

Maui Contract: Who would want to be a downstream purchaser?

BN Gundersen

Partner, Kensington Swan, PO Box 10-246, Wellington, Telephone 0064-4-472 7877, Email bng@ks.co.nz

Abstract

This paper considers, from a legal perspective, the problems faced by downstream purchasers of Maui gas in the current environment.

Introduction

Who would want to be a downstream purchaser of Maui gas? The answer is, only someone who is able to analyse and manage risk.

To date, downstream purchasers of Maui gas have managed:

- the reserves risk, by ensuring their resales of Maui gas are to other downstream purchasers so as to ensure their commercial incentives are aligned; and
- the risk represented by the “hospital pass” of take-or-pay liability, by achieving a strong position in both the electricity and gas wholesale and retail markets, and by having petrochemical plants.

In the future, downstream purchasers must be able to manage risk by fronting up to:

- the owners of the Maui Field;
- the Crown;
- other owners of gas reserves; and
- gas sector infrastructure owners;

and must have deep pockets.

In my paper I justify the answer by identifying how downstream purchasers of Maui gas have managed risks to date and looking to the challenges they face in managing risk as the tail end of the Maui Gas Contract approaches.

Contractual environment

The Maui field is owned by a consortium comprising Fletcher Challenge Limited (68.75%), Shell (Petroleum Mining) Company Limited (18.75%) and Todd Petroleum Mining Company Limited (12.5%) (commonly called the “Maui Mining Companies” or “MMCs”). Under a long term take-or-pay contract (the Maui Gas Contract) the Crown agrees to take or pay for annual contract quantities of gas. In turn, the Crown, under long term back to back contracts, onells the

Maui gas to Contact Energy Limited (“Contact”) the Methanex Group (“Methanex”), and to the Natural Gas Corporation (“NGC”). These contracts are commonly known as the “1990 Contracts”.

The Crown’s onsale of Maui gas to Contact was formerly to Electricity Corporation of New Zealand Limited (“ECNZ”) under Section 23, State-owned Enterprises Act 1986, but on Contact’s split from ECNZ it was, in effect, taken over by Contact (also pursuant to Section 23, State-owned Enterprises Act 1986). The Crown’s resale of Maui gas to Methanex was formerly to New Zealand Liquid Fuels Investment Limited (then a State-enterprise), also pursuant to Section 23, State-owned Enterprises Act 1986, prior to its sale to Fletcher Challenge and then by Fletcher Challenge to Methanex. The end result is that the Crown resells 42.79% of its entitlement to gas under the Maui Gas Contract to Contact, 29.74% to Methanex and 27.47% to NGC. The 1990 contracts with Contact and Methanex, being made under Section 23, State-owned Enterprises Act 1986, are in the public domain and (but for quantities) are on the same terms and conditions. For the purpose of this paper, one assumes that the contract with NGC is (but for quantities) also on the same terms and conditions.

Given the contractual environment, the terminology which is adopted in the remainder of this paper is:

- Fletcher Challenge, Shell and Todd, as owners of the Maui Field and the seller of Maui gas to the Crown under the Maui Gas contract, are referred to as the “MMCs” (the Maui Mining Companies);
- the Crown, as the buyer of Maui gas under the Maui Gas Contract and as the reseller of the Maui gas under its respective contracts with Contact, Methanex and NGC, is referred to as the “Crown”;
- Contact, Methanex and NGC, as buyers of Maui gas under their respective 1990 Contracts to acquire Maui gas from the Crown are called “downstream purchasers”;
- where this paper refers to a “downstream purchaser”, it refers to any one of Contact, Methanex or NGC (the point

made by the paper being applicable to any one of them); and

- references to Articles are references to the Articles of the Maui Gas Contract and references to Clauses are references to Clauses of the 1990 Contract for the resale of Maui gas to ECNZ (as already mentioned, in effect, taken over by Contact) as representative of all the contracts with the downstream purchasers.

Background

In my paper “*Legal Aspects of Gas Trading*”, 1994 New Zealand Petroleum Conference Proceedings 446, I considered the legal aspects of trading in Maui gas and concluded that parties would have to address the extent to which the contract for resale of Maui gas should be “back to back” to the seller’s contract to acquire Maui gas (so that the allocation of risks between the MMCs and the Crown are allocated between the seller and buyer in the same way). In the course of this paper I note that this holds good today.

