COMMERCE COMMISSION CONFERENCE
ON THE APPLICATION FOR AUTHORISATION BY THE POHOKURA JOINT VENTURE PARTNERS TO JOINTLY MARKET AND SELL GAS FROM THE POHOKURA FIELD

COMMISSIONERS: Ms Paula Rebstock (Acting Chair)
Mr Peter Taylor
Ms Denese Bates QC
Mr Shaan Stevens

CHAIR: I think we will convene the Conference now, so I'll start by saying good morning to everyone and welcome to the Commerce Commission's Conference being held in relation to the Pohokura Joint Venture Parties for authorisation to enter into arrangements to jointly market and sell gas produced from the Pohokura Gas Field.

I am Paula Rebstock, I'm acting chair of the Commission and I will also chair this Conference.

With me are Members of the Commission who will be making the determination on this matter. They are to my right Denise Bates QC and to my left, Shaan Stevens and Peter Taylor.

Also assisting us with this matter are a number of Commission staff and the Commission's consultant; they're seated at the table to my right and they are Guy Launder, Dick Adam, David Ainsworth, Mauzima Bhamji, Rachel Owens and John Bay, and I might say they're not in that order.

Rachel Owens, who's done an excellent job in organising the logistics of this Conference is available to those present who require any assistance and she's at the end of the table here, and I might also mention to you that she's holding the pass to the toilets which are around by the lift. So, you will have to get that pass from her.

I'd also like to welcome everyone, particularly those who have travelled from outside Wellington and those who have taken time to meet with Commission staff and make written submissions on this matter.

We're very appreciative that the Commission has access to the industry experience which is before us. As I've already said, this Conference relates to an application from the Pohokura Joint Venture Parties who I'll refer from this point on as "the applicants".

The application for authorisation was registered by the Commission on 23 December 2002. Commission staff then sought the initial views of interested parties on the competitive implications of the application. The Commission then issued its Draft Determination on the 16th of May 2003.

The Draft Determination outlined the Commission's thinking to that time and identified issues on which it sought additional information and views. Written submissions on the Draft Determination were received from ten parties and these were posted on the Commission's website.

I recognise that there is a large amount of complex issues raised by the application. We are appreciative of the assistance provided to date. The Commission will do its best to make its final determination on this application as soon as possible, and at this stage we anticipate doing so by the 7th of August 2003.

I'd like now to make some brief comments on the procedures of this Conference. We have set down three days for the Conference, though at this stage the third day is a reserve day. I understand that Commission staff have provided an indicative timetable to all parties here. If you don't have that timetable we can make it available.

At this time we propose to start with the applicant and then, as far as practicable given the availability of parties, follow with those who are generally supportive and those against. The applicant will then have the right of reply at the end.

I'll do my best to ensure that everyone is given a fair opportunity to present their case. If necessary some adjustments can be made to the timetable.

It's not proposed to close the Conference venue during the lunch breaks, however a Commission staff member will be in attendance during those times. These Conferences are designed to allow interested parties to present their arguments to the Commission and for the Commission to test those arguments by questioning.

S 64 of the Commerce Act requires that the Commission shall provide for as little formality and technicality as possible. This Conference is not, and is not intended to be, an adversarial proceeding. There will be no cross-examination. There is, however, the opportunity for questioning by both Commission members and staff. This is not a public Conference in the sense that while the public are welcome to attend, they do not have speaking rights or the right to ask questions.

A full record of this Conference will be maintained by both transcription and tape recording. Could any person speaking please do so from one of the microphones available and speak clearly and precisely. I would also ask that each speaker state their name and the party they are representing so that we can identify them clearly. It's important not to speak too fast because we'll end up having to go over the same material again if you do.

Commissioners have read all the submissions carefully, so please make any summaries of submissions as succinct as possible. It would be appreciated if speakers focus on the key issues in their addresses to us. I would like to point out that the Commission can consider only those issues within its jurisdiction and accordingly we do not wish to hear submissions on issues which are not directly relevant to the Pohokura gas application.

