



ICLG

The International Comparative Legal Guide to:

Oil & Gas Regulation 2015

10th Edition

A practical cross-border insight into oil and gas regulation work

Published by Global Legal Group, in association with Ashurst LLP, with contributions from:

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Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design

F&F Studio Design

GLG Cover Image Source

iStockphoto

Printed by

Ashford Colour Press Ltd
January 2014

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ISBN 978-1-910083-29-1

ISSN 2051-3348

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EDITORIAL

Welcome to the tenth edition of *The International Comparative Legal Guide to: Oil & Gas Regulation*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of the oil and gas sectors.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key issues affecting oil and gas regulation, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in oil and gas regulation in 40 jurisdictions.

All chapters are written by leading energy lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Geoffrey Picton-Turbervill of Ashurst LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The International Comparative Legal Guide series is also available online at www.iclg.co.uk.

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Domestic Challenges Facing Canada's Nascent LNG Industry

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Introduction

Canada is competing within the highly competitive global market for liquefied natural gas or “LNG” with a number of other countries, notably the United States and Australia, to build the infrastructure necessary to export LNG to key Asian markets. According to the United States Energy Information Administration, Canada is predicted to have recoverable shale gas reserves in the vicinity of 573 trillion cubic feet, which ranks Canada fifth in the world in terms of estimated shale gas reserves. The significant shale plays driving proposed LNG projects are the Montney, Horn River, Liard and Cordova Embayment.

Currently, there are approximately 18 floating or land-based LNG projects that have been proposed of various sizes and in various stages of development. The vast majority of the LNG projects currently under development are located near the Prince Rupert and Kitimat areas in the northwest corner of B.C., which benefit from both proximity to the major shale plays as well as relatively short transit times to Asia Pacific markets. 10 of these LNG projects have applied for and have received National Energy Board (“NEB”) export licenses to export gas to Asian markets, while another 13 projects, including some U.S. based projects, have applied for NEB export licenses which are currently under review. Project proponents include subsidiaries of state-owned companies, such as Petronas (Malaysia) and CNOOC (China); global industry players such as Royal Dutch Shell, BG Group and Chevron Corporation; and Canadian First Nations and Aboriginal groups (collectively, “First Nations”), such as the Haisla and the Huu-ay-aht First Nations.

From a global LNG market perspective, development of Canada's LNG industry faces a number of global challenges, including: a slow-down in key overseas markets, particularly in China and India; a wave of new global supply of natural gas driven, in large part, by the shale gas revolution in the United States; the recently announced \$400 billion deal between Russia and China for the supply of approximately 38 billion cubic metres of natural gas at prices that are a significant discount to current LNG prices; pricing challenges from Asian buyers no longer prepared to link the price of LNG to the price of crude oil; the development of volatile spot-market sales; and the trend away from traditional, long-term fixed contracting for supply.

These global challenges are such that no one anticipates that all of these projects will come to fruition. But the hope is that before this most recent “window of opportunity” closes, at least two major projects will go forward. There are four leading contenders in this category: the Pacific Northwest LNG Project, led by Progress Energy Ltd., a wholly-owned subsidiary of Petronas (62%) with

ownership by subsidiaries of Sinopec (15%), JAPEX (10%), Indian Oil Corporation (10%) and Petroleum Brunei (3%); the Canada LNG Project, led by Shell Canada Energy (50%), a wholly-owned subsidiary of Royal Dutch Shell, with ownership by subsidiaries of CNPC (15%), Mitsubishi Corporation (10%) and Korea Gas Corporation (10%); the Kitimat LNG Project, currently owned by Chevron Corporation after its partner, Apache Corporation, withdrew from the project; and the Prince Rupert LNG Export Project, led by BG Group. Each of these LNG projects has been years in the making with project proponents having already spent billions of dollars to capitalize on of the next “wave” of global LNG demand, which is anticipated to peak to almost 400 million tons *per annum* (“MTPA”) in 2020 and up to as much as 500 MTPA by 2025.

Industry proponents for a Canadian LNG industry have long touted the unique “advantages” that Canadian-sourced LNG has against its principal rivals, including close proximity to Asian LNG markets and a stable political, legal and fiscal business environment. These are all significant advantages. However, there are also a number of “domestic” challenges to the growth and development of Canada's nascent LNG industry that need to be recognized and accounted for, including: a current lack of pipeline infrastructure to support the transportation of natural gas to proposed LNG sites; uncertainty regarding provincial and federal fiscal regimes; federal and provincial regulatory regimes that may not be up to the challenge of supporting an efficient and timely process for taking advantage of the current window of opportunity; a requirement to undertake years of industry stakeholder consultation, including consultation with First Nations Groups; and increasing costs of capital and labour (and competition for skilled labour) within Canada, particularly from Alberta's oil sands industry.