In my paper “*Problems Arising from the Resale of Maui Gas*”, 1998 New Zealand Petroleum Conference Proceedings 371, I addressed the problems for downstream purchasers of Maui gas by undertaking a risk analysis and identifying potential problems and solutions. The paper addressed the reserves and market risks they faced.

In relation to the reserves, I concluded that given certain dynamics in the gas market, a downstream purchaser might face the problem of having to either resell Maui gas with incomplete Maui gas reserves information and be forced to accept a less than desirable allocation of the reserves risk accordingly, or, delay a resale of Maui gas until it has obtained complete reserves information and had obtained a redetermination of the reserves to adjust the Maui gas contractual entitlements. This paper speculates as to how downstream purchasers have managed this risk as part of my justification that the only person who would want to be a downstream purchaser is someone who can manage risk.

Likewise, in relation to the market risk (the “hospital pass” of a take or pay liability), I identified the risk that all downstream purchasers are likely to face an uncertain market and concluded that they would be reluctant to accept the market risk associated with take or pay. Therefore, downstream purchasers might be forced to either take a residual risk or seek relief from the Crown and the MMCs. Again, I justify my answer by looking at how downstream purchasers have managed this risk.

Also, the tail end of the Maui Gas Contract gives rise to new risks, and I examine how downstream purchasers might manage these risk by fronting up to:

- the MMCs;
- the Crown;
- other owners of gas reserves; and
- infrastructure owners;

with deep pockets.

The reserves risk

As between the MMCs and the Crown, the reserves risk is shared between the MMCs and the Crown. For example:

- information as to the reserves are to be provided by the MMCs to the Crown: Article 6.1;
- the reserves are to be redetermined at two yearly intervals which either party may procure by notice to the other: Article 6.1; and
- in the event of a shortfall in the reserves, the contract quantities and, therefore, take-or-pay, are reduced accordingly: Article 8.1.

Consequently, the MMC’s cash flow is compromised but its contractual obligation to deliver is reduced. The Crown’s entitlement to Maui gas is reduced but its take-or-pay liability is reduced accordingly.

The 1990 Contracts allocated the risk as between the Crown and the downstream purchasers in the same manner. For example:

- a downstream purchaser can require the Crown to exercise its rights to request information as to the reserves: Clause 6.4.;
- a downstream purchaser can require the Crown to obtain a redetermination of the reserves: Clause 6.6.2.; and
- in the event of a shortfall in the reserves, the contract quantities and, therefore, take-or-pay, are reduced: Clause 8.8.

Before embarking on the sale of Maui gas (say, by Contact to Methanex for use in its petrochemical plant and by NGC to Genesis for use in its thermal power stations) one would expect a prudent downstream purchaser to maximise its information as to the Maui reserves and to ensure that the reserves have been redetermined within the proceeding two years.

My 1998 paper noted that there was a risk here as the MMCs could:

- delay the provision of the information; or
- the MMCs may not call for a redetermination of the reserves whereupon the downstream purchasers must require the Crown to do so, and the downstream purchasers might be unable to agree amongst themselves to do this if their commercial interests were not aligned.

How have the downstream purchasers managed this risk?

Contact

There is some evidence that this risk materialised for Contact. For example, as at 31 March 1999:

- Contact faced a choice under its 1990 Contract whether to accept or decline some or all of a tranche of 180 PJ of Maui gas known as Block B Gas before 1 April 2000;

- if declined, Contact's take-or-pay quantities would reduce, but there was a risk that, as a result of certain downstream contractual arrangements with two customers, Contact could face claims or material loss of revenue from those customers;
- if Block B Gas was accepted, Contact expected it would have to pay for gas not taken throughout the term of its 1990 Contract and lose access to the prepaid gas upon expiry of the Contract.

See pages 17, 18 and 30 of Contact's 31 March 1999 prospectus.