It is expected that a number of experts will be attending and presenting at this Conference. I would like to stress that their role is as experts in their fields, and they should not act as an advocate for any particular party. If the Commission considers that experts are in fact acting as advocates for a particular party their submission may be treated as though they are part of that particular party's submission rather than as an expert opinion.

I hope that this Conference will be able to avoid confidential material. If it should be necessary to consider material which is confidential, the Conference will be closed during that discussion to all persons except Commission members and staff, the party providing the confidential material and to legal counsel and relevant experts who provide appropriate undertakings. I emphasise, however, that we have a strong preference for as much as possible to be heard in public sessions.

Having said that, I would like to note that on the 27th of June the Ministry of Economic Development made a submission on the Draft Determination. A public version of this submission has been made available on the Commission's website since last Friday. Access to a confidential version of the submission is available to external legal advisors and experts provided they sign an appropriate Deed of Undertaking. Copies of public and confidential versions of the submission and the Deed of undertaking are available from Rachel Owens.

I should make it clear at this point that the Commission does feel it is necessary to have a closed session on that submission and we propose to do that tomorrow. I will advise all parties later in the day at what time that will occur.

In that respect it's critical that any legal counsel or experts who want to participant sign the Deed of Undertakings before the session is to be held.

At this time I'd ask whether there are any questions relating to the procedure of the Conference or any other issues that I've raised? [**No comments**].

If there are further questions on procedures or the agenda that might arise as the Conference proceeds, please don't hesitate to contact either Guy Launder or Rachel Owens. The Commission has been looking forward with some interest to hearing the submissions that will be presented today. I would like to thank you all once more for your attendance and begin by asking representatives of the applicant to present their submission.

***

PRESENTATION BY POHOKURA JOINT VENTURE PARTNERS

DR BERRY: Thank you for the introduction. I'll introduce the members of the applicant's team, there's quite a few of us, so we don't all fit on these front benches, so I'll just go round in sequence. Opposite me are representatives from Todd, Mr Rodney Deppe, Mr Richard Tweedie and Christopher Hall. Next to Chris Hall is Professor Lewis Evans who is known to you no doubt. To Professor Evans' right is Mr David Salisbury of OMV. At this corner here we have Mr David Agostini and next to me is Mr Murray Jackson from Shell.

The other members of our team are seated in the front bench of the room here, I'll point out the two Westpac representatives on the end of this table here, they are Patrick Cocquerel and Mr Jonathan Ballantyne. Those will be the people speaking to the applicant's submission and these three gentlemen will be the prime submitters in this session hence their positioning in the better seats for the job.

Perhaps if I just begin by some introductory comments. I thought it would be useful just to give some initial themes and to give a feel for where our presentation is going to proceed today, so that we've got the presentational context before I hand over to the team.

First of all the application. What the application is about here is for authorisation for the Pohokura Joint Venturers and for their successors to enter into contracts to sell gas jointly from the Pohokura Field.

One point I want to emphasise, and it was made in the application, is that this application does not relate to the contracts to be entered into between the joint venture and the purchasers of gas; they are future contracts, and as is acknowledged in the application, they are subject to further analysis under the section 27 provisions of the Act at the appropriate time.

I'll come back to this later when we're talking about conditions, but I do urge the Commission to bear that in mind because many of the submissions of other parties are in fact moving into a matter that is not directly the subject matter of this application.

Moving on to our framework for the presentation, there are, in our submission, two key decision points, two main streams of issues. The first one is, to what extent does this proposal involve a lessening of competition? Now, the legal test is clear, it's a question of comparing the proposal which we've just outlined with what is the most likely counterfactual. As we stated in our submission, we accept the preliminary view of the Commission that Scenario 1, marketing, is the most likely counterfactual.

