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Crown Minerals

The New Zealand Gas Industry Legal and Commercial Highlights of 1996 and 1997 "Competition Emerges"

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at the 1998 New Zealand Petroleum Conference

Abstract

Since 1996 the New Zealand gas market has undergone a number of significant changes as a result of the resolution or settlement of litigation affecting key industry players, the emergence of new participants who have access to sufficient gas and sufficient capital to have a real influence on market conditions and the promulgation of a regulatory regime relating to gas transmission activities.

The result is that the contractual framework that was presented at the 1996 conference is now different in a number of key areas and is continuing to change. These changes suggest that robust competition is now a reality for all the major participants but less so for retail customers.

The paper will describe the key commercial and legal events that have occurred in the New Zealand gas market over the last two years. The paper will thus discuss:

- The role of Contact Energy Limited and one of its two core business activities, gas marketing and trading.
- The settlement of the Natural Gas Corporation (NGC)/Enerco New Zealand litigation and Enerco's emergence as a significant purchaser of gas.
- The resolution of the Kapuni litigation and entry into the gas market of Shell and Todd as gas wholesalers.
- The unbundling of transmission arrangements and the effect of the Gas (Information Disclosure) Regulations.
- The increased trading of gas entitlements.

The paper will conclude with some observations and a prognosis about the likely future pattern of activity.

Introduction

In March 1996 the writer presented a paper to the New Zealand Petroleum Conference entitled "Gas - An Overview of the Legal Framework".

My aim in this paper is to update the position so as to give you a perspective of the structural elements of the gas market and the various transactions that have rung the changes.

I should also add that this paper is mainly concerned with gas contracts. Oil production is usually the major commercial objective of most explorers. However, leaving aside the start of oil production from Maui, an event which was the subject of much discussion at the last conference, and the increased levels of exploration activity, there has been little of financial significance to occur in the upstream oil industry in New Zealand over the last two years. However, all New Zealand's fields produce gas in association with liquids production and it is frequently the case that gas contracts are very significant value drivers for those fields and for the major participants in the industry. Thus the focus for this paper.

My paper in 1996 described the key elements of the major contracts that shape the overall structure of the New Zealand gas industry. Thus the paper included a description of the interlinked relationship of all of the major gas contracts then operating in New Zealand. Contracts involving less than 5 PJ per annum were not dealt with because, in the then overall structural context, they were of only marginal influence, even if they were very important to the parties to those contracts.

Since then various circumstances and events have had a marked effect on the overall texture of the New Zealand gas market. Many of the rigidities that were in evidence have now been dismantled and the result is a market place that is much more dynamic and where there is evidence of real competition occurring between active participants.

There are five key events that have brought about these changes:

- The emergence of Contact as an active gas trader;
- The conclusion of the Kapuni litigation and the resulting presence of Shell and Todd as active players with gas to sell;
- The promulgation of the Gas (Information Disclosure) Regulations and the consequences of the unbundling of the energy and transmission components of gas contracts;
- Settlement of the litigation between NGC and Enerco concerning take or pay disputes and the resulting emergence of Enerco as a substantial new buyer of gas; and
- Evidence of increased trading in gas entitlements.

The Emergence of Contact as a Gas Trader

Perhaps the most important change to the overall dynamic of the New Zealand gas market has been the emergence of Contact Energy Limited as a significant gas trader.

Contact is a state owned enterprise that was formed in 1996 and commenced business in March 1996, that is, about the same time as the last New Zealand Petroleum Conference in Auckland.

Contact was formed as a result of the split from ECNZ of some of ECNZ's electricity generation assets. The policy objective was to create a second large competing electricity generator. As I noted at the last conference Contact has taken over all of ECNZ's Maui purchase obligations and entitlements and all of ECNZ's then contractual obligations to buy gas from the Tariki/Ahuroa, Waihapa and Ngaere fields (the TAWN contract).

As part and parcel of the Contact/ECNZ split, ECNZ entered into gas purchase obligations with Contact. This served two purposes, ECNZ became a substantial customer of Contact and ECNZ secured a supply of gas for its Huntly power station.