We conclude that while these challenges are not insignificant, neither are they insurmountable. What is most important to support Canada's global competitiveness in today's rapidly changing global LNG markets is to ensure that these “domestic” challenges and associated risks are mitigated through appropriate regulatory and fiscal incentives from the provincial and federal governments.

Lack of Pipeline Infrastructure

Canada's natural gas pipeline infrastructure has traditionally run from west to east and north to south in order to feed natural gas-hungry markets in Eastern Canada and along the eastern U.S. coastline. In fact, all major points of export are to the south for transportation eastward, with only two points of export to the south for transportation to the U.S. west coast.

There is currently only one existing natural gas pipeline that transports natural gas to the B.C. west coast; that being Pacific

Northern Gas Ltd.'s Western B.C. System, with a capacity of 115 mcf/d, that runs from Summit Lake in B.C. westward through to Terrace B.C., and from Terrace B.C. to Kitimat, to the south and Prince Rupert, farther west. The natural gas pipeline is currently used to distribute natural gas to residential, commercial and industrial customers in B.C. Pacific North Gas ("PNG") is owned by Altagas, which is also an LNG proponent with its joint venture partner, Idemitsu, for the Triton LNG Project, a proposed LNG facility to be located near Kitimat or Prince Rupert. PNG is currently proposing an expansion that could see total capacity increase to approximately 750 mcf/d.

The lack of pipeline infrastructure from the major gas producing regions in B.C. and Alberta to the B.C. west coast, to one or more of the proposed LNG project sites, means that each LNG Project proponent must include construction (by the project, or jointly with other projects) of necessary pipeline infrastructure.

Each of the leading contenders for a major LNG Project has announced corresponding pipeline projects: the TransCanada Coastal Gas Link pipeline proposed in connection with the Shell led LNG Canada Project; the Prince Rupert Gas Transmission system for the Petronas-led Pacific Northwest Pipeline Project; a pipeline proposed by Spectra Energy and BG Group in connection with the Prince Rupert LNG Project; and the Pacific Trail Pipeline, associated with Chevron's Kitimat Project, which has been held up as a model of successful engagement between industry and First Nations (discussed further below).

The lack of pipeline infrastructure means that billions of dollars of capital and hundreds of skilled labourers will be needed just to transport natural gas, primarily from within B.C., to the B.C. west coast, thereby adding significantly to both the cost and labour requirements of developing Canada's LNG industry.

Fiscal Regime Uncertainty

Fiscal regimes are tools of policy that are structured by governments to achieve important strategic, economic and political objectives. Fiscal tools can be used to encourage growth of an industry as well as the maintenance and support of an industry. Fiscal uncertainty, however, can be fatal to the growth and development of an industry.

On February 18, 2014, the B.C. Government unveiled its proposed LNG export tax, comprised of: (a) a tier 1 tax rate of 1.5% of an operator's net proceeds after commercial production payable; and (b) a tier 2 tax of up to 7% of net income less up to 100% of the capital investment account (i.e. the cost to build the infrastructure) until the operator's capital investment account has been depleted, less amounts payable on account of the tier 1 tax. The tax will be applicable to sales proceeds received from liquefaction of natural gas at LNG facilities situated in B.C.

Industry's immediate response to the proposed LNG income tax was not favourable. There were significant concerns that a tax as high as 7% of net income would render the proposed Canadian LNG projects uneconomic *vis-à-vis* their most immediate competitors in the United States and Australia. Many of the LNG projects along the U.S. west coast and in the Gulf of Mexico are scheduled to come onto production in advance of, or contemporaneously with, the Canadian LNG projects. These projects are U.S. and Mexican brownfield projects involving the conversion of now idle LNG import terminals into LNG export terminals. Most of the infrastructure capital required to support those projects has already been spent. All of the Canadian LNG projects, by contrast, are greenfield projects that may require up to two to three times the capital investment of a brownfield project.

On October 21, 2014, the B.C. government announced a tier 2 tax rate of 3.5% (rather than the proposed 7% unveiled previously) on net income from liquefaction activities for the taxation years January 1, 2017 to January 1, 2037. The rate will increase to 5% after January 1, 2037.