As at the same date, Contact had taken the following steps to obtain information to manage the reserves risk:

- ascertained the estimate of the Maui reserves as at 1 January 1999 from Fletcher Challenge's annual report filed with the United States Securities and Exchange Commission;
- from the same source, ascertained the MMCs' estimate of the reserves provided to the Crown in September 1997;
- ascertained the estimate as at 1 January 1998 that the operator of the Maui Field had reported to the Ministry of Commerce;
- obtained its own preliminary assessment of the reserves as at 1 January 1997;
- was "taking steps to manage its exposure in respect of Block B Gas";
- requested a redetermination of the Maui reserves, which request had been disputed, and proceedings to resolve the issue were under consideration:

See pages 50 and 59 of Contact's 31 March 1999 prospectus.

As at 31 December 1999, Contact reported:

- Contact had entered the retail gas market, through its purchase of Enerco's retail business (and this is expanded upon below); and
- most importantly, "another crucial milestone" was the sale of 130 PJ of Maui gas to Methanex on a take or pay basis for a term from 1 October 1999 to 30 September 2008.

See page 7, Contact's 1999 Annual Report.

These were no doubt the steps being taken "to manage its exposure in respect of Block B gas" reported as at 31 March 1999. Clearly, Contact elected to accept the 180 PJ Block B gas and managed its exposure by its entry into the retail market and resale to Methanex. How does this relate to the reserves risk? I speculate that both Contact and Methanex were comfortable with their respective assessments of the Maui reserves, but were further comforted by both being downstream purchasers under the 1990 Contracts, as their commercial incentives then become aligned, enhancing their ability to act collectively against the Crown so as to require

the Crown to exercise its rights under the Maui Gas Contract in relation to the redetermination of reserves.

Furthermore, I would expect that other than in respect of quantities, the contract terms will be "back to back" with Contact's 1990 Contract with the Crown, and may contain an agreement between Contact and Methanex as to how they will require the Crown to exercise its rights, and how they might encourage NGC to work with them.

NGC

NGC has:

- entered into an agreement with Fletcher Challenge that NGC could "put" to Fletcher Challenge all of its Maui prepaid gas in respect of each contract year up to 30 December 1996;
- sold 79.8 PJ of Maui gas (a tranche known as Advance Paid Gas) to Fletcher Challenge;
- transferred 25 PJ of prepaid Maui gas to Methanex, to be uplifted by 2006;
- agreed to sell 91 PJ of Maui gas to Genesis Power over eight years from 2000 to 2008; and
- agreed to sell 35 PJ of Maui gas to Petrochem over six years from 2000 to 2005.

See page 25 of the Annual Report 30 June 1999 and 31 December 1999 of the Half Yearly Report.

How does this relate to the management of reserves risk? Here again I speculate that by having transactions with Fletcher Challenge, the dominant MMC, and with Methanex, a fellow downstream purchaser under a 1990 Contract, NGC has taken the opportunity to ensure that their commercial incentives are aligned.

Methanex

Obviously, Methanex as a downstream purchaser, having acquired Maui gas from Contact and NGC, has obtained the position whereby all three downstream purchasers have aligned commercial incentives to manage the reserves risk of their 1990 Contracts, which enhances their ability to act collectively to require the Crown to exercise rights under the Maui Gas Contract in respect of Maui reserves.

This has implications for the Crown and for the MMCs.

Market risk

As between the MMCs and the Crown, market risk for Maui gas is allocated to the Crown. The Crown has an obligation to take-or-pay an annual quantity: Article 9. This is, of course, traditional for long term take-or-pay contracts in the gas sector throughout the world and the economic and commercial basis for this is well known. In the case of the Maui Field, the Crown obtained a long term supply of Maui gas for its

estimate of its demand for gas in reticulation and electricity generation markets. In return, the Crown's take-or-pay obligation to the MMCs provided a secure revenue stream which enabled the MMCs to develop the Maui Field.

My 1998 paper noted that the market risk from the perspective of downstream purchasers of Maui gas was significant due to an uncertain market for gas arising from deregulation of the sector, the prospect of other reserves being discovered, the de-regulation of the electricity market and the establishment of an electricity wholesale market. While there was an obvious incentive on downstream purchasers to pass on the "hospital pass" of take or pay, it was anticipated that the uncertain market may make further downstream purchasers of Maui gas reluctant to accept the market risk.