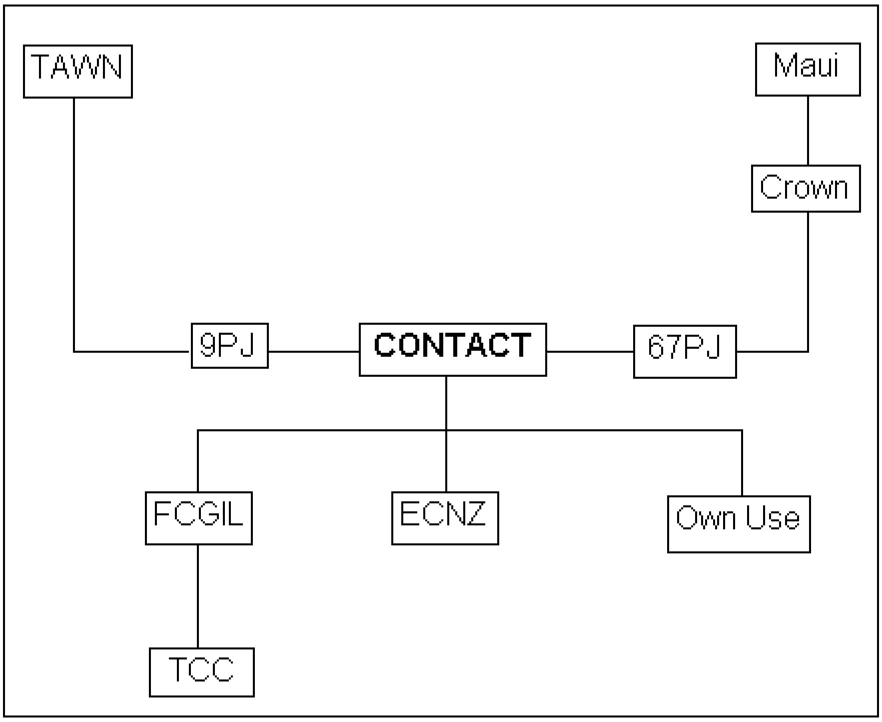
There has been no information made publicly available about the key elements of the Contract/ECNZ contractual arrangements. Thus we do not know:

- The price ECNZ pays for gas purchased from Contact;
- ECNZ's Annual Quantity and Maximum Daily Quantity entitlements;
- ECNZ's take or pay obligations (if any); and
- How much gas ECNZ takes or expects to take in any year.

However, we do know from ECNZ's published documents that for the year to 30 June 1997 ECNZ burned 48 PJ of gas, all but 5 PJ of which it would have acquired from Contact.

The assignment of ECNZ's rights to the TAWN contract to Contact involves a committed purchase by Contact of 9 PJ per annum. However, Contact also picked up the obligation to on-sell that gas to Fletcher Challenge Energy Limited (FCE) for use as a fuel source for the Taranaki Combined Cycle power station near Stratford.

The situation that existed as at the start of 1996 can be depicted as follows:



During the course of 1996 it became clear that Contact's gas purchase obligations (under its take or pay contract with the Crown for Maui gas and in respect of TAWN gas) exceeded the purchase commitments from ECNZ, FCE and Contact's then expected own use requirements.

It is little wonder therefore that dealing with its surplus gas entitlements (and resulting take or pay obligations) has become a major activity for Contact. Indeed in Contact's Statement of Corporate Intent for the year to 30 September 1998 it is stated:

"Contact's core business is primarily the generation, marketing and trading of electricity and the purchase, marketing and trading of gas."

In their 1997 annual report Contact noted:

"A special challenge to our company is the judicious management of our gas portfolio and contractual commitments under take or pay obligations to the Crown."

Thus, in a nutshell, Contact has a significant commercial incentive arising from its substantial gas purchase obligations and entitlements, and has the means in terms of financial power and analytical skills and a clearly stated commercial intent to enter the gas market as a substantial and active trader.

