Pipeline Outlook: How FERC Reliance on Precedent Agreements Could Change

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The domestic energy revolution, largely fueled by new sources of natural gas, would not be possible without the interstate pipeline grid that transports that gas to market, every mile of which was authorized under the Natural Gas Act. That law declares the "business of transporting ... gas for ultimate distribution to the public" to be "affected with a public interest." The standard for approval of any interstate natural gas pipeline project is that it is required by "public convenience and necessity," and that is determined by the Federal Energy Regulatory Commission (FERC). Approval by the FERC confers on the pipeline eminent domain authority. Therefore, how the FERC interprets public convenience and necessity, or public need, is significant, particularly for the many Texas-based energy companies that operate and/or transport natural gas on FERC-regulated pipelines. Recent signals suggest the FERC’s policy might be changing.

On Dec. 21, 2017, new FERC chairman Kevin McIntyre announced plans to re-evaluate the agency's policy for determining whether a project meets the public convenience and necessity standard. The current policy, established in 1999, emphasizes market need, balanced against potential adverse impacts, in evaluating proposed projects. The FERC's analysis relies heavily on precedent agreements as an indicator of market need. These are private contracts between the pipeline project and a prospective customer. They typically obligate the customer to sign subsequent binding transportation agreements, often for a term of several years, if the FERC approves the project. Pipelines, in turn, rely on commitments in executed precedent agreements to justify cost incurrence, obtain debt financing and seek out regulatory approvals to commence construction. It is common for these contracts to be governed by Texas law.

Environmental organizations opposed to fossil fuels have been critical of the FERC's reliance on precedent agreements with private companies to support a public convenience and necessity finding. Landowners subject to eminent domain are also opposed. These positions gained some traction among a minority subset of FERC commissioners in 2017. If more FERC commissioners are similarly swayed, the policy shift would reverberate throughout the industry.

**Private Contracts**

The FERC's reliance on private contracts to assess whether a pipeline project meets the public convenience and necessity standard dates to the early days of the Natural Gas Act. The FERC's current policy requires that it balance market demand against potential adverse impacts to the environment and private property rights. A project proponent must demonstrate public benefits that outweigh any negative effects on landowners and communities along the right-of-way. However, this balancing does not occur without an initial showing of market need. For example, the FERC rejected one application outright without evaluating potential adverse impacts because the applicant failed to provide sufficient evidence of market need in the form of executed precedent agreements. The agreements also allow the applicant to demonstrate to the FERC that existing customers will not subsidize project costs. The FERC views this "no subsidy" threshold as the market deciding which projects are financially viable.

Environmental groups and landowners advocate that the FERC take a more robust view of market need or reverse its approach and consider a project’s potential adverse impacts first. These arguments influenced FERC commissioner Cheryl LaFleur in twin dissents to two pipeline certificate orders issued last October. She suggested that FERC’s review based on precedent agreements was artificially narrow. She argued that the policy already permits a broader evaluation of economic need that includes regional considerations and environmental impacts even if the FERC did not interpret it as such. Former FERC
chairman Norman Bay raised similar sentiments in February 2017. He argued that the agency, in addition to the contracts, should consider whether the proposed project will deliver gas to new or existing natural gas-fired generators, create energy reliability or resiliency benefits, or promote competitive markets. Chairman Bay also suggested that FERC views differently an agreement executed with an affiliate, a policy shift.

Policy Revision Implications

The FERC established the current policy following a fairly rigorous industry, landowner and environmentalist stakeholder review. The FERC considered the tension between landowners and communities and the need to address the perception that pipelines served private, not public, interests. The FERC evaluated whether to: (1) authorize all applications that meet the regulatory requirements, then let the market pick winners and losers; (2) select a single project to serve a given market and exclude all other competitors; or (3) approve an environmentally acceptable right-of-way and let potential builders compete for a certificate. The FERC also entertained several proposals to look behind a precedent agreement, including whether to apply a different standard for affiliate transactions or to projects that did not require the use of eminent domain to acquire right-of-way.

The FERC will likely engage in a similarly robust process as it evaluates any update to the policy. Should the FERC de-emphasize precedent agreements in light of potential project impacts, pipeline customers could start asking more rigorous questions during the contract negotiation process. These could include asking for contractual assurances regarding other factors that may weigh against the “market need” of the project, such as environmental or landowner impacts. More diligence also may be required to assess a particular project’s chance of success.

Project sponsors could ask for longer termination dates (i.e., the date under the agreement by which the project must receive its FERC certificate and satisfy the other conditions precedent), to leave appropriate time for a heightened “balancing” review. These changes could risk creating tensions with shippers who may not want to be locked down for extended periods to permit the new FERC process to run its course.

Whatever happens at the FERC, it is incumbent upon counsel to understand their rights and remedies under precedent agreements.

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