

The Maui gas contract

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Abstract

The Maui Gas Contract underpins New Zealand's gas market. It is the large swing producer that has greased the industry's wheels. It is frequently and increasingly undervalued in terms of both deliverability and security of supply.

The Maui Gas Contract is in the final decade of its life. The Contract is a 30-year take-or-pay arrangement. It is ambiguous or poorly written in a number of areas that are critical to the efficient and effective management of Maui gas supply during the last third of the field life. The potential exists within this ambiguity to compromise gas production and ultimate recovery in the last years of field life. Moreover, the potentially adverse impacts of this ambiguity are compounded by poor precedent in that the Contract has not been implemented as was envisaged at the time of execution. This has resulted in it being informally adapted or stressed in practise.

Transition to post-Maui gas supply alternatives is firmly within the planning horizon of New Zealand's gas industry. The major participants are placing increased importance on managing Maui and other gas contract rights, and security of supply. As the contract comes under increasing scrutiny and pressure, tension will increase. It is in the interests of all involved that the transition is managed with professionalism by all involved. It will be important that the solutions arrived at should be developed by Seller and Buyer with a view to ensuring the transition to new supply arrangements occurs as seamlessly as possible.

Introduction

This paper has been prepared by Fletcher Challenge Energy to present to the Petroleum Conference 2000. It expresses the views of Fletcher Challenge Energy. It has not been prepared in consultation with Shell Petroleum Mining and Todd Petroleum Mining. It should not be regarded as representing the views of the Maui Joint Venture.

I recently re-read the paper presented by Martin Trachsel at the 1998 Petroleum Conference entitled "The Maui Gas Contract – Benefit or Burden? A Seller's Perspective". In the introduction to that paper Martin noted that "In the litigative environment in which we work it is perhaps also prudent to add that the views expressed are without prejudice to positions that Shell Petroleum Mining may take in any current or future dispute". The environment in which we work today is equally, or more, litigious. Therefore, I heed Martin's warning and record that the views expressed are without prejudice to positions that Fletcher Challenge Energy may take in any current or future dispute.

This paper will first provide a brief summary of:

- the history of the Maui Gas Contract;

- the key provisions of the Maui Gas Contract; and
- the 1990 arrangements entered into by the Crown with Methanex, NGC, and ECNZ (now Contact).

This paper will then consider key pressures associated with the Maui Gas Contract.

I will then address the topic of renegotiation of the Maui Gas Contract.

The paper will finish with a request that attention is focused on actively managing the Maui Gas Contract. Solutions to contract tensions should be developed by Buyer and Seller, not just in response to short-term pressures, but with a view to ensuring the transition to new supply arrangements post-Maui occurs as seamlessly as possible. This will include a brief discussion on the role of the Crown.

The Maui Gas Contract is ambiguous or poorly written in a number of areas that are critical to the efficient and effective management of Maui gas supply. This is particularly important during the last third of the life of the Maui gas field. The potential exists within this ambiguity to compromise gas production and ultimate recovery. The potentially adverse impacts of this ambiguity are compounded

by poor precedent in that the Contract has not been applied as was envisaged at the time of execution. The operation of the Maui Field as the large swing producer and the undervaluing of this capacity have the potential to compound these problems.

It would be widely agreed that the Maui Gas Contract and the 1990 contracts between the Crown and Methanex, NGC and Contact are not ideal. If they could be renegotiated, they could be improved.

At this time it is neither feasible nor necessary to renegotiate the Maui Gas Contract. It is unnecessary because the Maui Gas Contract is sufficiently robust. Fletcher Challenge Energy believes that while strained, the Maui Gas Contract can be given effect largely according to its wording and intent, and incorporating the adaptations that have occurred in practise up to this point.

Renegotiation is not feasible because it is not apparent to us that there is either the commonality of purpose or commitment required for such a major task. Until such time as the parties that comprise, or control, Buyer and Seller have a common desire to renegotiate and a commitment to a shared vision of the outcome of renegotiation, successful renegotiation will not be accomplished.