Since March 1996, Contact has concluded a number of arrangements that reflect these commercial imperatives.

- As will be discussed again later, in October 1997 Contact signed contracts whereby it became a major supplier of gas to New Zealand's largest gas retailer, Enerco. Both Contact and Enerco have been somewhat coy in all of their public statements about the volumes and price to be paid for that gas but a reasonable guess would suggest that the following is approximately accurate:

  Annual Quantity: 6 PJ

  Price: Approximately $2.70 per GJ

  The gas price is on a fully delivered basis at Rotawaro. The term of the contract appears to be for a number of years but again these details have not been announced.
- However, this is not all that Contact has done.
- As noted earlier Contact is committed to supplying FCE with gas for the Taranaki Combined Cycle plant at Stratford. The total quantities of gas involve approximately 20 PJ per annum. The gas can come from both TAWN and from Contact's Maui entitlements.

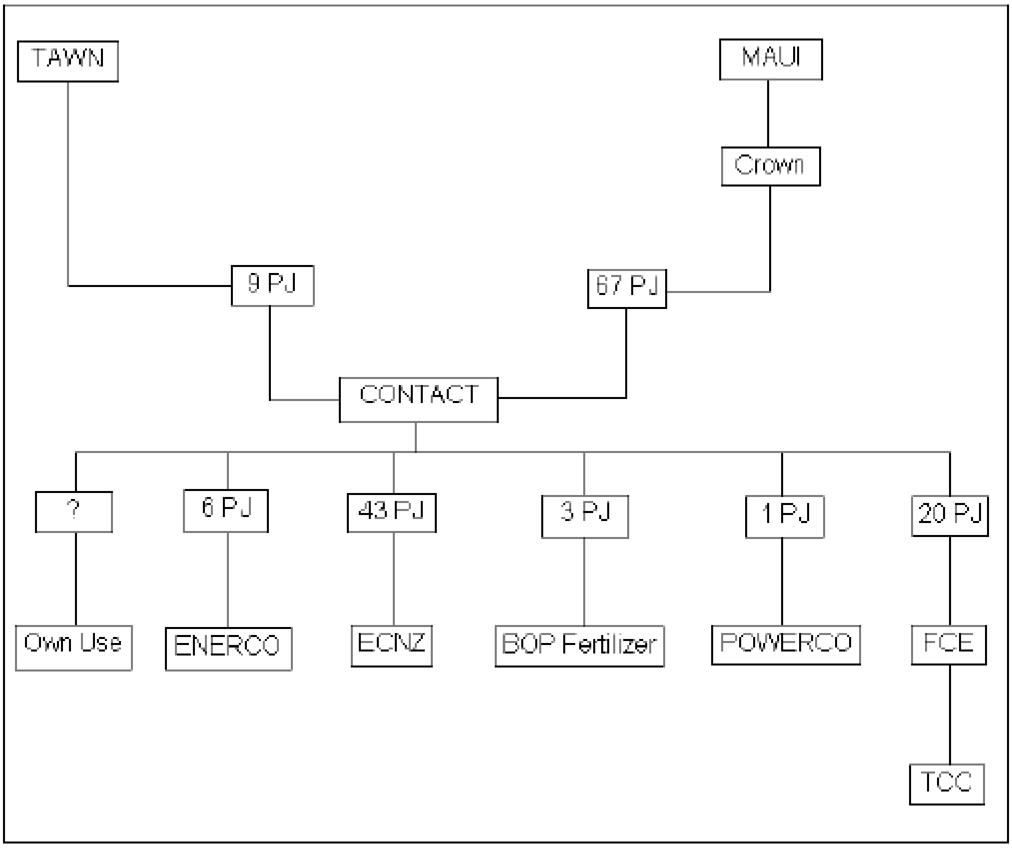
Contact's Position is Now:

- Contact is the preferred supplier of gas for a co-generation facility being constructed by the New Zealand Dairy Group at Te Rapa.
- Contact has concluded gas sales contracts to Powerco, a New Plymouth based gas retailer. There have been no details announced of the volume involved but it is unlikely to exceed 1 PJ per annum.
- Contact is the supplier of gas to Bay of Plenty Fertiliser Limited, the owner of the ammonia area plant in Taranaki. The total volume is approximately 3 PJ per annum.

