

Maui - a Base Load Buyers Perspective

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Abstract

The commercial terms of the Maui Contract have historically had a reasonable fit to Methanex's desired contract profile. Why then does this contract cause so much agony? Why do we spend hundreds of thousands of dollars in time and resources each year dealing with issues from this contract?

The answers lie in the legal and administrative complexities of the contracts and the relationships and motivations of the parties involved with the sale and purchase of the gas.

Introduction

Methanex Corporation is the global leader in methanol production and marketing. In 1997 we marketed approximately 7 million tonnes of methanol and have production facilities in New Zealand, Chile and North America. To meet our customers delivery needs we operate our own shipping company with 13 dedicated ships under time charter. Methanol, typically produced from natural gas, is a basic chemical building block used in the production of formaldehyde, methyl-tertiary-butylether (MTBE), acetic acid and a variety of other chemical intermediaries. These derivatives are ultimately used in the manufacture of a wide variety of products that we find in our everyday lives, including: adhesives, paints, inks, urethane and MDI foams, gasoline additives, silicones, PET plastic, polyester, solvents, spandex, and windshield washer fluid. Methanol is also used directly as a fuel. The methanol industry is characterised by volatile pricing due to rapidly changing supply and demand balances.

Methanol is a commodity chemical and is only differentiable in the market place by the service provided by the supplier. Guaranteed on time and on specification delivery to the customer where ever they may be in the globe is how Methanex continues to be the leader in this industry. Low costs are important to the success of any business, but they are critical in a commodity industry such as methanol. The key for the continued success of the company is then its control of costs. There are three categories of cost in the production and marketing of methanol. These are Logistics, Operations and Feed Stock. Maui gas provides the feed stock for our New Zealand operation and the Maui Contract documents the details of the supply and purchase of that gas.

With a global organisation we have developed a preferred contract profile for the delivery of natural gas to our production facilities. This paper examines this preferred profile and compares the Maui Contract as it directly concerns Methanex.

Commercial Terms

In commercial terms the contract defines the quantity of gas, the quality of gas and the price of the gas. For a base load user these three areas provide certainty for the feed stock costs of the production facility and provide the key to the decision to invest in a new production facility and/or maintain the operation of existing production facilities. To invest US\$1 billion precisely defined quantity and quality are needed.

Quantity

The contract quantity is defined by Total Contract Quantity (TCQ), Annual Contract Quantity (ACQ), Maximum Daily Quantity (MDQ), term and reserves dedication. For Methanex a dedicated TCQ of gas based on proven reserves over a term of 25 years with upside flexibility subject to additional proven reserves is preferred. The ACQ is a function of TCQ and the term. The MDQ is the seller's obligation to supply on any single day and is preferred by Methanex in a base load plant to be 115% of the ACQ expressed on a daily basis. Best endeavours are requested to exceed the quantity terms if requested by Methanex.

The Maui Contract details the term (30 years) in Article 3, the quantity of gas, ACQs and MDQs (150% of ACQ expressed on a daily basis) are tabulated in Article 8, and methodologies for upside flexibility are provided in the relevant articles along with methodologies for dispute resolution.

Quality

The quality of the gas provided is defined by a specification which provides the user with a guarantee of gas composition. Plant design, capital investment, product quality, maintenance expense and operating efficiency can all be affected by changes in the gas specification. Early agreement of the range of composition will determine the viability of the project. Early knowledge of changes to delivery compositions will ensure the safety of the plant and personnel and ensure the product is produced as required. The chemical industry is characterised by an abundance of catalytic processes and unfortunately the catalyst used are usually sensitive to contamination. The methanol process is no exception and a very defined specification is a requirement of any gas supply which Methanex will contract for. Methanex will entertain a Reasonable Endeavours obligation to process out of specification feed stock.

The Maui Contract gas quality provisions as detailed in Article 7 and Annex B provide a definitive specification and document procedures to be used should there be a variation. The Methanex New Zealand plant was designed in accordance with these specifications and its reliability of operation is enhanced by the consistency of supply composition.

Price and Payment

The gas price and the cash flow provisions of a gas contract need to provide certainty for a base load buyer over the economic life of the project. The history of methanol pricing is very volatile and cyclic with the average trend being stable over the long term. The floor price has tended to be limited to the incremental cash costs of delivering methanol to the market place and has three key components, Logistics, Operations and Feed Stock. Methanex has an aggressive drive to reduce the delivered cash cost of its product to a level that will ensure the company's survival at the lowest point in the price cycle and the price it pays for its gas is key in this drive. Methanex prefers a fixed price with no escalation which enables it to calculate future cash costs with certainty. We do entertain discussion of methanol price linked pricing but this must be over the whole range of methanol pricing, thus sharing the revenue risks over the complete methanol price cycle. For the seller, gas field developer Take Or Pay (TOP) provisions provide certainty of cash flow into the future. Methanex is very willing to accept TOP provisions as our plants operate at or above name plate capacity with an on stream availability of 96+% inclusive of statutory and process turn around requirements. An ability to gain relief from TOP for Force Majeure incidents is a requirement of any contract and some level of production flexibility is necessary to satisfy marketing requirements.