Renegotiation exposes Buyer, Seller, NGC, Methanex, and Contact, as well as other downstream purchasers, to considerable contractual and commercial uncertainty. There is no defined process for renegotiation. Given the number of interested parties, the conflicting objectives and the value at stake, any negotiations will be protracted and difficult to conclude. In the absence of sufficient pressure on **all** parties requiring a renegotiation for the benefit of all parties, renegotiation is very unlikely to occur or to lead to a satisfactory outcome.

The parties to a Maui renegotiation may also have difficulty because of the provisions of the Commerce Act. Finally, it is likely that some of the parties who would be involved in the renegotiations are constrained by agreements other than the Maui Gas Contract that inhibit their ability to engage in, or agree to, a renegotiation.

In this context, therefore, Fletcher Challenge Energy believes that it is essential that the Maui Gas Contract is managed and operated with professionalism by Buyer and Seller. Solutions arrived at should be developed with a view to ensuring a smooth transition to new supply arrangements post-Maui.

The underlying premise of this paper is that, notwithstanding the pressure on the Maui Gas Contract, it is sufficiently robust to continue its full term.

In the absence of renegotiation, the pressure that exists under and around the Maui Gas Contract is likely to be mitigated through ancillary deals. In this category we include deals such as the on-sale of prepaid gas entitlements and the resale of Maui gas. Examples are the recent deals between Contact

and Methanex, and NGC and Genesis. Fletcher Challenge Energy is optimistic that such arrangements provide a pragmatic solution to the commercial pressures arising from the Maui Gas Contract and related arrangements.

History of the Maui Gas Contract and the 1990 Contracts

The primary issue arising from the discovery of the Maui Field in 1969 was how to use the potentially large quantities of natural gas that could be produced (proved plus probable recoverable reserves were estimated at about 5500 PJ). The economic development of the field depended on there being a user of gas willing and able to take very large quantities of gas under a long-term contract.

At the time, natural gas was only used for reticulation in New Zealand and that market was small and well served by the Kapuni Field. The Government was the only entity capable of finding a use for such a large quantity of gas and consequently joint venture discussions began between the Shell-BP-Todd consortium and the Government. Government officials studied possible uses for Maui gas and concluded that generating electricity was the only feasible use for the gas that could sustain a realistic price and could take large quantities.

Consequently, the Crown entered into the Maui Gas Contract with Maui mining companies (Shell, BP, Todd and the Crown (through the Offshore Mining Company)) on 1 October 1973, with the intention of taking large quantities of gas to supply thermal power plants. The Crown intended that four thermal power plants would consume Maui gas – New Plymouth (already built), Huntly, Auckland 1 and Auckland 2 (all to be built). The Maui pipeline was intended to supply Maui gas to all four plants.

Key terms of the Maui Gas Contract reflect the underlying intentions of the Seller and Buyer that the gas would primarily be used as fuel for three new thermal generation plants.

For instance:

- The definition of “Reasonable and Prudent Operator” in relation to Buyer means an operator whose standard of performance is equal to or better than that generally recognised as good thermal power station practise.
- Article 3.4.2 records that Buyer proposes to erect one power station near Huntly and two power stations near Auckland that will use gas supplied under the Maui Gas Contract. Buyer undertook that at least six months before the commissioning of the first generating unit at each such station it would give to Seller notice of the date on which it would expect gas to be supplied on a continuous basis to such station.
- The points of delivery for gas specified under the Contract are:
 - The New Plymouth power station

- The Huntly power station
- The two Auckland power stations
- Delivery capability at the delivery points is defined in the Maui Gas Contract by reference to the anticipated capacity of the power stations.

The Maui A platform was installed in 1978 and production commenced on 28 June 1979. However, this coincided with an economic downturn and electricity demand did not meet the Crown's forecasts. Consequently, the two Auckland power stations were cancelled and the Crown sought new ways of using Maui gas so that it could relieve itself of its onerous take or pay obligations.

This also coincided with the world oil shocks of the late 1970s which greatly increased the potential value of the liquids revenues that the mining companies would have expected to derive. Therefore, the Crown's failure to take its annual contract quantities of Maui gas at that time resulted in significant adverse financial consequences for the mining companies.