One point that you'll hear emphasised as a central theme is, what is this concept of Scenario 1 marketing all about? It's important to realise that it is not three independent sellers. It is three co-ordinated sellers sourcing jointly from a commonly owned field. There will need to be a significant level of co-ordination which will be required before the three joint venturers could go to market even under Scenario 1 marketing.

Just to touch upon two issues relating to output and price, and again this will be developed in the submission; for example on questions of output on Scenario 1 there would need to be agreement on optimal depletion path rates. There will need to be co-ordination to match what buyer's demands are; they are unlikely to match each of the joint venturers' entitlements. On the question of output again, another issue that we will develop, is that under joint marketing there will be no restriction in output compared with Scenario 1 marketing.

In terms of price under Scenario 1, this is a situation where there is an absence of a significant commodity market, which is a highly significant fact in the context of this application. And so there will, in this setting, need to be, between the joint venturers under Scenario 1, some kind of cash balancing arrangements.

In the absence of commodity markets, how is that price reached; it becomes an issue of what is the market price, and as you will see from our submission, this then starts to walk into a need for information sharing between the joint venturers on questions as to price.

And so, when you begin to understand what Scenario 1 marketing is all about, it really is no more than a form of joint selling, as it has been described. And, in the absence of the ability to undertake separate marketing which we say is not feasible, this is the most likely counterfactual which the Commission has identified and as we accept.

David Salisbury here will speak in more detail and try and give as full a picture as possible to explain what are the differences between the proposal and counterfactual, and he's got some considerable detail on that issue which follows on from the submission already lodged with the Commission.

Another line of argument that we will be advancing is that the proposal does not involve any lessening of competition compared with the counterfactual, and we've got Professor Evans further developing arguments as to why joint marketing is pro-competitive and enhances dynamic efficiency, and it will facilitate contracts to support the development of the field.

The Joint Venture Field will enter the market as an entity, and successful harvesting of the field will incentivise exploration. Now, all of those are very important matters in the context of a market which is scarce on resource. The question of the importance of exploration is another theme that will be progressed as we go along.

So, at the end of the day what we say is really, if the Commission was to look at what would be the most likely counterfactual in operation in the marketplace in Scenario 1, you would end up causing the market to undertake a great deal of activity at the end of the day to achieve nothing in terms of a competitive advantage.

So, that in broad outline is our first line of argument, that this proposal involves no lessening of competition and it follows that the Commission, if it reached that conclusion, would decline jurisdiction to the application.

Moving on to our second key issue; if, however, a lessening of competition is found, then the Commission, of course, is required to undertake cost-benefit analysis. The starting point is, first of all, to identify the relevant detriments, and we note that the Commission has set out three conclusions as to detriments in paragraph 400 of the Draft Determination.

The first one is that there is an assertion that the proposal will lessen the options available to purchasers in terms of amounts of gas and the non-price terms, and the conclusion also goes on to state that buyers will be less informed about market conditions which could increase prices. But again, as I've begun to introduce the theme, the co-ordination required under Scenario 1 means that there will in reality be no lessening of competition relative to those considerations when compared with Scenario 1.

The second key conclusion as to detriment is that joint marketing is likely to increase the potential for price discrimination, and Professor Evans will speak to this issue and articulate why price discrimination is no less likely to occur under Scenario 1 than it is under joint marketing.

The last of the Commission's reasons on detriment is that the proposal would inhibit or delay market developments, and we say that on the contrary the successful harvest of Pohokura will incentivise development and future exploration, as I mentioned before.

Before I just pass off detriments, a preliminary comment, the Commission has not quantified detriments so we are not in a position to comment on that issue, and we will come back to that, but our position is that there are no detriments and so therefore there should be zero attached to detriments for the purposes of this application.

The next issue after detriments is, of course, public benefit, and the focus of our submission here is that the benefits of this proposal compared with the counterfactual are the avoidance of delay. This is the crucial link to the public benefit argument.