There are various indications that Contact continues to be a new and competitive force in the market place. Contact is in a special position because, under the terms of its Maui purchase rights it can take delivery of Maui gas at any point along the Maui line. This is of particular significance because, as a result, Contact has no requirement to pay NGC any delivery costs associated with transporting gas from Taranaki through to Huntly.

Thus Contact has, if not an outright competitive advantage, at the very least substantial equality with other would be gas suppliers such as NGC. Contact is at an advantage, in this respect at least, as compared to (say) the Kapuni Mining Companies and FCE, each of whom will have to pay transmission costs to get product to the more northern markets.

The transactions just referred to are concrete evidence of the emerging position of Contact as a gas trader.



The Kapuni Contract

In my 1996 paper it was noted that litigation concerning the Kapuni contract was scheduled for a hearing in the Auckland High Court commencing May 1996. Despite various efforts to settle the litigation the case in fact proceeded to trial during the course of 1996 and was heard over a period of 48 days. The final submissions were presented in early August 1996. The judgment of the court was eventually handed down 3 February 1997. As a result of difficulties associated with sealing the Courts judgment a further supplementary judgment was handed down on 26 May 1997.

It is unnecessary to traverse the arguments presented during the course of the case or to analyse the judgment of the High Court because this is a subject of a separate paper later in the conference. Conference delegates will have the opportunity on Wednesday to not only hear a legal analysis of the judgment but also to hear the views of representatives of two of the main protagonists in the case, Mr David Kirk from Fletcher Challenge Energy Limited and Mr Richard Tweedie of Todd Petroleum.

At the risk of grossly oversimplifying matters the key outcomes from the case can be stated as follows:

1. The contractual interpretations contended for by the buyers (Kapuni Gas Contracts Limited (KGCL) and NGC) were upheld. In particular, the dedication provision, which was an integral part of the overall contractual arrangements, was affirmed by the High Court. The writer's own comment on this is that it is somewhat reassuring to see that the Court interpreted the contract in light of what the words clearly appear to say rather than some of the more ingenious arguments that were advanced.
2. On the competition issues the arguments of the Kapuni Mining Companies (Shell and Todd) were substantially upheld which had the effect of largely nullifying the success enjoyed by the buyers on the contractual results.
3. In order to remedy the competition issues, the High Court declared that half of the output from the Kapuni field was to be made available to the Kapuni Mining Companies (KMC) with the other half to continue to be sold under the terms of the original contract to KGCL and NGC.

As noted in my earlier paper, in the realm of gas contracts the devil lurks in the detail. Thus what was no doubt considered to be an admirably elegant solution left unanswered a number of very important questions. For this reason a supplemental judgment was sought.

It appears that both sides to the litigation were less than entirely happy with the outcome of the case and there was considerable talk of possible lines of appeal. However, the parties were able to negotiate a settlement, the key ingredients of which being:

- The available output from the Kapuni field is to be divided between the Kapuni Mining Companies and KGCL/NGC;
- The Adjusted Annual Contract Quantity (relevant for splitting the annual output) has been fixed at 16 PJ per annum;
- The Maximum Daily Quantity at which gas can be taken from the field is fixed at the relevant productive capacity of the field from time to time;
- As directed by Justice Sir Ian Barker in his supplemental judgment, the entitlement to half the output is not an entitlement to half the reserves of the field but to half the annual production from time to time. In essence this means that parties entitled to the gas must either use or lose that entitlement;
- The price payable by KGCL/NGC has not been fixed but is either to be agreed following discussions between the parties or else the subject of an arbitration. However, both a floor and a ceiling price has been agreed. At this point the arbitration is set to be heard in September 1998;
- The KMCs are required to process gas through NGC's gas processing facility. However, they are free to sell unprocessed gas or build their own processing facility; and
- The KMCs are not permitted to sell gas to electricity generators or the petrochemical market.