The Maui Contract defines the pricing and cash flow provisions for the supply of Maui gas to the Buyer in Article 9. The price that Methanex pays under the Maui Contract results in Methanex being the highest cost producer of methanol delivered into Japan, our most important Asian market. This is not a sustainable long term position. The escalation provisions are tolerable when there is low inflation but are dependent on the Government maintaining control of the inflation within New Zealand. One further issue is that the gas is priced in \$NZ whereas methanol is always priced in \$US. \$US gas pricing would be an optimal result for the company.

Conclusion

From the foregoing discussion it can be easily seen that, other than the pricing provisions, the Maui Contract has a reasonable fit to the Methanex preferred contract profile. Then why does this contract cause us so much agony? Why do we spend hundreds of thousands of dollars in time and resources each year dealing with issues arising from this contract? The answers lie in the legal and administrative complexities of the contracts and the relationships and motivations of the parties involved with the sale and purchase of the gas.

Lawyers, Administrators, Buyer, Seller and Users

Contracts are documents that attempt to put on to paper an agreement that has been arrived at by negotiation which is by its nature a confrontational process where the combatants have done their best to arrive at a win solution for themselves and their companies usually with a feeling that the other side has lost. This process has been going on for all time where the fittest shall survive. History tells us that win/win solutions yield the best results in the long term and modern pundits are attempting to change this process to one where there is a mutual win/win approach but I think we are fighting against nature and the propensity to concentrate on the short term.

Contracts being written documents are also blessed with the complications of the English language where what I say or write isn't really what I mean and by the time the lawyers both real and bush have finished, we have a mammoth volume that attempts to provide a solution for every eventuality. Being that we are human beings we now consider this a challenge and set about finding ways to defeat the document to create value usually at the expense of the other parties particularly where the individuals involved change.

The Maui Contract was signed on 1 October 1973 with the first gas supply scheduled for 1 October 1978. Over the past 25 years New Zealand has undergone considerable change and it is fair to say that the drivers of the parties are no longer the same as they were, at least this can be maintained on the buyers side. In 1990, to further cloud the contractual position, the Crown disposed of its Petrocorp assets and gas sales contracts were completed between the buyer and the gas users. Originally this process was meant to be an assignment of the buyer to Petrocorp. The contracts were ultimately written on the basis of a Memorandum of Understanding (MOU) and were intended to be back-to-back documents with the Maui Contract. Not all parties signed on to the MOU and hence there are differences within the resulting contracts.

Administration

The MOU had objectives to match the entitlements and liabilities of the purchasers of Maui gas to those of the Crown and to minimise the level of management required by the Crown to manage the Maui Gas Contract. The differences that ensued in the downstream contracts have required that the Crown undertakes a higher level of management than intended by the parties the MOU. In my view this has led to a complex administration process compromising the efficient operation of the gas supply system and involving non-value adding middlepeople. An example is the "notifications" process.

Any notifications process is an operational tool that allows the gas supplier to ensure that the gas users have the gas they require when they require it within the constraints of the system. It is a flow of information from the gas user to the gas seller and vice versa and in an ideal world should follow the flow of gas as each section of the gas transmission process completes its task (Figure 1). Administratively and in accordance with quality systems and the contracts this can be documented to meet all the contractual requirements. Prior to late 1995 the Maui gas system operated successfully in this manner, all be it without the quality documentation system.

Subsequent to the foundation of Contact and as a result of the games being played in the energy area in the name of competition, parties to the Maui contracts have been in discussion for 18 months regarding a "notifications" system, such discussions having been governed by the absolute wording of the contracts rather than the practicality of operating the system. The resulting process (Figure 2) is cumbersome and impractical and will be unable to respond operationally to the business of operating a gas supply system when it really needs to.