Chris Hall will be discussing the question of our position that there would conservatively be a three year delay. We say that the Commission has no basis upon which to conclude that the time difference between the counterfactual and Scenario 1 is only one year. The Commission acknowledges that the AIPN survey is not scientific but nonetheless appears to attach some weight to it.

Our position is that this survey is flawed to the point that no weight can be attached to it. Chris will also speak to the other commercial realities one-by-one in terms of the Commission's reasons to support the view that there is a one year delay.

Now, our presentation on benefits will conclude with Professor Evans then describing the considerable benefits that will result from early production, again based on the assumption of a three year delay differential.

At this stage our presentation will move to the conditions and at that point we will begin with general legal submissions which I'll present and then will be followed by Professor Evans, so we will each speak to all of the Commission's proposed conditions, and then what will follow is a discussion from each of the participants making up the joint venture as well as the Westpac representatives.

CHAIR: Can I just clarify, Dr Berry; will you at that point make clear what your submission was at the beginning of your introduction about this application not being about the contracts for gas themselves?

DR BERRY: In the course of the legal submissions on conditions it will be -- the argument will be advanced that a number of the proposed conditions of other parties are irrelevant so far as they relate to the future contract, which is property subject to the application of s.27 at a later time. I'll go through that argument in full when I do the legal submissions relating to conditions.

The position we take is that each of the Commission's proposed conditions is unacceptable variously upon grounds of inappropriateness, unworkability and illegality, and we will also demonstrate how they would also serve to delay development of the field.

One theme that we will emphasise as we go through this part of the presentation is that the conditions will serve in fact to frustrate the achievement of the benefits of early production of the field and we'll take the Commission through each conditions as to why we say there is that particular prospect.

So, that in a nutshell -- those are the issues we will cover as we go through those two main lines of argument, that this competition analysis necessitates. In order to wrap-up our presentation we will make available to you Mr Agostini, and you will be aware of his background as a member of the COAG Report, and Mr Agostini will outline the context of that report and provide his views on the issues relating to the start up of Pohokura. His discussion will serve to highlight that separate marketing is not feasible within the New Zealand context, and his views are also supportive of the issues surrounding Scenario 1 marketing.

The last element of our presentation will be to briefly discuss the Australian examples that the Commission picks up in its Draft Determination, Geographe, Thyacine, Yolla and Vencorp, and Mr Tweedie will go through those particular examples. So that in a nutshell is where this presentation is heading.

Given the number of different participants hopefully we'll get the flow right. You are, of course, free to ask questions as we go, but I just wonder whether it may not help the flow if we can have a bit of a run to get it through before the questions start coming perhaps.

CHAIR: I understand why you ask the question, but I am also aware, that you realise that for us to ask questions effectively, it actually helps to ask them as you go. So, to the extent that we can ask questions at the end of each presenter, we'll try to handle the majority of them there, but I think we need to reserve the right to ask questions during the presentations as well, particularly on points of clarification, but also questions get lost if they're not asked immediately and the purpose of the hearing is to allow that interchange. So, we'll try to accommodate you as much as we can, but not to the extent that it gets in the way of us understanding your submissions.

DR BERRY: Sure, I understand. Okay, well, that's me done for the moment and so if we can now move to the commencement of the applicant's presentation. There is an initial point that we want to raise in relation to s.26 within the context of this application, and so once we've discussed that then we'll move on to David Salisbury talking about the meaning of Scenario 1 marketing.

CHAIR: Who's going to address s.26?

DR BERRY: Okay, this follows on from essentially what was stated in our submission in response to the Draft Determination, and this is a situation where the Government has issued two Policy Statements, and I just want to make some brief observations about each of these two Government Policy Statements.

The first one is one of a general nature where the Government states its hope that some depth will emerge in the market which will be likely to support the emergence of a competitive wholesale and secondary market situation. And so, that's the Government Policy Statement of a general nature, and of course one matter that is relevant to the background of that is the need for the right incentives for exploration; we're not going to reach those goals without the discovery of a lot more reserve.

