the Way to Support Exports to Asia

No LNG export can occur without obtaining an export authorization from the NEB. Given importers' preference for long-term offtake agreements that meet long term supply needs to anchor decisions to proceed, project proponents are not relying on liquid hubs to support their investments but are seeking export licences which may be granted for a maximum of 25 years and for any volume. The NEB must determine that the proposed export licence is in the public interest and that the proposed export is surplus to Canada's domestic energy requirements. Applying a "Market-Based Procedure", the NEB determines whether gas destined for export is surplus to reasonably foreseeable Canadian requirements. Several aspects of the NEB's historical treatment of export licences have been challenged by LNG export projects which typically involve new market expectations and demands, new and unconventional supply sources and new environmental considerations related to marine tankers. Balancing the sensitivity of LNG buyers to public disclosure of export sales contracts can be achieved if proponents successfully demonstrate that changing market conditions make such disclosure an unwarranted level of risk. The changes in natural gas supply sources in North America have required Canadian natural gas producers to find new markets in order to continue to develop their reserves, making LNG exports from Canada in the national public interest. Because some Canadian consumers are beginning to source their natural gas from the U.S., the fundamental premise that Canadian gas consumers will be supplied exclusively with Canadian-sourced natural gas is undermined. Due to the immaturity of the shale gas industry in Canada, exporters and the NEB had to rely on possible and contingent resource estimates to demonstrate adequacy of supply, a far cry from the NEB's historic focus on established reserves.

Oral public hearings were relied on by the NEB as a forum in which any party could raise concerns as to whether a proposed export would have adverse impacts upon either the price or the level of supply Canadians would pay or need to meet their energy requirements. New federal legislation (see below) has now alleviated the oral hearing requirement. This has caused the NEB to re-evaluate its Market-Based Procedures and consider whether other factors can be relied upon to ensure that long-term gas exports from Canada will not adversely affect Canada's domestic supply requirements. We believe this outcome is likely as it reflects today's market realities. The Canadian gas market is entirely integrated with the North American market. The development of U.S. shale gas reserves situated in proximity to Canadian gas consuming markets, coupled with the well-functioning nature of the North America-wide gas marketplace, provides an important new and competitive source of supply that can be used to meet Canadian supply requirements. In light of this, removal of the oral hearing requirement for export authorizations, coupled with the reconsideration of the NEB's Market-Based Procedures, is a positive step in reducing regulatory risks and the requirements necessary to obtain long-term authorizations.



### Impact of Recent Federal Legislative Changes on Canada's Emerging LNG Sector?

We think the fundamental changes resulting from the passage of Bill C-38 (the federal government's recent budget) will be largely positive for the development of Canada's LNG industry, for the following reasons:

- the environmental assessment process for most projects will become the responsibility of provinces, with the federal government limiting its review to discrete areas of federal jurisdiction;
- the federal environmental assessment process will be expedited by establishing fixed timelines<sup>1</sup>;
- the number and type of interveners in federal environmental assessments will be limited to parties that are directly affected by the application or persons that have relevant information or experience;
- the overlap between federal and provincial assessments will be reduced; and
- applications for NEB export licences will be granted without the need for a public hearing and the scope of the application will be limited to the issue of whether the proposed export will exceed Canadian domestic requirements, compressing the time expended in obtaining such applications.

There are also changes to the federal *Fisheries Act* and *National Energy Board Act* that may allow pipeline projects and LNG facilities to be constructed with fewer ancillary approvals required from the federal government. Conversely, Bill C-38 increases the maximum penalties under the *Fisheries Act* and creates new enforcement provisions in the *National Energy Board Act* and the *Canadian Environmental Assessment Act* that will increase the costs of non-compliance for any project subject to those federal laws.

### How Do the Risks in LNG Projects Differ from Risks of Conventional Oil and Gas Projects?

The short answer is "in many ways." Development of a new industry that links upstream exploration to downstream liquefaction and export is extremely complex and fraught with risks that are much different than those in conventional operations. Considerable expenditure of capital and dedication of resources over a 2-4 year period is required before the commercial feasibility of such projects is determined. The front end costs and time it takes to determine whether or not to proceed with such a project are exponentially higher than for conventional oil and gas projects partly because the legal, contractual, regulatory and commercial frameworks for such projects must be substantially settled prior to proceeding and are without Canadian precedent. A long term export license is required from the NEB, as are long term marketing contracts. Finding a constructible path for a pipeline route rather than tying into an existing system or market presents other new challenges. Land tenure rights are required for the foreshore to afford marine access, in addition to the site rights for the facility. Those First Nations whose territorial

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<sup>1</sup> 365 days for standard assessments, 18 months for NEB reviews and 24 months for assessments by a review panel.



rights are impacted by the project must be consulted and their interests accommodated. Increasingly, proponents are considering equity participation. Approval of the federal government may be required if foreign investment that exceeds regulatory thresholds is a component of the project. As the number of variables increase, so does the risk that the project might not proceed.

CONTRIBUTORS

From a political perspective, there is more support for an LNG industry in and on BC's shoreline than there is for a bitumen pipeline to its shoreline. From an environmental perspective, there are lower environmental risks associated with LNG projects. If a pipeline or tanker carrying LNG were to leak, run aground or collide with another vessel, the LNG cargo that escapes would disperse into the atmosphere while a heavy oil cargo that escapes would damage the aquatic marine environment and shoreline. From a legal perspective, the regulations associated with development of conventional oil and gas projects are well established. For an LNG project that is to be located on First Nations lands (and therefore governed by federal laws), there is no current federal regulatory regime or agency authorized to regulate the activity. The *First Nations Commercial and Industrial Development Act* (FNCIDA) enables the federal government, at the request of a First Nation, to make regulations to govern commercial and industrial undertakings on its reserve lands<sup>2</sup>. Creating such new regulations involves extensive and lengthy negotiations. Until such regulations are in place, an interim contractual solution where the BC Oil and Gas Commission is authorized by all affected parties to regulate activities as if they were located on provincial Crown lands can afford the degree of regulatory certainty project proponents need to proceed. Having to anticipate all possible applicable provincial acts and regulations under such an agreement at a time when the detailed engineering and design of what's being regulated may not be fully completed, adds to the complexity.

LNG export requires sufficiency of long term gas supply. In BC that sufficiency relies on shale gas production. The shale gas industry relies on fracking procedures. Although such procedures are well entrenched and western Canada's regulators have considerable experience with them, the public debate over fracking has escalated. Opposition continues to be expressed over perceived environmental and public health concerns, leading some jurisdictions to ban or curtail fracking operations. Political pressure to gather more information and conduct more studies of the consequences of fracking has caused the federal and certain provincial governments to announce reviews of existing regulations. Whether or not additional regulations will be adopted in western Canada in response to such pressure is not yet known. What is known is that governments are cognizant of the need to balance the economic benefits of shale gas development and the associated LNG export industry against the need to safeguard against groundwater aquifer contamination and other perceived risks. The outcome of that political balancing act, coupled with the convergence of market pressures, may place Canada's LNG export industry at a crossroads. When the music stops, it will be interesting to see how many of the five projects still have a chair.

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<sup>2</sup> S.C. 2005, c. 53, section 5.