The Crown's failure to take its annual contract quantities of Maui gas led to the Crown establishing New Zealand's petrochemical industry and constructing three petrochemical plants: Petrochem's ammonia urea plant at Kapuni, and Methanex's Motonui and Waitara methanol plants. However, despite the establishment of this new Maui gas consumer, consumption of Maui gas never met expectations. Since production started, deliveries of gas to the Buyer have exceeded the take or pay quantity in only three delivery years: 1985/86, 1991/92 and 1998/99. Consequently, Buyer has paid for about X PJ of Maui Gas which it has been unable to take to date.

Key provisions of the Maui Gas Contract

In negotiating the Maui Gas Contract the parties focussed on the following key provisions:

Price

The price was agreed at 37 cents per MMBtu escalated essentially at half the rate of inflation. The Crown offered this price on the basis that it made thermal generation cost effective.

Take or pay

Article 9 contains a commitment by the Crown that it will take or pay for an amount of gas each year equal to the contracted annual quantity. The take or pay provision gave the mining companies some assurance that they would be receiving adequate cashflows from the Crown to finance its projected development costs. In this particular case, the take or pay provision was also seen as providing the mining companies with some limited recompense for being unable to access liquids because gas was not taken.

Reserves risk

Article 8 provides the Seller with protection against reserves risk. I understand that if the mining companies had taken the reserves risk by agreeing to deliver a fixed quantity of gas, they would have required the Crown to pay a higher price.

Post facto review

Article 18.3 provides that the parties would review capital expenditure one year after completion of construction of the second platform and recoup to the relevant party any over or under expenditure.

The contract provides an initial term of 30 years from the date of first delivery (28 June 1979). The annual contract quantity profile started at about 40 PJ and steadily increased to a plateau of 160 PJ from 1987 to 1999. The profile is now declining steadily to about 65 PJ in 2009. Therefore, irrespective of the actual deliverability of the field, the parties agreed that the contract quantities would steadily decline through the period 1999 to 2009.

1990 Maui gas arrangements with Methanex, NGC, and ECNZ (now Contact)

In 1990, the Crown restructured its involvement in Maui gas by selling its interest in the Motonui plant to Fletcher Challenge and standardising its downstream supply contracts ("1990 Contracts"). The 1990 contracts in aggregate were designed to mirror as closely as possible the Maui Gas Contract so that the Crown's rights and obligations effectively mirrored the purchasers' rights and obligations.

The important point is that the Crown remained the Buyer under the Maui Gas Contract rather than assigning the Maui Gas Contract and ceasing its involvement in Maui gas. Therefore, although the Crown intended to effectively remove itself from the Maui gas arrangements, it ultimately must comply with the Maui Gas Contract and therefore manage its 1990 Contracts accordingly. The purchasers have no privity in respect of the Maui Gas Contract and can only look to enforce their rights with the Crown.

Key pressures associated with the Maui Gas Contract

We have reviewed the history of the Maui Gas Contract. What I want to consider now is the Maui Gas Contract in the current commercial and economic environment.

The Maui gas field supplies over 70% of New Zealand's annual gas consumption. This includes consumption by the petrochemicals sector, electricity generators, industrial, commercial, and domestic customers. These different customers have load profiles varying from relatively flat to highly seasonal and with substantial daily variation. In 1998-99 petrochemicals accounted for around 49% of Maui gas

consumption, electricity generation accounted for around 42% of Maui gas consumption, and the balance was supplied to industrial, domestic and commercial customers.

Despite having been in production for over 20 years, the Maui gas field remains New Zealand's largest producing field. It also has the greatest installed delivery capacity. It operates as the key swing producer, meeting the significant variation in New Zealand's aggregate gas consumption in addition to the base load demands of such consumers as the petrochemical companies and some industrial customers.

This is a far cry from the intentions of the parties at the time that the Maui gas contract was negotiated.

This section of the paper will address key pressures that arise under or are associated with the Maui Gas Contract in today's environment.

Price

As discussed, the price was set at 37 cents/GJ inflated by half inflation if inflation is less than 6% and at 3% less than inflation at rates of inflation above 6%. Obviously, this leads to a fall in the real value of the gas price year by year and encourages consumption of Maui gas.