But more particularly, the second of these Government Policy Statements, the one issued in April this year, is specific in nature relating to Pohokura and I'd have to say from my experience I can't recall a Government Policy Statement that has been so focused in relation to an authorisation application.

I'll just touch on the key points that come out of this statement, and there essentially are four of them for our purposes. The first is that the development of Pohokura is important for energy security. The second key point is that with steadily increasing demand for electricity, New Zealand needs further significant electricity generation to meet that demand growth.

The third key point is that the development of Pohokura will help remove uncertainty about New Zealand's medium term energy security.

And finally, the development of Pohokura will facilitate early decisions on new electricity generation investment.

Now, as the Commission is no doubt aware, the caselaw is clear in terms of what meaning attaches to Government Policy Statements. The Commission must give genuine thought and attention to both of these Government Policy Statements and more particularly it must attach appropriate weight to both statements.

But what I would invite the Commission to do is to focus in particular on the second of the Policy Statements and to attach significant weight to the goals that are stipulated in that Policy Statement.

CHAIR: Is there any basis for the Commission to give one Policy Statement additional weight compared to the other, or should they not be read side-by-side?

DR BERRY: They ought to be read side-by-side, but I would suggest that, because of the specific and express nature of the Pohokura Policy Statement, it is giving a particular direction relating to this given field.

CHAIR: But the requirement on the Commission is to give them both due consideration to meet that requirement. It seems to me we have to give both of them due consideration, not one greater consideration than the other. So I assume that's not your submission?

DR BERRY: Well, it is possible to give them both appropriate weight and still at the same time attach the appropriate considerations to the importance of the Pohokura Statement.

CHAIR: I think it would be helpful for us if you spoke to specifically which areas of that that you thought the Commission should give further consideration to.

DR BERRY: I think it's fair to say, in the course of our presentation as we go through this, there will be reference to the importance of the need to incentivise exploration that is sitting there amongst these Policy Statements, and this is important to get Pohokura on-stream as an important starting point to give the right signals and incentives to the industry to permit a jointly owned field to be able to be marketed jointly in a timely fashion. Again, feeds into much of the submission that follows beyond the, so --

CHAIR: So that's the key matter that you believe needs additional consideration by the Commission?

DR BERRY: I think also, all of those other considerations have to be taken into account relating to --

CHAIR: I understand that they all have to be taken into account, my question to you is, which ones do you think need to be given further consideration by the Commission from what has already occurred?

MR TWEEDIE: If I might offer some words on that point. The 2nd of April 2003 Policy Statement, we would argue, has to be very closely considered by the Commission in terms of this application because it is specific to this application. The earlier -- the March 2003 Policy Statement was a far more general Policy Statement that covered a lot of other things, but certainly the second one which was specifically directed to the development of the Pohokura Field, I could refer to the summary that the Minister has provided; he says:

"Pohokura is the only significant new gas field that can be brought into commercial production quickly. Secondly, gas from Pohokura needs to be available in a timeframe and manner that ensures the national energy security and economic growth interests are met."

Very specific, very direct, very clear, very unequivocal.

Furthermore, the statement goes on to say:

"Pohokura is the only sizeable commercial field available to meet the requirement of significant quantities of new gas. The Government recognises that it is not certain that gas from Pohokura will be secured for electricity generation, however, investment decisions on a number of generation projects are currently on hold until there is greater certainty of the future of gas supply.

The timely supply of gas from Pohokura is therefore important to provide greater certainty over where the gas is used enabling new generation investment decisions to be made. Accordingly, gas from Pohokura needs to be successfully marketed and in production in a timeframe and manner that ensures that the national energy security and economic growth interests are met. This is particularly important to ensure that new electricity generation projects can be built in a timely manner to meet growing electricity demand."

So, that statement very clearly deals to the national interests; national interest and the importance of Pohokura to the national interest and precisely that comes back to a timely development, that means an early development to meet that shortfall of gas.

