

Problems Arising from the Resale of Maui Gas

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Abstract

The paper follows an earlier paper by the author "*The Legal Aspects of Gas Trading*", 1994 New Zealand Petroleum Conference Proceedings, which identified the legal aspects of trading in Maui and other gas. One aspect was the extent to which the contract for resale of (Maui) gas is to be back to back with the reseller's gas purchase contract.

The paper identifies the problems which may arise from the resale of Maui gas in this context by undertaking a risk analysis from the perspective of the reseller (Contact Energy Limited, Methanex New Zealand Limited or Natural Gas Corporation (NGC)) and the buyer (say an electricity utility, cogeneration venture or a gas utility) and finds that the risks associated with reserves and the market for Maui gas and the need to allocate those risks (and the extent to which it can be done by back to back contracts) show that there is a prospect of inefficient investment decision-making resulting in a misallocation of resources and/or high transaction costs. While the optimum solution would be a renegotiation of some aspects of the Maui Gas Sale and Purchase Contract and the contracts by the Crown for resale of Maui gas to Contact Energy, Methanex and NGC, one can see that this has its own problems.

Introduction

My paper, "*Legal Aspects of Gas Trading*", 1994 New Zealand Petroleum Conference Proceedings, considered the legal aspects of gas trading in the context of the Ministry of Commerce report "*An Energy Baseline Forecast to 2020*" which focused on the future interactions of energy demand and the energy supply that meets it and presented a forecast of energy use patterns. This report addressed the concern as to the depletion of New Zealand's then currently known gas reserves and assumed:

"That the major gas users will trade their rights to marginal quantities of gas as the country's reserves approach depletion ... remaining gas supplies would be directed to the highest value end users, since the purchase of gas by a relatively high user of gas from a low value user is in the commercial interests of both parties ..."

In this context, one of the legal aspects of gas trading identified by the paper was that a contract for the resale of gas was likely to be appropriate in most circumstances (as opposed to an assignment of contractual rights to purchase) and, therefore, the parties would inevitably have to address the extent to which the contract for resale of gas should be back to back with the vendor's gas purchase contract.

This holds good today. While this paper focuses on the problems arising from the resale of Maui gas it will be seen that they are confronted when one considers the extent to which the contract for resale of gas is to be back to back with the reseller's contract to acquire Maui Gas from the Crown.

The scheme of the paper is as follows:

- The contractual environment in which a resale of Maui gas takes place is briefly summarised;
- A risk analysis from the perspective of those who purchase Maui gas from the Crown and then resell (Contact Energy, Methanex and NGC) and the buyer (an electricity utility, cogeneration venture or a gas utility) is undertaken to identify potential problems; and
- Possible solutions to the potential problems are identified and their viability discussed.

Contractual Environment

Currently, there are two major sources of gas production in New Zealand; the onshore Kapuni Field and the offshore Maui Field. The Maui Field accounts for approximately 76% of New Zealand's annual gas production and Kapuni approximately 20%. Other fields currently in production are McKee, Kaimiro, Waihapa and Ngaere.

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 collectively the "Maui Mining Companies"). 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) for the generation of electricity by thermal power stations, the Methanex Group (Methanex) for use in petrochemical plants, and to the Natural Gas Corporation (NGC) for use in the domestic reticulation market.

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 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.

The Kapuni Field is owned by Shell (Petroleum Mining) Company Limited ("Shell") and Todd Petroleum Mining Company Limited ("Todd"). The Kapuni Gas Purchase Contract, originally between Shell and Todd Consortium and NGC, was transferred by NGC to Kapuni Gas Contracts Limited (a subsidiary of Fletcher Challenge) in 1991. It requires the buyer to take or pay an annual quantity of gas and reserves to the buyer, subject to renegotiation of terms, the entire gas production of the field. The contract provides that, after 1995, the price for some of the gas in the annual quantities to be taken by the buyer shall be those agreed. The contract provides an arbitration mechanism to resolve the differences between buyer and seller, including differences as to price and annual quantities. As a consequence of the High Court decision these provisions have in effect been upheld except that the dedication clause was held to be contrary to Section 27, Commerce Act 1986, and by way of remedy the Court ordered that after 1 April 1997 the output of the field had to be divided equally: *Shell and Todd v Kapuni Gas Contracts Limited and NGC* (C.L. 5/94, Auckland Registry, High Court, 3 February 1997). In turn, Kapuni Gas Contracts Limited onells the gas to Methanex, Bay of Plenty Limited and NGC. In arrangements made with Kapuni Gas Contracts Limited, NGC has obtained rights as first purchaser (other than the petrochemical plants) of Kapuni Gas after Kapuni Gas Contracts has met supply obligations to the petrochemical users. The gas onsold to NGC is resold by NGC to gas utilities which distribute and retail gas in the North Island and of the new Southdown electricity power station as a feedstock for electricity generation.