What has happened?

Contact

Since its establishment in 1996, Contact has paid for gas not taken so as to accumulate a substantial volume of "banked" gas, namely prepaid gas.

It is evident that Contact has not been sitting on its hands in its management of the market risk evidenced by its take or pay liability to the Crown:

- In 1999 Contact entered the retail market through its purchase of Enerco's retail business, which has secured Contact's place as New Zealand largest gas retailer based on customer numbers. NGC's sales volumes were adversely affected as a result of Contact using its own gas to supply Enerco's customers (see NGC's 31 December 1999 half year report);
- The increase in sales volumes resulting from the above and the sale of 130 PJ of Maui gas to Methanex means that Contact has established a balance between its expected future gas use and take-or-pay obligations.

Contact believes it will be able to fully utilise its prepaid gas. See page 8 of Contact's 30 September 1999 Annual Report.

NGC

NGC has likewise not sat on its hands in managing its take-or-pay liability to the Crown. Its resale of Maui gas will increase dramatically with its two major gas sales to Genesis and Petrochem. NGC reports that it will take more Maui gas than its take or pay obligations as from this year, and can start accessing its prepaid entitlements: See NGC's 31 December 1999 Half Year Report.

Methanex

Until Methanex's recent purchase of Maui gas, the prospects for additional gas to service Methanex's Waitra Valley and Motonui Plants seemed limited. In 1996 Methanex made a decision to focus methanol production at the Motonui site and to "idle" the Waitra Valley plant as from the beginning

1998. This decision resulted in Methanex writing down the value of the Waitra Valley plant. In 1997, it then considered the likelihood of purchasing additional gas had improved significantly, and made the decision to continue operating the Waitra Valley plant. Methanex was then offered a small number of parcels of gas and signed a memorandum of understanding with Fletcher Challenge to work with it to secure additional large volumes to operate the plants in the longer term: See Methanex's website <http://www.methanex.com>.

There seems no doubt that Methanex needs all the gas it can get and, one assumes, was willing to negotiate the purchase of Maui gas from Contact thereby permitting Contact to elect to accept Block B gas rather than reject it and have the Crown put the gas to Methanex on less flexible terms. However, Methanex must continue to manage its market risk; methanol is a global commodity and earnings are significantly affected by fluctuations in methanol prices and natural gas costs. The largest factor influencing Methanex's earnings is the price of methanol but the market has seen significant volatility in prices driven by overall demand and supply balances.

Management of future risks

The downstream purchasers of Maui gas are now looking down the barrel at the tail end of the Maui Gas Contract.

The scheme of the Maui Gas Contract in this regard is as follows:

- The contract quantities are reduced in accordance with the Maui reserves as explained above;
- If there is a short fall of Maui reserves, so that the MMCs cannot deliver the contract quantities to the Crown then:
 - (a) if the MMCs cannot meet the contract quantities during the plateau period from 1985/86 to 1999/2000, the contract quantities for the remaining term are reduced to a minimum floor;
 - (b) if the MMCs cannot meet the contract quantities at that minimum floor, quantities are reduced to a level which will deplete the economically recoverable reserves over the remaining term: Article 8.8.

The scheme in relation to take or pay is:

- In the last two years prepaid gas can be taken before the annual quantity: Article 9.3;
- In the last year the Crown must use its best endeavours to take the annual quantity but need not pay if it cannot take: Article 9.3.

The effect of these provisions is passed through to the downstream purchasers under the 1990 Contracts: See Clause 6.7 and 8.8.

All this turns on the "economically recoverable" Maui reserves. For the purpose of this paper, I construe this to mean the proved and probable reserves which can be recovered at a profit.

It is clear that during these last years both Contact and NGC will take prepaid gas (the Methanex position not being known, one assumes that it has and will continue to take its full Maui gas entitlement and thus will continue to take and pay for gas). Thus, in addition to falling revenue as the Maui gas price falls in real terms (the Maui gas price adjusts at a rate less than inflation: Articles 9.1 and 18.1), the MMCs also face the prospect of receiving revenues from Methanex only, a 29.74% downstream purchaser of Maui gas (recognising, of course, that the MMCs have had the benefit of having already been paid for gas to be taken as prepaid gas without further payment by Contact and NGC).