CHAIR: Can I just ask you a question. Would you agree then that if the Commission accepts, and I think in the Draft Determination it did, that early development of the field gave rise to significant benefits, at least in principle, but the Commerce Act itself requires us to be reasonably certain that those benefits are achievable. Would you therefore agree that part of what the Commission should consider is how to ensure those benefits are actually realised?

MR TWEEDIE: The timely development of Pohokura, no one would disagree with that objective, but the way the Commission has approached that issue is something we fundamentally disagree with, and subsequent submissions will address that point.

CHAIR: But you do agree that it needs to be dealt with?

MR TWEEDIE: The issue of a timely development --

CHAIR: The issue of ensuring that the benefits from the development are achieved; do you agree that that is something that needs to be addressed through this process?

MR TWEEDIE: Our submissions will be addressing that point.

DR BERRY: I think it's fair to say that this was put up as a preliminary theme which will be picked up as we go through the submission, and so, I think these questions are beginning to pre-empt where some of the substance of the presentation goes, and so, I just wonder whether we don't move into the presentation because you'll get the chance to ask these questions.

CHAIR: I'll just check with Ms Bates on whether she wants to pursue it and I do appreciate that you do come back to a lot of issues.

MS BATES QC: Yes, I do want to pursue it Mr Berry, just briefly.

You accept the law doesn't state that the Commission has to give evidence to Government Policy under a Government Policy Statement?

DR BERRY: The position is as stated in the case that I cited.

MS BATES QC: It gives it such weight as it considers appropriate, correct?

DR BERRY: Correct.

MS BATES QC: You've identified four matters from the Government Policy Statement. Are you saying that it's your submission that the Commission hasn't taken those into account?

MR TWEEDIE: If I could answer that. The answer is, it hasn't adequately taken them into account in terms of its Draft Determination.

MS BATES QC: Well, what we'd be asking you to do is to identify with much more precision exactly --

MR TWEEDIE: We will do.

MS BATES QC: -- exactly why you think the Commission has not taken those matters into account.

DR BERRY: I think particularly when we come to discuss the conditions, the extend to which they may put at risk the achievement of development and so on, this is where you will see the linkage of --

MS BATES QC: So is it really that, if we had given proper consideration to the matters, we couldn't possibly have reached the decision we did? Is that the thrust of it?

DR BERRY: I think if you have regard properly to the considerations of s.26, we say you would give authorisation attaching no conditions, and so, when we come through those parts there we explain why conditions put at risk the achievement of the goals of this Policy Statement.

MS BATES QC: But it may be that we have taken into account all of the matters referred to in s.26 and we would suggest that -- in the Policy Statement under s.26, and we are of the view that we have, but are you saying that there is further argument that needs to be taken into account by us that we haven't already addressed?

DR BERRY: I think that's fair to say. I mean, by the time hopefully you've heard all of our submissions you will see why we say that there is a need to have authorisation without conditions to achieve the Government Policy Statement.

MS BATES QC: Yes, but at this stage we haven't given sufficient weight to the Government Policy Statement, or that there are further arguments to be addressed on it?

DR BERRY: It's both, weight and there are further arguments relating to the achievement of the benefits.

MS BATES QC: From the legal perspective, I think you need to make it very clear.

DR BERRY: In particular it's the latter argument, not just weight but also the potential to frustrate the achievement of the benefits is a particular concern which does dovetail with this Policy Statement.

MS BATES QC: Thank you.

CHAIR: Can I just, before we go on, I'll check with my other colleagues whether they had any questions at this stage.

[**No comments**].

MR DEPPE: Before we get into the main -- my name is Rodney Deppe and I'm from Todd.

Before we get into the main part of the presentation, I just wanted to quickly go through some of what might be called background information, but is very important background information because it puts the entire application in context.

The first role obviously is the key point is that Pohokura has a market share at the moment of nil, and that we are proposing, and we hope to as quickly as possible, to enter the market and that means that we will not rise to 100% of the market as the NZIER submissions suggested, but we will rise to approximately 30%.

