The role of the Crown in the Maui gas contracts

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Abstract

The Crown's role in the Maui gas contracts may be viewed as essentially that of a conduit for gas delivery and payments. The Crown found itself in this role as a result of regulatory concerns regarding competition in the upstream and downstream markets when attempting to exit the gas industry in the early 1990s. While the role of the Crown in the Contracts is fundamentally that of a commercial player, this role is often misunderstood or confused with the Crown's wider public policy roles. The Crown's primary responsibilities in the gas contracts are to meet or enforce its contractual obligations or rights. The role of the Crown is seen by some industry participants as a commercial nonsense, hampering the ability of the other Maui players to contract directly with each other. Given its position, the Crown seeks to manage its contractual responsibilities in a manner that allows for the efficient and effective supply of Maui gas. However, the Crown cannot step outside its contractual framework and needs to operate in a way that minimises risk to taxpayers.

Introduction

Looking at the list of attendees at this conference, you will find a sprinkling of public sector delegates, most of whom fulfil a policy-related function in the industry. It will surprise some to learn that a representative from the Treasury will be addressing the conference from a commercial perspective, as a contractual party to the most consequential agreements in the gas industry - the Maui gas contracts. In this paper I will outline the Crown's role in the contracts, highlight the issues that it faces and, equally as important, touch on the elements that the Crown does not see its role as encompassing.[1]

History

To understand the role of the Crown in Maui today, a history of the Crown's involvement is useful.

The early years

The Maui discovery came in 1969. In order to enable development of the field, in 1973 the Crown purchased a 50% share in the field and entered into a 30 year take-or-pay gas purchase contract with the mining companies. This contract, known as the White Paper, in effect dedicated all of the then estimated recoverable gas reserves to the Crown. In addition, the Crown provided special tax incentives and agreed to fund net capital cost overruns on the project by way of a Post Facto Review process. The Maui White Paper sets out in detail the risk sharing arrangements between the New Zealand taxpayer and the discovering consortium.

In 1979, 10 years after the discovery of the field, the first Maui gas came ashore. The Crown had expected to use most of the gas in meeting anticipated growth in electricity demand and had planned to construct four new major power stations. However, the electricity market did not develop as quickly as forecast and less than half the thermal generating capacity was built. In the early years this lack of demand resulted in the Crown building up, under its take-or-pay obligation, large quantities of gas which it had paid for but not taken.

In 1981 and 1982, in part to utilise its take-or-pay obligations, the Crown entered into agreements to establish a petrochemical industry centred on Taranaki. These included an ammonia-urea plant at Kapuni, a chemical methanol plant at Waitara Valley and a synthetic gasoline plant at Motunui – the latter two involving the Crown as joint venture partners. All plants had passed into private hands by 1990.

What happened around 1990?

A number of factors came together to make 1990 something of a watershed year for the Crown's interest in Maui gas. Initial plans to get out of the business completely were impeded and the Crown had to look to other arrangements.

At the time, the Crown:

- had an (at least implicit) obligation to Mobil to toll about 50 PJs per annum into the Motunui plant until at least 2003;
- had a take or pay agreement for gas to be used by Petralgas that was not back-to-backed with provisions in the Maui

[1] The views expressed in this paper represent those of the Treasury and not necessarily those of the Government.

agreement and therefore did not reflect the intentions of the Crown for undertaking the development;

- was in dispute with the Natural Gas Corporation (NGC) over the take-or-pay conditions and the level of the Crown levy applicable under NGC's Maui contract; and
- was in the process of negotiating a gas contract with Electricity Corporation of New Zealand, and was committed to selling some gas to that company for use in their existing thermal stations.

In 1988, the Crown had reached an agreement with Petrocorp for that company to acquire the Government's contractual obligations under the Maui take-or-pay agreement, the on-sale contracts and the Synfuels venture. The Crown was motivated by a wish to place the risks of production and the related commercial decisions back into the private sector. The Synfuels divestment was seen as the best resolution of the Government's concern over the ongoing losses of the venture. However, in 1989 the Crown was prevented from executing all of its plans by the Commerce Commission which had concerns over Fletcher Challenge's dominance in the upstream and downstream gas markets. As a consequence of this, the Crown had to adopt a second-best strategy.