However, this analysis does not truly capture the significance of the end result. What has occurred is that there is now a major, well funded and technically capable consortium able to sell large quantities of gas which is to be produced from a location very close to all the essential infrastructure needed. The KMCs are unconstrained by any existing contractual obligations and can sell up to one half of the Maximum Daily Quantity (approximately 20 PJ per annum) into the market place. The KMCs therefor now represent a very significant potential source of supply to large scale consumers (other than electricity generators).

The KMCs have quickly moved to take advantage of this situation and are already the suppliers of significant quantities of gas to the Kiwi Co-operative Dairy for co-generation purposes. There can be little doubt that various other initiatives will be being actively pursued.

NGC and Enerco

The 1996 paper noted that litigation had been commenced by NGC against Enerco concerning the take or pay obligations contained within the 1980 contract between Enerco and NGC. By mid-1997 the litigation was at a point where it was ready to be set down for trial. However, as is often the case as the realities and risks of a protracted trial become apparent, the parties attempted yet again to resolve the differences through settlement negotiations. This time the negotiations were successful.

Key drivers that influenced a settlement included:

- A likely litigation war weariness for NGC, especially after the horrors and strain of the three month trial in relation to Kapuni;
- A desire of NGC that it press ahead with its new transmission arrangements; and
- The risks for NGC that a judicially imposed resolution could be much more difficult to manage than a negotiated settlement.

Thus in September 1997 NGC/Enerco settled, the overall effect of which being that:

- Enerco was relieved of some of its take or pay obligations to NGC;
- NGC accepted a new gas contract under which Enerco was no longer obligated to purchase its entire gas supply from NGC;
- Enerco surrendered its gas transmission rights as contained in the old "bundled" 1980 contract but signed a new transmission agreement; and
- Received a one off payment of $14.5 million from NGC for the purchase of 6 PJ of prepaid gas.

The new gas supply terms, as announced by Enerco and NGC are as follows:

- Annual quantities of 12 PJ reducing to 10 PJ;

- A contract term of 10 years; and
- Price has not been disclosed.

Almost at the same time as the NGC/Enerco settlement was announced, and as already noted, Enerco also announced that it had entered into contractual arrangements to be supplied with gas by Contact. This event signalled the introduction of another new and substantial seller of gas into the New Zealand market. The Contact/Enerco agreement represents the most significant change to the structural elements of gas supply to retailers almost since the reticulated natural gas industry first began.

Thus from a situation two years ago where New Zealand's largest gas retailer was contractually tied to one supplier on terms that could be said to have been long past their "use by" date, we now have a situation where that retailer has two sources of supply, and, as its market grows, has the ability to access further supplies from other sources. Indeed, Enerco is also now an active explorer in its own right as it seeks to better manage the cost of its gas supply.

Open Access Transmission Regulations

On 7 July 1997 the Gas (Information Disclosure) Regulations 1997 were finally promulgated and came into force 7 August 1997. While these Regulations had long been anticipated they are now a reality. New Zealand does have an open access gas transmission network.

A more detailed analysis of the gas transmission network and the open access regime will be presented later at this conference.

However, for purposes of this paper, the key point to note is that any party seeking access to the gas transmission network now has clear rules and guidelines which can be followed and upon which pricing and terms will be based. Whatever the different protagonists may feel about the economic efficacy of the pricing regime as promulgated by NGC it is nevertheless a significant step forward from the highly uncertain position that existed as at March 1996.

It is now possible to assess likely transmission costs in advance of any contractual commitment and to be confident that the same rules will apply to all.

The Kupe Field

In early 1997 attention became focussed on the Kupe Field. In February 1997 FCE acquired a 20% interest in the Kupe Field from Norcen. But this was only the start.

In March 1997 FCE and ECNZ each acquired in the names of subsidiaries and through a joint vehicle, an aggregate 40% interest in the Kupe Field which was achieved as a result of the purchase of the interests of Western Mining. The combined ECNZ and FCE interests in Kupe are now 62.5%.