Given the contractual environment, it is important to outline the terminology which is adopted in the remainder of this paper:

- 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 contracts to acquire Maui gas from the Crown and potential resellers of Maui gas, are called "resellers";
- Where this paper refers to a or the "reseller", it refers to any one of Contact, Methanex and 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 Crown's 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 resellers.

The Problems

What then are the potential problems arising from the resale of Maui gas by a reseller?

Like any other contract, a contract for the resale of Maui gas by a reseller will be a vehicle for the allocation of the risks which are inherent in the transaction. It follows that analysis of the risks inherent in the transaction and how they might best be allocated will identify potential problems arising from the transaction.

The sale and purchase of gas is subject to risks which include the following:

- The reserves risk - will the recoverable reserves of gas to which the seller has access be such so as to deliver the contract quantities?
- The production and transport risk - will the gas production and gas transmission facilities operate so as to deliver gas from its source to the point of delivery as and when contemplated?
- The processing risk - will the buyer's processing plant (or petrochemical, electricity generation or manufacturing plant) operate so as to process (refine, generate or manufacture) the end product to be marketed?
- The market risk - what will be the future demand for the buyer's end product? Will the buyer's demand for Maui gas be sustainable over the contemplated term of the contract so that Maui gas is taken as and when contemplated and cash flows from the buyer to the reseller accordingly? What will be the future supply of natural gas and what will be the other competing demands for Maui gas over the contemplated term of the contract?
- The credit risk - has the reseller the resources to maintain its access to Maui gas? Has the buyer the resources to undertake its processing (refining, generating or manufacturing) and, if necessary, meet any take or pay obligations.

A contract for the resale of Maui gas by a reseller will allocate these risks; the objective being that they be allocated to the party best able to manage the risk and in a manner which promotes the efficient management of that risk by that party.

While an analysis of all these risks is of interest, this paper simply addresses the reserves and market risks.

As between the MMCs and the Crown, the risk of a shortfall in the reserves of the Maui Field 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 6.1.1 and 6.1.2;
- The reserves are to be redetermined at two yearly intervals which either party may procure by notice to the other: Article 6.1.1; and
- In the event of a shortfall in the reserves, the contract quantities and, therefore, the take or pay, are reduced accordingly: Article 8.8.

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 and its take or pay liability is reduced commensurate with the contract quantities.

The contracts for the resale of Maui gas by the Crown to the resellers allocate the risk as between the Crown and the resellers in the same manner. For example:

- A reseller can require the Crown to exercise its rights under Article 6.1.2 to request information as to the reserves in the Maui Field: Clause 6.4.
- A reseller can require the Crown to obtain a redetermination of the reserves under Article 6.1: see Clause 6.6.2.
- In the event of a shortfall in the reserves as determined by the Maui Gas Contract, there is a reduction in the contract quantities provided for by the resale contract: see Clause 8.8.

Before embarking on the resale of Maui gas (say, to a utility wishing to construct its own thermal power station, an industrial concern establishing a cogeneration plant or a gas utility for local retail and distribution), one would expect a prudent reseller to maximise its information as to the reserves of the Maui Field and to ensure that the reserves have been redetermined in accordance with the Maui Gas Contract within the preceding two years. After all, surely the buyer of Maui gas (the electricity utility, the cogeneration venture or the gas utility) will take the position that the reseller is the best person to manage the reserves risk (it having the interface with the MMCs via the Crown and the other resellers, and it being able to do so most efficiently by being able to manage its rights against the Crown). Therefore, the buyer will say that the reseller must accept the risk in terms of firm supply and liability for failure to deliver over the term of the resale contract.

Is there a problem here?

There is, if the MMCs have an incentive to:

- Minimise the extent of reserves information given to a reseller; and/or
- Delay any redetermination of the reserves pursuant to the Maui Gas Contract which might adjust the current contract quantities.