The B.C. LNG Alliance, an alliance among 14 companies proposing six LNG export facilities on BC's coastline, which include: the Kitimat LNG Project, led by Chevron Corp.; the Pacific NorthWest LNG project, led by Petronas; the LNG Canada Project, led by Shell Canada Energy; Prince Rupert LNG, led by the BG Group; as well as the AltaGas, led by Trion LNG Project and the Woodfibre LNG Project, led by global energy company, Pacific Oil & Gas Limited, who have been equally as vocal, at both the provincial and federal levels. Provincially, the B.C. LNG Alliance has warned the provincial government that a Canadian LNG industry is not a "foregone conclusion". The LNG industry must be globally competitive. They have likewise taken that message to Ottawa, pressing for a change in the tax classification of LNG plants as Class 47 assets of a distribution business to Class 43 assets of a manufacturing operation. According to the Canadian Association of Petroleum Producers, the current Class 47 tax category, an LNG facility would take approximately 27 years to depreciate the bulk of its asset, compared with only seven years for a manufacturing operation in Class 43. There have been recent indications from Ottawa that certain tax measures favourable to the LNG industry will be introduced in the next federal budget in February 2015.

The Complex Regulatory Environment

In Canada, the provincial governments have the authority to regulate the development of natural resources, whereas jurisdiction over the environment is shared between the provincial, federal and to a lesser extent municipal levels of government. This means that project proponents seeking to develop an LNG facility typically require a number of regulatory and environmental approvals from both the federal and provincial governments in order to construct and operate an LNG project.

The regulatory and environmental assessment process to advance an LNG project can be complex and time consuming, particularly in B.C. where vast portions of the province are subject to competing and in some cases overlapping claims by First Nations and Aboriginal groups to whom the government owes a legal duty to consult, and, where appropriate, accommodate aboriginal interests where those interests may be impacted by a proposed project.

A brief description and overview of the most significant approvals required for an LNG project are set out below.

Federal Environmental Assessment Approval

The *Canadian Environmental Assessment Act, 2012* (Canada) ("CEAA") is the primary legislation governing environmental assessment by the Canadian federal government. In those cases where a proposed LNG facility meets the thresholds set out in the CEAA's *Regulations Designating Physical Activities*, a federal environmental assessment may be required. By virtue of changes made to the CEAA in 2012, the objective of the federal environmental assessment process is limited to considering potentially adverse environmental effects within areas of federal jurisdiction, principally, in the case of LNG projects: fish and fish habitat; other aquatic species; migratory birds; impacts on Aboriginal peoples; effects that cross provincial or international boundaries; or projects that take place wholly on federal lands.

A federal environmental assessment can be a time-consuming process and project proponents typically budget between 24 and 36 months from the submission of a complete application for a particular project through to the completion of the review. While the CEAA does contain mandatory timelines within which the review must be completed, delays may occur in those cases where additional information is required or where timelines are extended by the minister to accommodate project specific circumstances.

Provincial Environmental Assessment Process Approval

In B.C., the primary environmental assessment legislation is the *Environmental Assessment Act* (British Columbia) with the B.C. Environmental Assessment Office acting as the primary responsible agency for the provincial review and assessment process. In those cases where a proposed LNG facility meets the thresholds set out in the legislation's *Reviewable Projects Regulation*, a provincial environmental assessment will be required. Factors the provincial environmental assessment will consider are broad ranging and include environmental and socio-economic factors as well as the heritage and potential health effects of the project. The application review process is governed by legislated timelines which apply once the pre-application stage is completed. The pre-application stage can be a time-consuming process in and of itself depending on the scope of the project as well as the degree of Aboriginal consultation (discussed further below) which may be required. All told, the provincial environmental assessment process for an LNG facility can be expected to take upwards of 24 months to complete from the pre-application stage through to a final decision.

There is often a degree of overlap between the provincial and federal environmental assessments as such the federal and B.C. governments have entered into a number of agreements to co-ordinate the environmental assessment process, including the Memorandum of Understanding on the Substitution of Environmental Assessments which seeks to avoid duplication and facilitate a single review process.