The Kupe Field contains probable reserves of approximately 250-300 PJ. However, as has been noted elsewhere, the field requires further appraisal drilling and, on almost any basis of economic analysis, the economics for development of this field are difficult. Development will only be able to occur if a substantial gas contract can be entered into between the owners of the field and a gas purchaser and at gas prices that are likely to be considerably in excess of those payable under either the Maui contract or likely to be paid with respect to any purchaser of Kapuni or Mangahewa gas.

While it is not the province of a legal adviser to make economic predictions concerning the developments of oil and gas fields, other events since March 1997 (in particular the possibility that Mangahewa is a significant discovery) make it difficult to foresee early development of the Kupe Field.

The acquisition by ECNZ and FCE of the Kupe interest from Western Mining is also set to become the subject of judicial scrutiny. Late in December 1997 the Commerce Commission commenced proceedings against FCE and ECNZ alleging that the acquisition and the Generic gas contract, dealt with below, are in breach of the Commerce Act. Needless to say both defendants have said they will be vigorously defending themselves.

What can be said is that this litigation will no doubt be yet another examination of the nature and extent of the activities of FCE in the New Zealand gas market place. In light of the various transactions canvassed in this paper it will also be interesting to see what market definitions are now considered appropriate.

Mangahewa

A key exploration and development highlight of 1997 has been the successful efforts to obtain production from Mangahewa. How this was achieved and the engineering and geological implications is the subject of a separate paper. In terms of its commercial implications it is a very exciting development indeed.

Mangahewa is located in very close proximity to:

- Both the main Maui line to the northern gas markets and the NGC high pressure gas transmission network; and
- The petrochemical plants operated by Methanex at Waitara Valley and Motunui.

The field seems to be capable of producing in substantial volumes and, even if fracturing is an expensive process, the costs of development are clearly likely to be much lower than the costs of development of any offshore field. The gas is of high quality and requires relatively little processing and, while not spectacular, has a useful associated liquid stream to assist the overall economics.

The indications appear to be that the reserves from this field are substantial but obviously further appraisal drilling will be necessary.

Mangahewa is potentially the new low cost high volume gas producer in New Zealand. Mangahewa therefore could very substantially alter the commercial dynamics for gas production in New Zealand.

FCE/ECNZ

In September 1997 FCE and ECNZ announced that an agreement had been concluded whereby Fletcher Challenge has agreed to sell 20 PJ per annum of natural gas to ECNZ over a 17 year period.

The most interesting aspects of this announcement are:

- It is a contract that is not tied to any particular field or fields. Fletcher Challenge is free to provide the gas which it sells to ECNZ from any source whatsoever whether it be Mangahewa, McKee, Kupe (if all the participants agree) or any other field. While NGC has entered into such contracts with its utility purchasers for some time, in the context of the New Zealand gas market, this is the first large scale "generic" gas contract signed by a gas producer;
- A supplier has now committed to supply gas for the period beyond the expected expiry of the Maui contract and available Maui reserves; and
- It is a clear demonstration of ECNZ's determination to secure a long term gas supply, further evidenced by its participation in the Kupe acquisition.

FCE/Methanex

FCE and Methanex signed a memorandum of understanding in the latter part of 1997 pursuant to which they each agreed to investigate the possibility of FCE being a substantial supplier of gas to Methanex. The lawyer in me suspects that there is not much in the arrangement that is enforceable in any conventional sense. However, taking a broader view, it is a very clear signal between two of the leading industry players of their desire to work towards common goals. The fortunate position of Mangahewa directly beneath the two methanol plants and the now progressive decline of Methanex's Maui gas delivery entitlements mean that some of the key commercial elements to ensure this understanding can be commercially consummated are in fact in place.

NGC/Methanex

Late in 1997 NGC and Methanex announced an arrangement whereby Methanex has purchased from NGC some 25 PJ of NGC's prepaid gas entitlements. In effect, NGC has sold for value today a future entitlement to prepaid gas. For its part, Methanex has paid value today for an entitlement to be delivered prepaid gas for no payment at some time in the future. An interesting aspect of this transaction is its innovative nature. However, the most important thing about the transaction, namely, the value paid for the prepaid gas entitlements is unfortunately not the subject of any announcement - we are left having to speculate what that value might be.