The problem with this is that it sends the wrong price signals to explorers and consumers. As gas becomes increasingly scarce, new exploration and development is depressed. Explorers are discouraged from spending funds exploring for and developing new sources of gas supply when there is only limited opportunity for new gas sales and at depressed prices in the near term.

This situation is compounded by the gas market dynamics that have further depressed the delivered price of gas. The Maui Gas Contract dominates New Zealand's production of natural gas at over 70% of total net annual production. Key purchasers of Maui gas have take-or-pay obligations. On average, these purchasers have consistently failed to uplift their annual contract quantity that is the threshold for the take-or-pay payments. This has resulted in the Crown, and Contact and NGC, holding large entitlements to prepaid gas. These entitlements are not physical quantities of gas but contractual rights. Contractual uncertainty and commercial pressure has seen these companies enter into relatively low price deals to secure sales and optimise business value. Similar take-or-pay type arrangements downstream of Contact and NGC have seen similar behaviour by other gas suppliers.

The result of this is to:

- depress market prices for delivered gas;
- increase reliance on gas sourced from the Maui field; and
- discourage the exploration for and development of other gas supplies

at a time when the Maui field is entering the final third of its life and can be expected to go into decline.

We acknowledge that the take-or-pay provisions of the Maui Gas Contract have proven to be difficult for Buyer. Back-to-back take-or-pay obligations under the 1990 Contracts with NGC, Contact, and Methanex have similarly been difficult for those parties.

It must be remembered that the take-or-pay provisions were included because the Crown was willing to assume market risk in a gas market that at the time was not consuming sufficient gas to encourage the development of the Maui gas field.

It must also be remembered that Sellers valuation of the development of the field assumed liquids recovery associated with gas used at the rate implied by the Contract annual quantities. Failure to uplift gas at the minimum rate implied in the take-or-pay obligations has resulted in Seller recovering to date less liquids from gas than anticipated.

Security of supply, transition

As discussed, already, the combination of falling real cost of gas supplied under the Maui Gas Contract and pressure to utilise entitlements to prepaid gas have:

- increased reliance on gas sourced from the Maui field;
- depressed the market price for gas; and
- discouraged the exploration for and development of additional supplies of gas.

The consequence of this is substantial market risk. The gas industry is increasingly concerned about the availability of gas post-Maui. It is symptomatic of the significant uncertainty in the New Zealand market and its reliance on one predominant field that views of security of supply wax and wane so wildly with each new discovery or, as is usually the case, exploration failure.

The transition to supplies of gas post-Maui involves more risk and uncertainty the greater the reliance placed upon the Maui Field at this time and the more that other exploration for and development of gas prospects is deterred.

Deliverability

Under the Maui Gas Contract, Buyer has the right on each day to purchase a quantity of gas equal to the Maximum Daily Quantity (Article 8.1.1). In addition, Buyer has the right to request delivery of gas at a rate above the Maximum Daily Quantity (Article 8.5.2). Provided that Seller has uncommitted capacity to make such delivery it will use all reasonable endeavours to do so, consistent with the standards of a Reasonable and Prudent Operator (Article 8.5.2).

Article 8.1.7 specifies the Daily Quantity, Annual Quantity, Maximum Daily Quantity and Maximum Hourly Quantity.

These quantities peak in the period 1988 to 1997. Thereafter these quantities decline so that by 2007-2008 the Daily Quantity, Annual Quantity and the Maximum Daily Quantity are only around 40% of their 1997 levels.

Table 1 sets out the contract Annual Quantity and Maximum Daily Quantity.

Coincident with the declining contractual entitlements to Daily Quantity, Annual Quantity and Maximum Daily Quantity, New Zealand's aggregate demand for gas continues to grow.

As noted, the Maui gas field under the Maui Gas Contract, currently supplies around 70% of New Zealand's total annual gas consumption.

The delivered price for gas in New Zealand is insufficient to stimulate significant new gas development to bring gas discoveries into production at this time. The major driver for gas exploration and development is for supply post-Maui. The market opportunity for gas at present is for supply post-Maui, with gas wholesalers and users focusing on security of supply post-Maui, assuming supply of Maui gas in the interim and attempting to mitigate the risk of transition.