LNG Export License

A party seeking to export LNG from Canada requires a license granted by the NEB pursuant to the provisions of the *National Energy Board Act* (Canada). In order to grant a license to export gas for a defined term, the NEB must be satisfied that the quantity of gas proposed to be exported over the term of the license does not exceed the surplus remaining after due allowance has been made for the reasonably foreseeable requirements for use in Canada having regard to trends in the discovery of gas in Canada. As noted above, the NEB has currently issued 10 long term gas export licenses with varying conditions and is currently considering a number of additional applications which are currently before it.

Other Ancillary Approvals and Regulatory Issues

In addition to the primary approvals set out above, LNG projects will typically require a number of other approvals from various federal and provincial authorities. Notably, projects contemplating a marine terminal may require a completion of the Technical Review Process of Marnie Terminal Systems and Transshipment Sites process, typically referred to as the TERMPOL process, which examines shipping routes in Canadian waters and the offloading from ship to shore.

Other notable federal approvals which may be required include those related to the protection of species at risk pursuant to the *Species at Risk Act* (Canada), and the protection of fisheries pursuant to the *Fisheries Act* (Canada).

The Government of B.C. has previously committed to reducing greenhouse gas emissions in the province by 33% below 2007 levels by 2020. The extraction, transportation and liquefaction of natural gas to support the development of the LNG industry present a potential challenge to the Province's ability to meet its stated emission reduction targets. While the provincial government has touted its commitment to having the "cleanest LNG facilities in the world", what remains less clear is what policies the government will be required to implement in order to achieve its stated goal of encouraging the development of the LNG industry while still meeting its greenhouse gas reduction targets. On October 20, 2014, the Government of British Columbia introduced legislation aimed at advancing its commitment to having the "cleanest LNG facilities in the world". The proposed legislation provides that BC LNG facilities will be required to meet a benchmark of .16 carbon dioxide equivalent tonnes per tonne of LNG, a rate which is lower than comparable benchmarks from other jurisdictions such as the U.S. or Australia. Project proponents who are unable to meet this threshold will be required to purchase B.C.-based carbon offsets or invest in a technology fund at a rate of \$25 per tonne. While this policy represents a step forward towards B.C.'s stated goal of having the "cleanest LNG facilities in the world" the government has not imposed an ultimate limit on emissions or taken steps to address the impacts of upstream or midstream natural gas development, both of which are significant contributors to the life cycle emissions impact of proposed LNG development in the province. As such, it remains uncertain how the government will continue to balance its LNG development objectives, while at the same time achieving its public commitment to significantly reduce the province's greenhouse gas emissions.

In October 2013, the Government of B.C. commissioned an independent assessment of the Kitimat air shed to inform regulatory and policy development for future industrial activity in the Kitimat area. The Kitimat air shed is considered a constrained air shed due to its topography. The report was designed to consider the potential impacts on both human health and the environment from industrial emissions based on existing use within the area, including the existing Kitimat aluminum smelter as well as a number of future industrial uses posited for the area, including, but not limited to, four proposed LNG terminals and a proposed crude oil terminal conceptualized to be sited in the Kitimat area. Notwithstanding the overall conclusion of the report that the potential impacts of NO₂ and SO₂ are manageable, cumulative emissions related to future LNG facilities in Kitimat remain an important environmental concern for the LNG industry and one that will continue to attract stakeholder concern going forward.

Complex First Nations Relationships and Recent Supreme Court of Canada Jurisprudence

In Canada, both provincial and federal governments have a duty to consult, and where appropriate, accommodate First Nations whose rights may be impacted by approvals related to an LNG project. The duty to consult is easily triggered; however, the level of consultation that will be required is highly fact driven. In general terms, the more significant the potential impacts, the greater the degree of consultation that will be required. The duty applies to all of the authorizations or permissions that may be required to advance an LNG project and is an ongoing obligation that applies

throughout the life of the project, up to eventual abandonment and reclamation.

While the duty to consult ultimately rests with the provincial and federal governments, the procedural aspects of the government's duty is frequently delegated to project proponents who are often the best placed to not only consult with interested First Nations groups, but also are in the best position to work with such groups to develop mitigation strategies to avoid impacting the rights of interested First Nations.

Unlike many parts of Canada which are covered by numbered treaties wherein First Nations' lands were surrendered to the Government in exchange for certain defined benefits and payments, almost all of the territories likely to be impacted by shale gas development and LNG projects lie within the traditional territories of a number of different First Nations, each claiming unique and sometimes overlapping interests in the territory. This means that coordinating First Nations consultation can be a time-consuming and difficult task, particularly in those cases where an LNG project contemplates both the production of upstream shale gas reserves, necessary pipeline infrastructure to transport the gas, as well as the construction and operation of the LNG terminal infrastructure. Engagement, and potentially agreements, with multiple Aboriginal groups may be required in such circumstances.