NGC/ECNZ

For the sake of completeness mention should also be made of a transaction that took place in early 1997 between ECNZ and NGC for a spot sale of 5 PJ of gas by NGC.

It is unlikely that this transaction will be a precursor to the development of any more broad based spot market. Again, however, it does illustrate the willingness of participants in the industry to take advantage of a perhaps isolated situation and to pursue value wherever it might appear. The size of the transaction is not particularly big but clearly demonstrates the desire of key participants to seek out as much flexibility as possible.

Conclusion

The various transactions described in this paper demonstrate that there are new dynamics at work in the market place for gas within New Zealand.

Thus, we have a new and committed gas trader in the form of Contact Energy - an organisation with access to large quantities of gas, favourable transmission entitlements because of its Maui purchase rights and which has the balance sheet and analytical ability to actively pursue value wherever it sees it.

We have the ability in New Zealand for the two longest established and arguably most experienced gas producing companies, Shell and Todd, to aggressively enter the market because of their new entitlement to directly sell Kapuni gas. The volumes they are able to sell are substantial.

NGC now offers unbundled energy and transmission arrangements. Would be sellers of gas can now work out in advance the cost of transmission and securing capacity rights. NGC has also demonstrated its willingness to become a more nimble competitor by reason of:

- Spot sales to ECNZ;
- Sales of prepaid gas to Methanex;
- Making comprehensive rearrangements of its contractual arrangements with Enerco.

NGC has thus demonstrated an ability to adapt to the changing market circumstances.

Our largest gas retailer, Enerco, has been released from its exclusive supply arrangements with NGC. Enerco has taken advantage of this by immediately entering into arrangements with Contact. As is obvious from other papers at this conference, Enerco is clearly seeking to further diversify its upstream supply arrangements by direct participation in ongoing exploration efforts both in Taranaki and elsewhere around New Zealand. Enerco is thus also showing a determination to be nothing other than a dynamic participant in the market.

Accordingly we have seen and will continue to see more and different arrangements being entered into as participants seek value. It is likely to be the case that smaller scale transactions will become more common and more sought after as all participants seek to preserve for themselves flexibility and to obtain value wherever it might appear.

We are also seeing the breakdown or even abandonment of the old characterisation of participants in the market place. Descriptions of participants as generators, producers, petrochemical companies, wholesalers or retailers simply do not do justice to the dynamism and flexibility apparent across the whole market place. Thus, we have Contact selling gas to retailers, using gas for its own use, selling gas to other wholesalers to onsell and selling gas to petrochemical clients.

NGC, which has been described as a gas wholesaler, now sells gas entitlements to petrochemical companies, has sold gas to an electricity generator in the form of spot sales to ECNZ, as well as sales to other retailers and its own use plus cogeneration sales. In other words NGC now sells to many different markets wherever it can obtain value.

Methanex is sourcing its gas from each of the Crown, NGC and perhaps FCE but could be supplied in future from all of these companies plus Shell/Todd and Contact.

ECNZ has sought to move upstream to secure gas supply by acquiring a stake in the Kupe Field and entering into generic gas supply arrangements with FCE.

When I last spoke to you in 1996 the market was relatively static and characterised by several long standing, often contested contracts. In the two years since a lot has changed and all the signs are there for this new dynamism in the market to continue.

Author

James Willis is a commercial lawyer who has been a partner in the national law firm of Bell Gully Buddle Weir since 1982. He specialises in the area of upstream petroleum activities with a particular focus on gas contracting issues, both with respect to the existing gas contract framework as applicable in New Zealand and in relation to contracting for the sale or purchase of new sources of gas. He acts for substantial participants in the New Zealand upstream petroleum arena. He is currently Chairman of the Energy and Natural Resources Law Association of New Zealand and is a director of the listed Australian explorer Timor Sea Petroleum NL.