In 1990 the Crown negotiated contracts with downstream users with the same principal aim of reducing the Crown's petroleum industry exposure. This was achieved by transferring the bulk of the Crown's rights and obligations under the Maui Contract to the actual gas users via a back-to-backing framework. The counterparties were New Zealand Liquid Fuels Investment Limited (for use at the Synfuels plant), Petralgas, NGC and Electricorp (now Methanex, NGC and Contact Energy).[2] The sale of the Crown shareholding in the Synfuels plant, and the completion or amendment of contracts with the Maui gas users, was duly finalised in July 1990.

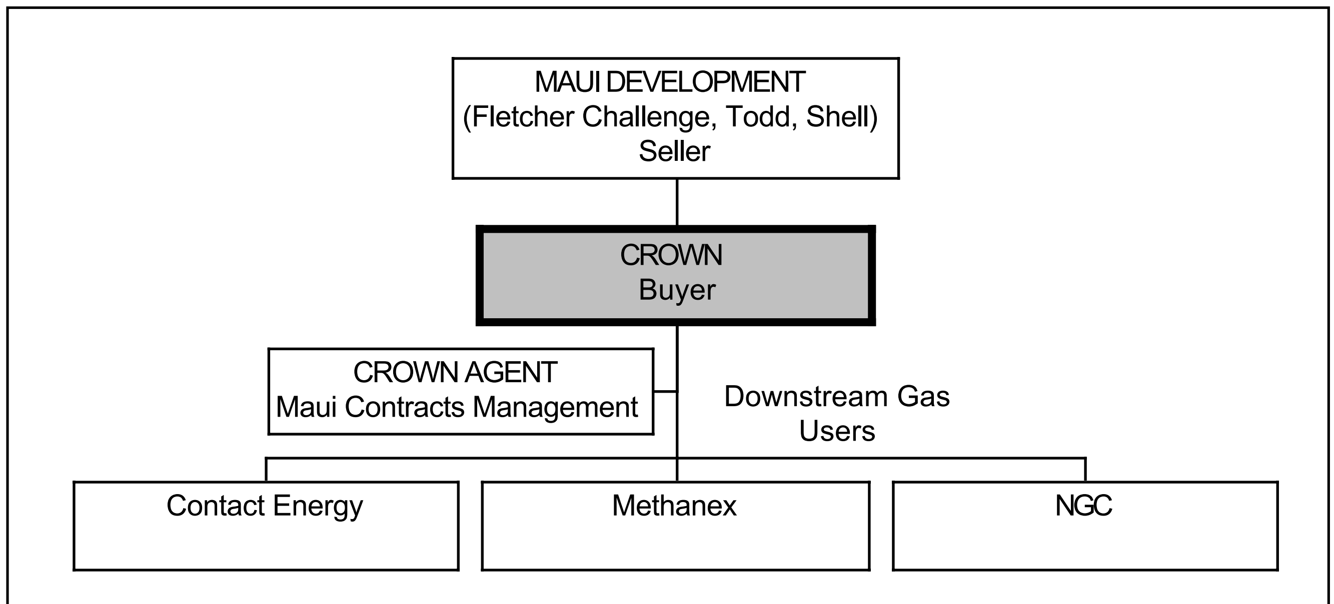
Current position

The new downstream contracts brought about a position for the Crown which is still in place today, after allowing for corporate ownership changes. The situation can be illustrated as follows.

The 1990 contracts were negotiated concurrently in an attempt to ensure that they jointly matched most of the rights and obligations included in the Crown's contract with MDL. The new contracts approximately sum to the Crown's take-or-pay obligation, match rights to gas with actual gas available from the field prior to 2009, and rights to delivery with those available from the infrastructure in place, and so on. An ongoing Memorandum of Understanding, initially agreed between the Crown and Petrocorp, also supports the matching objective of the Crown in respect of the current NGC and Methanex contracts.