There is also a problem if the resellers are subject to different incentives and cannot act in a united manner.

Whether the MMCs have (or will have) such an incentive turns on the dynamics of the market. On one hand, one could argue that as the MMCs face a declining price for Maui gas in real terms (see Articles 9.1.1 and 18.1.5), they have an incentive to minimise the information as to reserves so as to promote uncertainty as to the reserves which, in turn, increases the demand for gas and incentivises early and maximum use of Maui gas and, hence, early and maximum cash flow to the MMCs, and an increase in the value of any other gas reserves which the MMCs may have. On the other hand, one could argue that early disclosure of reserves information and regular redeterminations of the reserves under the Maui Gas Contract provides certainty to resellers which creates a climate of confidence and, therefore, optimum (early and maximum) resales which also maximises the cash flow to the MMCs.

However, assume for the moment that the MMCs have an incentive as first described above.

Do the MMCs have an opportunity to respond to this incentive? The MMCs have. For example:

- If a reseller requires the Crown to request the MMCs for information as to reserves under Article 6.1.2, MMCs can take a robust position on what is a reasonable time by which the information is to be provided. The Crown must use its best endeavours to ensure compliance (Clause 17.1.1) and if such involves the commencement of proceedings (eg for a declaration as to what is reasonable time) a reseller may take an assignment of the proceedings and pursue them accordingly (Clause 17.1.2(c));
- The MMCs may not call for a redetermination of the reserves as provided by Article 6.1.1, whereupon a reseller must require the Crown to do so. The Crown must consult with all the resellers and in the event of delay tactics by MMCs, the Crown must again use best endeavours. Again, if proceedings are required, a reseller may take an assignment of them.
- If the MMCs do not have the incentive as first described above, or it is in their own interests to secure a redetermination of reserves, a reseller may be held hostage by the other resellers who have different incentives. For example:
 - If a reseller has requested the Crown to redetermine the reserves by agreement (as contemplated by Article 6.1.1), the Crown can only do so with the consent of all resellers who have a right to purchase 85% or more of the Crown's entitlement to Maui gas: Clause 6.7.1. In effect, therefore, any one reseller must ensure that the Crown gets the consent of the other two resellers. Given that the current resellers have different uses for Maui Gas (electricity generation and for resale, petrochemical production and reticulation), this may prove difficult and require its own negotiation and transaction costs;
 - If the reserves must be determined by an independent expert, then a complicated and cumbersome procedure (whereby all the resellers must endeavour to agree upon a hearing agreement so as to present a united front before the independent expert) must be undertaken (Clause 6.8).

Naturally, the enforcement by the reseller of its rights under its contract for resale of Maui gas by the Crown to require the Crown to enforce its rights against MMCs under the Maui Gas Contract and/or the need to negotiate with and obtain the agreement of the other resellers, will involve delay and transaction costs.

Consequently, given certain dynamics in the market for gas, a reseller may well face the problem of having to either resell Maui gas with incomplete information as to reserves and be forced to accept an allocation of the reserves risk accordingly, or, delay a resale of Maui gas until it has obtained complete reserves information and has established a current redetermination of the reserves and an adjustment to the contractual entitlements.

Under the Maui Gas Contract, the market risk is allocated to the Crown. For example, while the Crown has an entitlement to purchase a daily quantity per day, if the Crown does not take the equivalent contract quantity for the year, it must pay for the same (subject to various adjustments for the Maui Mining Companies' inability to deliver by reason of force majeure and the Crown's inability to take delivery by reason of force majeure and the like): see Clause 9.2.2. This is, of course, a traditional position for long term take or pay contracts which are prevalent in the gas sector throughout the world and the economic and commercial basis for them is well established.

Long term take or pay contracts have the benefit of providing long term security supply (eg to base load gas purchasers such as power companies and natural gas distribution and retail companies) which, in turn, enables either remote or offshore gas reserves to be developed and transmitted to markets. This benefit is illustrated by the Maui Gas Contract. The Crown obtained a long term supply of natural gas from the Maui Field for reticulation and as a feedstock for the generation of electricity. In turn, the Crown's take or pay obligation to the MMCs provided a secure revenue stream enabling the MMCs to develop the Maui Field.