In the absence of new gas supplies entering the market and with pressure on purchasers to use Maui gas we expect that Maui gas will continue to be the base gas source.

At least as importantly, and in our view more importantly, the Maui gas field has the greatest installed delivery capacity and operates as the major swing producer.

The net result of this is that there is increased pressure on delivery of gas from the Maui gas field coincident with declining contractual entitlements to Annual Quantity and Maximum Daily Quantity under the Maui Gas Contract. We anticipate that Seller could receive frequent and sustained requests from Buyer for delivery at rates in excess of Maximum Daily Quantity. Seller's obligation is to use reasonable endeavours to do so consistent with:

- its obligations as a Reasonable and Prudent Operator, and
- its obligations not to sell Maui gas if such sale would impair or be likely to impair its ability to perform its obligations under the Maui Gas Contract to supply the Annual Quantity and up to the Maximum Daily Quantity on any day (Article 4.3).

This tension has been inherent in the Contract from the outset. To effectively manage the Contract to its term and encourage a smooth transition to post-Maui supplies it requires some constraint by Buyer in its nominations of Maui gas. It is our view that Seller is not required to meet requests for supply at rates above Maximum Daily Quantity on a frequent or sustained basis. In fact, Seller is obliged under the Contract not to meet such requests if there is doubt about its ability to meet its primary obligations under the Contract.

Moreover, the proper pricing of supply at rates above contractual rates will be important in any transition. With out appropriate marginal pricing for deliverability there will be no incentive for new gas to be brought on stream to fill the gap between gas demand and Maui contractual delivery rates. New Zealand could be relying on deliverability that the Seller has no obligation or incentive to maintain.