In Canada, particularly in B.C., project developers frequently negotiate agreements with First Nations commonly referred to as impact and benefits agreement or "IBAs" that define the relationship between a project proponent and a First Nation group as a component of its consultation in respect of a project. IBAs aim to provide benefits to the local community and frequently contain clauses related to training and business opportunities, economic incentives as well as potentially some form of profit sharing or equity participation in the appropriate circumstance.

An early example of a successful arrangement between the LNG industry and First Nations involved a benefit agreement underlying the Pacific Trails Pipeline discussed earlier. The arrangement was founded on an agreement between the Province of B.C., the Pacific Trails Limited Partnership (a partnership between the proponents of the Kitimat LNG project) and the First Nations Group Limited Partnership ("FNLP"), a consortium of 15 First Nations whose territory may be impacted by the pipeline. The FNLP ensures that First Nations not only receive financial benefits, but also direct access to economic opportunities presented by the Kitimat LNG project, including training and employment opportunities as well as direct employment related to the construction of the pipeline.

The importance of adequate engagement with First Nations and the accommodation of First Nations interests through measures such as IBAs has been underscored through a number of decisions of the Supreme Court of Canada, including the Court's recent decision in *Tsilhqot'in Nation v B.C.*, 2014 SCC 44 wherein the Court clarified the legal test to establish Aboriginal title and awarded Aboriginal title to a relatively significant piece of land in the interior of B.C. to the First Nations claimant. The Court also confirmed that where Aboriginal title is established, the consent of the First Nation to a proposed development will be required. The Court's recent judgment also provided an analytical framework for the government to infringe Aboriginal title; in those cases where the infringement can be justified on the basis of a compelling and substantial government objective, infringement may be permitted. Practically speaking, the decision is almost certain to act as a

leverage point in future negotiations pertaining to LNG projects between First Nations, the government as well as industry proponents anxious to move their projects ahead with maximum certainty, all of which underscores the importance of achieving buy-in from First Nations who may be impacted by LNG development.

Maintaining Cost Competitiveness for Capital and Labour

Skilled labour shortages have inflationary implications for large-scale capital projects. Having witnessed the skilled labour crunch in the Alberta oil sands industry five years ago, B.C. Premier Christie Clark was very quick to initiate an education programme within B.C., designed to provide the Canadian LNG industry with a pool of skilled labour for an anticipated 2018 "peak construction period". Called "*B.C.'s Skills for Jobs Blueprint: Re-engineering Education and Training*", the initiative focuses on, among other things, supporting and expanding industry training programmes, funding opportunities for apprenticeships, promoting "skills foundation courses" in high schools and providing skills training scholarships. It is anticipated that for the top 10 LNG-related occupations required at peak construction, up to an additional 30,000 jobs may be created. Between 2015 and 2018, if five LNG projects are constructed, there would be a need for 58,700 additional direct and indirect construction jobs and up to 23,800 additional permanent direct and indirect jobs for operations. These requirements for skilled labour will compete directly with the Alberta oil sands industry's requirements for the same skilled labour. In Alberta, the Petroleum Human Resources Council predicts that expansion related hiring for the oil sands construction, maintenance and operations workforce will peak in 2019 with the addition of 16,420 new jobs. This number, however, does not account for age-related attrition, which makes the net-hiring requirements much larger than the number indicates.

Conclusion

Our conclusions are short. Canada currently has a relatively short window of opportunity to become a meaningful participant in the global LNG industry. That window of opportunity, however, is quickly coming to a close as global LNG markets change and evolve. Projects that were conceived based on the economics of LNG markets less than five years ago have some adapting to do, as do the B.C. provincial government and the Canadian federal government. If Canada wishes to maintain its global competitiveness in the natural gas resource industry, it must become a participant in the global LNG market. This means overcoming a number of "not insignificant" domestic challenges, as we outline above. To the extent these challenges are within the control of industry and government, the risks associated with these challenges need to be mitigated. Two of the single most effective mitigative measures that the provincial and federal governments can take include ongoing engagement and consultation with First Nations regarding the potential impacts and benefits of LNG development and ensuring that the fiscal regimes that are put in place not only support, but also incentivize, the growth and development of the LNG industry in Canada.

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