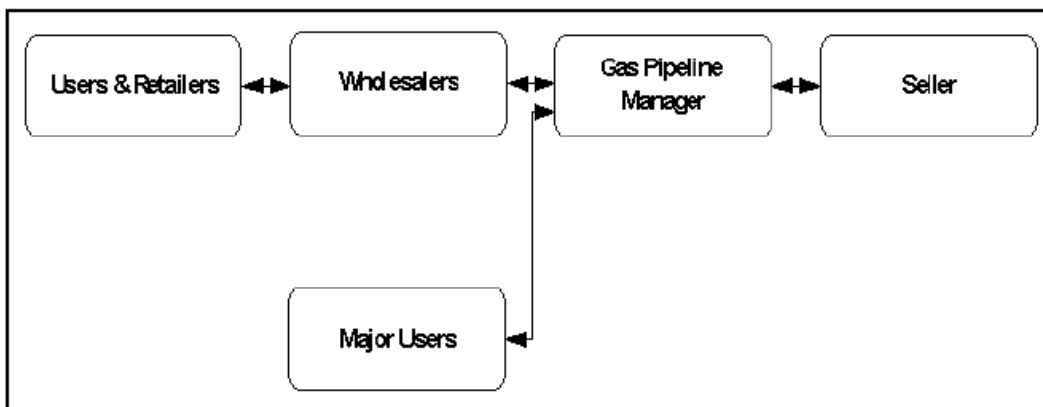


Figure 1. Operational notification flow sheet.

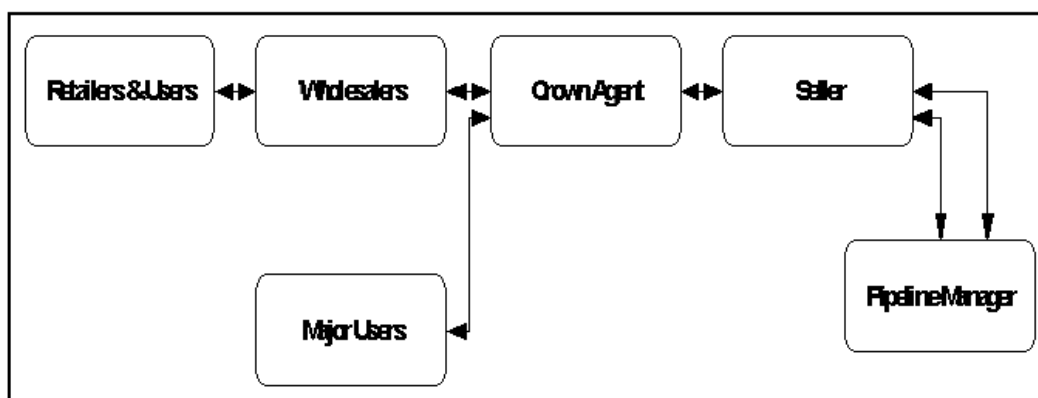


Figure 2. "Contract" notification process.

The inclusion of the Crown Agent adds no value to the operation of the system, the order of the seller and pipeline manager will create delays and the timing of information flow will be longer and cause untenable obstructions when needed most. Poor use of resources has created double handling and pass through type operations which add no value.

Relationships

With the passing of the years, what was a contract involving five parties (Figure 3) has changed with sale and purchase and privatisation to be a complex relationship tangle (Figure 4).

Add to this the tangled relations of some parties in the only other significant proved gas reserve in New Zealand and it is not surprising that what might have been viewed as a win/win solution back in 1973 is now viewed as a win/lose contract and those who perceive that they are losers are setting about extracting their pound of flesh at the expense of the other parties. In this environment information is king and secrecy is jealously guarded with onerous confidentiality agreements where lawyers take over and common sense flies out the window. A simple request for Maui reserve information took 12 months to be completed and then under such a restricted scope and under such difficult conditions that the requesters are left to wonder at what is being hidden, what is the hidden agenda of the sellers and what do they hope to gain.