The declining Maui gas price in real terms, and the reduction in revenue to the MMCs suggest that downstream purchasers face two risks:

- a less than optimum depletion of the Maui reserves; and
- substantially increased prices for Maui and other gas, on expiry of the Maui Gas Contract.

This will be at a time when gas is necessary to ensure substantial thermal electricity generation and retail assets will continue to generate revenue.

Management of risks

I have demonstrated that the commercial incentives on the downstream purchasers in relation to the reserves risk are aligned. This could be utilised to pursue options open to the downstream purchasers:

- the downstream purchasers could front up to the MMCs now to negotiate new direct contract post the Maui Gas Contract based on full disclosure of the Maui reserves and a new market price for Maui gas. This could include “top up” payments to the MMCs on gas taken by the downstream purchasers from the Crown under the 1990 contracts so as to maximise the “economics” of the optimum recovery of the Maui reserves. The Crown need not be part of this;
- The downstream purchasers could front up to the Crown by:
 - (a) calling upon the Crown to maximise its interface between the downstream purchasers and the MMCs to facilitate a transaction of this kind which maximises the “economic” recovery of the reserves. Clearly, the 1990 Contracts were part of the Government’s desire to exit from its former “think big” participation in the energy markets. However, can the Government stand by and let unnecessary transaction costs and inefficient allocation resources occur; or
 - (b) calling upon the Crown to utilise its rights under the Maui Gas Contract in respect of reserves.
- The downstream purchasers could front up to the owners of other gas reserves. The owners of the Kupe Field are a prime example here;
- The purchase of non-Maui gas requires the downstream purchasers to front up to the gas sector infrastructure owners. For example:

(a) Access to the main North Island gas transmission network owned and operated by NGC. In this regard, NGC is a signatory to the Gas Pipeline Access Code and provides open and non-discriminatory access to its transmission and distribution systems (see NGC’s October 1999 Gas Networks Information Memorandum);

(b) The Maui onshore line from Oanui to the Huntly Power Station owned by the MMCs. The downstream purchasers are entitled to receive Maui gas at their respective delivery points (Clause 7.1) and as a consequence the acceptance of downstream purchasers is to be required for the co-mingling of gas on the Maui onshore joint line. However, as the downstream purchasers have aligned commercial incentives, access to the line for the transport of other gas by one or more of them, may well be commercially viable.

- The facilities that are used to separate and process crude oil and gas streams before being transported:
 - (a) the Oanui Plant owned by the MMCs used to process Maui gas and associated goods;
 - (b) the Kapuni Plant owned by NGC used to process gas from the Kapuni Field and associated liquids;
 - (c) the McKee production station owned by Fletcher Challenge which is used to process oil and gas from the McKee Field; and
 - (d) the Waihapa Production Station owned by Fletcher Challenge which is used to process oil and gas from the Waihapa/Ngarae Field.

James Willis in his paper “*Access to Petroleum Production Facilities*”, (1994 New Zealand Petroleum Conference Proceedings page 452), at page 460 concludes that there are no significant competition law restraints to access these facilities and that “market forces” will prevail. Given the right balance of economic incentives he sees there is every reason to believe that satisfactory arrangements can be concluded.

Consequently, downstream purchasers of Maui gas face further risks which must be managed. From my perspective, the options for management which I have identified are of a kind which requires someone who has commitment to the market by virtue of past investment and deep pockets to fund the management of the risks.

Conclusion

Consequently, I offer the foregoing in justification for my answer to the question posed by the subject of this paper. A person who would want to be a downstream purchaser of Maui gas is someone who is able to analyse and manage risk, and be able to manage the future risks by fronting up to:

- the MMCs;
- the Crown;
- other owners of gas reserves; and
- gas sector infrastructure owners;

with deep pockets.

Author

BRYAN GUNDERSEN is a senior partner in the national commercial law firm, Kensington Swan. Bryan leads the firms energy and resources team. He practices in the oil and gas, and electricity sectors in relation to project structures, contractual relationship and competition law issues.