Thus in practice, while the individual contracts with the downstream gas users (DGUs) do not appear to precisely offset the Crown's obligations as Buyer, few "mismatch" situations should arise.

Additionally, the Crown continues to have an ongoing trading profit interest in the contract with ECNZ/Contact Energy. While NGC and Methanex paid a lump sum up front for their relative shares of the pre-paid gas asset that had been



[2] With ownership changes the NZLFI and Petralgas contracts are now with Methanex. With the split of ECNZ, the ECNZ contract was surrendered and the Crown entered a new contract with Contact Energy.

accumulated up to 1990, ECNZ opted instead to pay a margin over time. This has resulted in the Crown receiving a margin of about $40 million per annum and retaining a prepaid gas asset. The Crown has the right to access this pre-paid gas balance in the last three years of the Maui contract (2007 to 2009) or in any year in which it has taken its annual contractual quantity.

The Maui gas contracts themselves are complex documents. The White Paper alone consists of over 300 pages and is fruitful territory for those who revel in contractual interpretation – an exercise not helped by the fact that the document was written nearly 30 years ago. Needless to say, the gas industry has progressed significantly in that time. Some provisions in the contracts remain to be tested.

It will be evident that, largely as a result of unavoidable circumstances, the Crown now finds itself caught in the middle between upstream and downstream operators. This is hardly an enviable position for an organisation which has no operational presence in the gas industry.

Relationships and day-to-day management

The Crown seeks to maintain effective working relationships with parties on both sides of the contracting arrangement. This is subject to those parties understanding that the Crown places a high emphasis on not adding to its existing risk profile, at the same time as abiding by the requirements of the contracts. Our position of neutrality in operational matters is one we wish to preserve, albeit at times to the consternation of other parties to the Maui contract.

On the upstream side, the Crown's contractual relationship is with one body, MDL, although this body is in practice made up of three distinct entities. On the downstream side, the Crown contracts with a further three companies. The channels of communication are hence multiple, particularly for the Crown which is regularly obliged to act as the medium between Seller and Users. In general we believe that the working relationships that the Crown has established with both downstream and upstream parties are very positive.

While we are contractually required to take various actions at the request of DGUs either individually or collectively, there is certainly no sense in which the Crown is an advocate for another party. Any actions we are required to take are done so subject to explicit contractual terms and instruction from DGUs. While the interests of DGUs and the Crown may be aligned in some instances, from the Crown's perspective this is a positive coincidence rather than representative of any advocacy role.

The Crown employs an agent - Maui Contracts Management Limited (MCML) based in Wellington - to administer the day-to-day mechanics of the Crown's buying and onselling of gas. The Crown agent is charged, amongst other things, with notifying DGUs requirements, obtaining production statements from Seller, issuing invoices to DGUs, providing accounts to the Crown, dealing with adjustments to ACQs, and generally assisting the Crown.

In many instances, MCML is the first point of contact for Seller and Users on matters relating to the Crown's contractual role in Maui. However, on behalf of the Crown, Treasury manages all issues which are strategic or non-operational in nature. Examples are the Maui Post-Facto Review completed in 1998, claimed incidences of force majeure, and matters relating to contractual interpretation. Material issues are referred to the Minister of Finance for information or decision.

The Crown as a commercial counterparty

The Crown operates under different governance structures compared to private operators due to the more complex workings of government decision-making, less ability to engage in deal-making, and scrutiny from a wider array of stakeholders (ultimately the general public). Despite these differences, a positive feature is that the Crown does have a position of relative neutrality brought about by the establishment of the 1990 contracts. This is not to say that the Crown will allow itself to be cajoled or manipulated, and experience has demonstrated this to be the case.

The Crown's role in the Maui gas contracts is managed by the Asset and Liability Management (ALM) Branch of the Treasury. ALM is not a regulatory agency but a manager. Its interest is in the efficient and commercial management of the Crown's assets and liabilities. In this case, it is not a regulator of the gas industry, nor does it wear this mantle by virtue of its involvement in the gas contracts, but rather it deals with ownership and risk minimisation issues in the contracts.