Long term take or pay contracts have the weakness of not always accommodating the unpredictable variables of the gas market. Natural gas is resold as a fuel or feedstock to end users who often have a range of options, including variation of demand dependant on the economy, increased conservation and periods of rising prices and alternative fuel choices. This weakness is also illustrated by the Maui Gas Contract. When the contract was entered into in 1973, the Crown's intention was to use the gas for reticulation and generation of electricity. By 1978, it was apparent (in the wake of increased oil prices commencing in 1973) that natural gas was too valuable a resource to be used as a power station fuel, and there was a surplus of generating capacity which required the Government to shelf plans for gas fired power stations. This led to the Government exploring alternative uses for Maui gas which mitigated the Crown's "take or pay" commitment and, finally, a decision to use a significant portion of Maui gas for petrochemical production.

In 1989 and 1990, it was apparent that all was not well with the Government's decision. In July 1990 the Government finally managed to put together an acceptable deal to sell its petrochemical interests (it in fact paid Fletcher Challenge \$171.8 million to take the interests off its hands) reselling Maui gas to ECNZ (for electricity generation), to Fletcher Challenge (for petrochemical production) and NGC (for reticulation) under the existing resale contracts.

Is there a problem here (in relation to the allocation of the market risk)?

There is when one considers the market risk from the perspective of both the reseller and buyer (the electricity utility, cogeneration venturer or gas utility). For example:

- The buyer and the reseller face an uncertain market for gas. It is quite different from that faced by the resellers in 1990 (when the contracts for resale of Maui gas were entered into). For example:
 1. the gas market has been deregulated by virtue of the Gas Act 1992;
 2. there are other reserves of gas (held by the MMCs in other capacities in other fields);
 3. the electricity market has been deregulated by virtue of the Electricity Act 1992; and
 4. the electricity generation market is competitive with the ECNZ/Contact split (and there is a prospect of a further split), independent power producers have (and can) enter into the market, and this is facilitated by the establishment of the NZEM (the New Zealand Electricity Market);
- The reseller also faces a take or pay liability to the Crown under the contract for the resale of Maui Gas by the Crown. It will be in the reseller's interest to pass on a proportionate liability to the buyer;
- However, as noted, the buyer is likely to face an uncertain market and will be reluctant to accept the market risk associated with any take or pay liability. Given the reseller's demand for cash flow to meet its already existing take or pay obligation to the Crown, it may be that the reseller will be forced to either take the residual risk or seek relief from the Crown and the MCCs.

The Solutions

As foreshadowed above, one solution to both problems addressed in this paper would be a renegotiation of the Maui Gas Contract and the resale contracts between the Crown and the resellers. This has its own problems:

- The interested parties (the MMCs, the Crown, the resellers and those to whom they resell Maui gas) are diverse and have different incentives (even at the same functional level, for example, different incentives as between the MMCs, the resellers and the end purchasers of Maui gas) making an early negotiated outcome difficult;
- To the extent that there has to be understandings between the parties (at the same functional level) to obtain resolution (for example, as to a Maui gas price and/or take or pay liability), Section 27, Commerce Act 1986 (which strikes down anticompetitive contracts, arrangements or understandings) is likely to be impediment.

This solution seems unlikely.

Other alternatives could be:

- For a reseller to:
 1. enforce the Crown's obligations to exercise its rights under the Maui Gas Contract to obtain reserves information and the Crown's best endeavours obligation to obtain compliance;
 2. require the Crown to obtain a redetermination of the Maui reserves under the Maui Gas Contract and obtain (if need be, for value) the consent of the other resellers; and
 3. as a last resort, for a reseller to renege on its take or pay obligations to the Crown. However, this would seem most impracticable for Contact (given that it is owned by the Crown) and impracticable for Methanex or NGC unless it had a bona fide argument as to the legality of the take or pay.

These alternatives come with the disadvantages of delay, high transaction costs and uncertainty as to the outcomes;

- For the Crown to amend the Gas (Information Disclosure) Regulations 1997 to require disclosure of gas reserves. This, however, this would address only part of the first problem (as an aside, one might note that the Crown can obtain information as to the Maui reserves under the Gas (Statistics) Regulations 1997 "... as the Secretary [of Commerce] requires for statistical purposes": see Regulation 5).

The conclusion must be that the resale of Maui gas may well involve an allocation of risks which results in inefficient investment decision-making and a misallocation of resources and/or high transaction costs.

Author

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