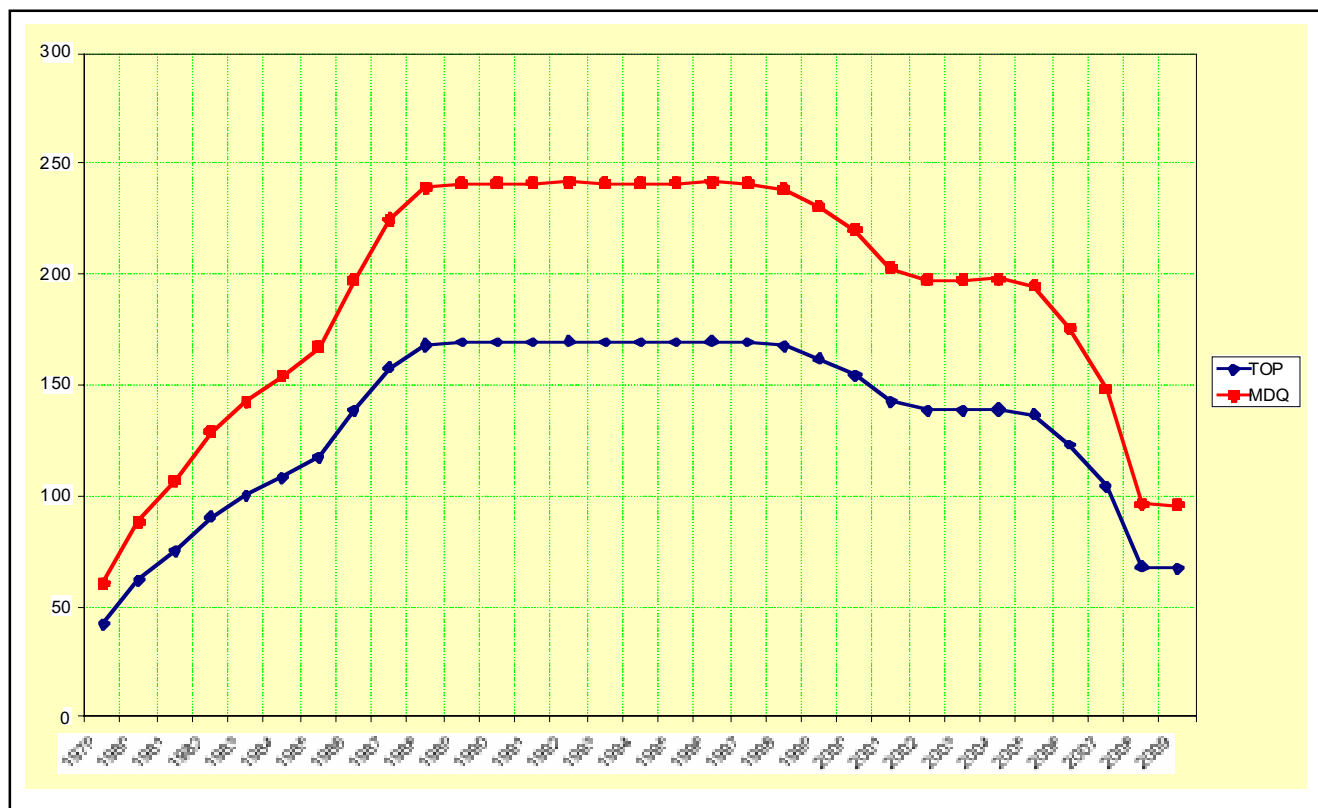


Table 1: Contract Annual Quantity and Maximum Daily Quantity.

We believe that all gas producing and gas using entities in New Zealand should seek price signals at the margin to encourage new supply. Without appropriate incentives at the margin we cannot be confident that new supplies will come on in time to replace Maui.

Third party supply

To facilitate the transition to post-Maui gas supply, Maui gas will need to be supplemented with gas sourced from other fields. This is likely to mean non-Maui gas mixing with gas sourced from the Maui gas field for transmission on the Maui pipeline. It is our view that the Maui pipeline should be made available for this purpose, and will inevitably be so.

Balancing the rights of Buyer under the Maui Gas Contract with the need to facilitate new supplies is important for security of supply in New Zealand. Supply of non-Maui gas on the Maui pipeline during the term of the Maui Gas Contract can be consistent with Buyer's rights and a practical development.

Redetermination

No discussion of the Maui Gas Contract seems to be complete without reference to the process of redetermination.

Under Article 6 of the Contract, Seller and Buyer have the opportunity every two years to make a redetermination of the Economic Recoverable Reserves. The Economic Recoverable Reserves are the "quantities of gas that are estimated to be economically recoverable from the Maui field as determined or redetermined from time to time...". Article 8.8 provides an adjustment mechanism to redefine Seller's obligations following a downward redetermination of Economic Recoverable Reserves.

The application of Articles 6 and 8.8 is fraught with legal, commercial and practical problems. To make it work requires definition of key variables such as:

- economic Recoverable Reserves: what is economically recoverable, how is this determined;
- what are Seller's obligations at any moment in time; and
- how do Seller's obligations adjust applying Article 8.8

Resolving these matters in the context of redetermination is likely to be a drawn out process involving recourse to both arbitration and court proceedings.

Renegotiation of the Maui Gas Contract

Over the past few years there have been numerous calls for renegotiation of the Maui Gas Contract. This includes Martin Trachsel of Shell who made such a request at the last Petroleum Conference in 1998. Calls for renegotiation of the Maui Gas Contract have also been made by other industry participants, contract parties, and industry commentators.

We believe that it would be widely agreed that Rolls Royce gas contracts for supply from New Zealand's principal gas field are desirable.

Unfortunately, we have inherited an Edsel. The Edsel appeared to be a good idea to people at the time, some even thought it looked good and would perform well. However, over the years it has become apparent that the customer got what it asked for but ultimately did not like what was delivered. The manufacturer delivered what was requested but has been disappointed with the customer's response.

Like many great home handymen our unhappy customer chose to remodel the Edsel. This included a three-tone paint job, mag wheels, fluffy dice, and a much louder stereo.

This vehicle was then rented to three mates. The first wanted a high performance vehicle specially adapted for racing. The second wanted a limousine for executive travel. The third wanted a freight train.