When gas industry participants comment on the role of the Crown in the Maui contracts, there is sometimes an underlying implication that the Crown should use its position to achieve various policy goals. However, the Crown gave away this flexibility in the 1990 contracts in favour of securing profits and minimising its commercial exposures under the contracts. It does not consider it appropriate to act in any way other than commercially in its current position, wanting to secure its remaining net profit streams and minimising any upstream or downstream contractual risks.

In any case, ownership of contracts is generally an inappropriate place to seek regulation. Should the Government wish to pursue energy policy options, this will normally be completed through the various regulatory functions of other departments or agencies, for example the Ministry of Economic Development. These agencies operate separately from ALM's commercial focus. Nevertheless, the Crown's role in the contracts ultimately relies on the decisions of Ministers of the Crown, generally the Minister of Finance.

Recent discussions relating to contingency planning provide an example of how players in the industry sometimes mix the Crown's commercial and broader policy roles. Affected

parties were attempting to agree on a procedure in the event of an outage of the Maui field. As noted above, the role of the Crown in the contracts is simply to facilitate discussions between the upstream and downstream contractual participants, while protecting its own commercial interests. Nevertheless, at times it appeared some parties believed the Crown should break deadlocks on account of the political effect on the Government of a contingency occurring without a workable shutdown plan in place. The Crown resisted this pressure, preferring instead to distinguish between its dual roles wherever possible.

The future

As mentioned, as a commercial player in the contracts the Crown is very risk averse. I would suggest this stance is understandable. It reflects the fact that risk-taking activities are better handled by companies which are immersed in the industry and hence in a better position to evaluate risks and outcomes. I would be amongst the first to recognise that the Crown's role in Maui is a slightly artificial one. Nevertheless, given the situation, we do our best to ensure that the supply of gas is as efficient as possible.

At the last conference in 1998, Martin Trachsel from Shell Petroleum Mining presented a paper entitled "The Maui Gas Contract – Benefit or Burden? A Seller's Perspective". In that paper, Mr Trachsel suggested that the Maui contracts should be renegotiated to remove the Crown and allow the upstream and downstream parties to enter into a direct contractual relationship. In this way, market distortion would be reduced and overall value enhanced. The Crown has not given any detailed consideration to possible mechanisms for exit. Nevertheless, I would like to take this opportunity to address the issue as some of the comments that were made in that paper remain very relevant today.

I have noted that the role of the Crown in the contracts was brought about as a result of Fletcher Challenge's dominance in the upstream and downstream markets. This dominance had been reduced by Fletcher's sale of Petrocorp and its interest in NGC, but residual competition concerns may be raised.

While not wanting to pour cold water on the concept of renegotiating the contracts, perhaps it is not surprising that any progress on this matter has failed to eventuate. The renegotiation of the contracts would require the agreement of the three upstream and three downstream companies as well as the Crown. Such agreement would not only be to the concept of removing the Crown, but also to the exact terms and conditions of the new contracts. Should one of the seven parties not agree to the concept or even an individual condition of a new contract, the Crown would remain in the relationship.

It has been suggested that Seller would attempt to seek further value from the contracts with a higher gas price should a renegotiation occur. While the Users may well be prepared to balance price verses supply obligations, we envisage difficult negotiations would precede acceptance of any significant increase in price.

The Crown has no current plans to exit the contracts. If Seller and/or Users were to put a proposal to the Crown, some of the issues the Crown would have to consider (general policy considerations aside) are:

- the extent to which the Crown would obtain full consideration for the value it holds via the contracts;
- whether the proposal left the Crown with any residual liabilities or contractual connections; and
- whether the negotiation process could be conducted at moderate cost and without being unduly resource consuming.

It remains to be seen whether Users and Seller will identify sufficient mutual benefits and determine to pursue a goal of Crown exit in the months ahead.

Author

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