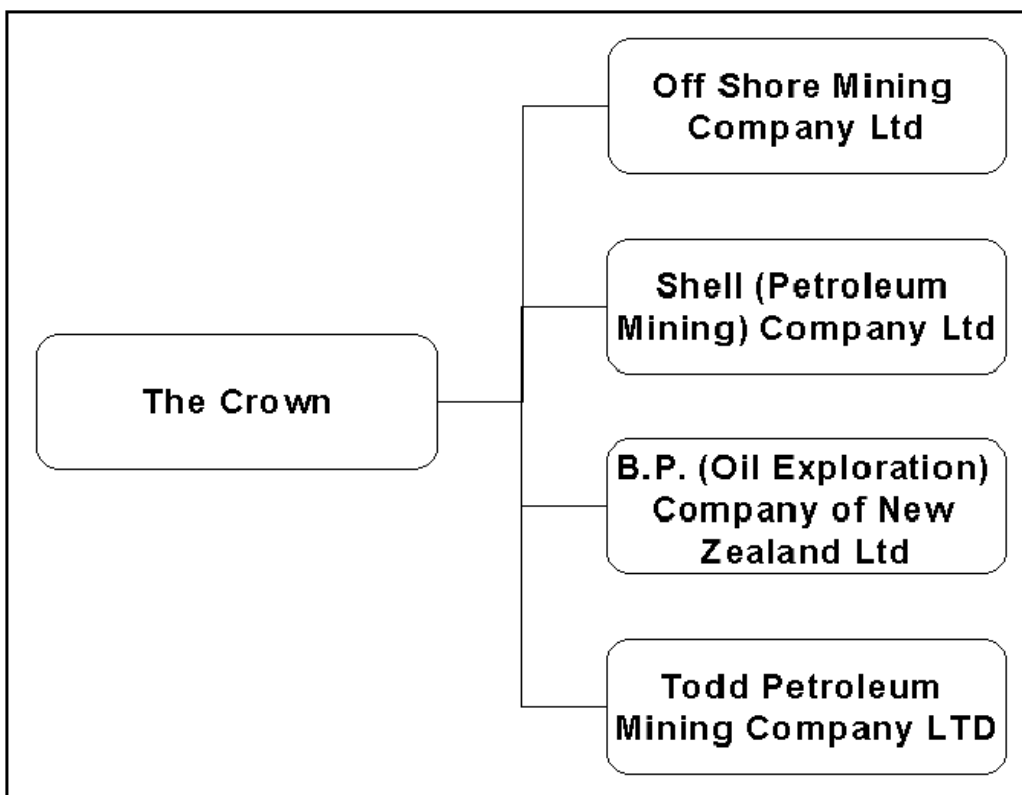


Figure 3. Original Maui Contract parties.

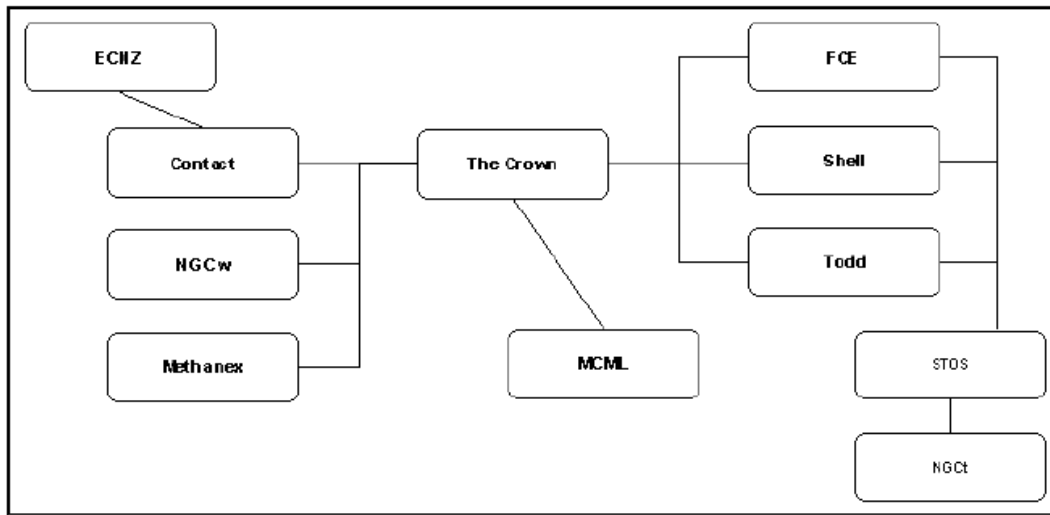


Figure 4. Current Maui Contract parties.

A Final Thought

From a base load users perspective the Contract is a workable document if common business sense is applied and the parties wish to work together. If the relationship between the parties is at all strained, the drafting of any contract will provide an opportunity for the offended party to begin to interpret the contract in other than the intended ways in order to gain value at the expense of the others. There appears to be a drive by some to create an impression that the Contract is not adequate for the purpose, particularly as the parties have changed and there may be a perception that the gas has a greater value. Methanex would gladly renegotiate the gas supply contract if it were to lead to our utilisation of our New Zealand assets economically for a longer period than is currently contracted for. We are well aware that with only around five years remaining in our contracts now is the right time to take the hard decisions if they are needed. We understand that other gas users can pay more for their gas and must be ahead of Methanex for sales contracts. The New Zealand gas market is small and for a supplier to monetise their field Methanex is the only discretionary gas purchaser.

Any renegotiation of the Maui Contract will need to recognise that to remain viable, the New Zealand methanol plants must be cost competitive with producers in other countries. Methanex has a strong desire to maintain a world scale operation in New Zealand however, at the end of the day, international cost competitiveness is a fundamental requirement.

Author

Russell Williams is a Business Development Executive for Methanex New Zealand Limited working from their Auckland Office. He is involved in exploring new opportunities for the global Methanex business inclusive of investigating new production hub locations, negotiations for gas contracts and investigating market development opportunities for methanol. He is a member of the team that manages the gas supply contracts in New Zealand. Russell is a Chemical and Materials Engineering Graduate of Auckland University and has 18 years experience in the hydrocarbon processing industry. He joined Methanex in 1983 when it was then New Zealand Synthetic Fuels, from Sasol in South Africa, and has held a number of positions in the manufacturing side of the business in both New Zealand and Canada. His last role before taking up his present position was as a Project Manager in Market Development in Vancouver.