These mates subsequently found that, notwithstanding the looks, the vehicle had the same brakes, engine and suspension as any other Edsel. These mates have complained about the performance, not just to the customer, but also to the manufacturer.

The problem now in 2000 is that the mates continue to share the Edsel for racing, limousine services and industrial deliveries and complain about unsatisfactory performance. The manufacturer, while hearing the complaints of the three mates, is not sure what the customer thinks and is not confident that the Edsel contains all of the parts required to create the three vehicles desired. To build three modern high performance vehicles one would not choose to start with an Edsel.

To date renegotiation has not occurred and no significant steps have been made towards renegotiation.

Renegotiation has not occurred primarily because:

- There has been insufficient pressure on all parties with involvement in the renegotiation process and outcome to create an environment where the parties can agree to meet and engage in negotiations. In the absence of sufficient pressure on all parties requiring a renegotiation for the benefit of all parties, renegotiation is very unlikely to occur or to lead to a satisfactory outcome.
- There is not a sufficient commonality of vision for the outcome of the renegotiation. Until such time as the parties that comprise, or control, Buyer and Seller have a common desire to renegotiate and a commitment to a shared vision of the outcome of renegotiation, renegotiation will not be accomplished.
- Renegotiation exposes Buyer, Seller, NGC, Methanex, and Contact, as well as other downstream purchasers, to considerable contractual and commercial uncertainty.
- There is no defined process for renegotiation. A useful first step would be to define the process and basic tenets of a revised deal.

- Given the number of parties involved, the conflicting objectives, and the value at stake, any negotiations will be protracted and difficult to conclude.
- The parties to a Maui Gas Contract renegotiation may have difficulty with regard to discussing matters because of the provisions of the Commerce Act.
- It is likely that some, if not all, of the parties who would be involved in the renegotiations are constrained by agreements other than the Maui Gas Contract that inhibit their ability to engage in, or agree to, a renegotiation.

In the absence of renegotiation to date there have been arrangements entered into to mitigate or solve some of the commercial and contractual pressure associated with the Maui Gas Contract and ancillary arrangements for the sale of Maui gas.

I mentioned in the introduction the recent deals between Contact and Methanex for 130 PJs, and NGC and Genesis for 90 PJs. Both of these deals reduce for the seller contractual and commercial pressure associated with take-or-pay obligations under that parties purchase contracts for Maui gas.

The implementation of these deals reduces some of the pressure on the Maui gas contract that was leading to calls for renegotiation. In particular, financial pressure associated with take-or-pay payments and large prepaid gas entitlements are reduced.

A key matter raised in the past as a driver for renegotiation is the need to send the correct price signals to the market. As noted earlier, gas prices in New Zealand are depressed at a time when exploration and development of new fields needs to be encouraged. This is in large part due to the overhang of Maui prepaid gas entitlements but is also affected by the

relatively low price received by Seller for additional Maui gas. The implementation of large volume deals by Contact and NGC have locked in the low gas prices for the term of the Maui Gas Contract and largely removed the opportunity for renegotiation to address of the contract gas price.

However, the area of pricing for incremental Maui and non-Maui gas is where the decisions on transition will be made, and it is this area that will become the focus of interest. It is this signal where matters of security of supply and deliverability will be ultimately addressed.

The way forward

It is our view that the Maui Gas Contract can be managed through to termination without recourse to extensive litigation and/or renegotiation. To achieve this, attention must be focused on actively managing the Maui Gas Contract by all involved. Solutions to contract tensions must be arrived at by Buyer and Seller not just in response to short-term pressures but with a view to ensuring the transition to new supply arrangements occurs as seamlessly as possible.

These solutions must provide the right pricing signals in order that NZ does not put at risk its security of gas supply over the years of the transition from Maui.

The Crown has a key role to play in actively managing the Maui Gas Contract. The Crown is the contracting party and the contract requires active management. It is important that the Crown has a pro-active approach rather than acting simply as the messenger between the Seller and NGC, Methanex, and Contact. The Crown must have consistent and clearly defined views as to what is in its interest and will assist with NZ's transition to other gas. To do this it must work closely with Seller to see through the Maui Gas Contract in accord with the best interests of NZ.

Author

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