Now, that 30% is approximate, and the reason I say it's approximate is because Pohokura will compete with other fields and the dynamics in the petroleum market shouldn't be underestimated. There are things changing every day as we speak, and it's highly complex and is very high technology nowadays, and the rate of change of technology is increasing every day. And so in other words, the other fields comprise approximately of 30% -- sorry, the other fields comprise approximately 70%.

Then of course we're also competing with the other gas contracts. Now, the other gas contracts have a high degree of flexibility about them, this is the Maui and Kapuni contracts in particular, and so therefore the buyers can basically take more gas or less gas to a fairly higher degree and that is an alternative for them and, therefore, they are able to use that as an alternative and, therefore, that not only constrains the price, but it also gives them real alternatives all the time.

CHAIR: Mr Deppe, may I interrupt to clarify something with market shares.

I wonder if you can tell me, in terms of uncommitted gas, looking at reserves as well as currently available gas, what percentage of the market would Pohokura gas make up when we look simply at uncommitted gas?

MR DEPPE: Well, there are two points there. First of all, I think it is incorrect to only look at uncommitted gas. First of all --

CHAIR: We can look at it -- we've got the big picture. I would like to know if you know what the percentage is that Pohokura makes up of uncommitted gas.

I accept that we have to have the big picture as well, but do you know what that percentage is?

MR DEPPE: That percentage would be higher than 30%, but --

CHAIR: Is it 80, is it 60?

MR DEPPE: In 2006 onwards it would be approximately 50%, but I think at the end of this slide you will understand the reason for the approximation figure, and the reason I say that is for the balancing point, which is acceleration of reserves and exploration.

Those two reasons are pretty important in the gas market. What's happening right now as we speak is that there is a high degree of acceleration of reserves occurring. The McKee Gas Field has announced already that they are accelerating some reserves. There is in fact 2,000 petajoules of gas reserves sitting under the ground right now potentially able to be accelerated. So that gives a fairly high degree of ways in which technology can be applied --

CHAIR: Is that gas economic?

MR DEPPE: Well, that's the point and a very relevant question for this application, because as the gas price rises, those gas reserves will become more economic. So, therefore, that constrains the ability of Pohokura to extract higher prices, because the competition actually increases as prices increase because the other fields produce more reserves or can and do have the ability to produce more reserves, and that's occurring in virtually every field that we have in New Zealand right now.

CHAIR: I guess the question is the extent to which it constrains. It may provide some constraint at some point, but I think to be useful for us we need to understand at what point would that gas provide a constraint.

MR DEPPE: Well, it varies --

CHAIR: And on what terms.

MR DEPPE: It varies from field to field. I can only comment specifically in respect of the fields that we actually have an interest, and I think you referred earlier to the issues at Maui and we will probably discuss those later on in the closed hearing, so I won't refer to those now, but please remember those issues do bear on competition when we talk about them later.

Specifically referring to Kapuni, interestingly we're actually co-operating with NGC -- wouldn't think so from the submissions -- but nevertheless we are co-operating with them to try and increase production at that field. They, on their side of the fence, are going to be expanding a third field and we are, on our part, hosting a very wide range of activities to increase production; this is from workovers, to well sidetracks to water shuttles, there are a host of complex issues at all of the wells, and there are a lot of wells at Kapuni so there are a lot of things that can be done.

MR STEVENS: Mr Deppe, just picking up on that point of acceleration of reserves and the exploration putting pressure on the applicants; will that also assist in reducing the timeframe of delays given? I also note in your last point on the slide there that there is a strong incentive to maximise the gas sales as quickly as possible. At the moment the applicants are predicting a lengthy time delay; do you see that this pressure from future explorations, the pressure from the acceleration of reserves and your desire to maximise the gas sales will actually mean that some of the contracts that we're talking about later on which contribute to the delay will actually be able to be done a lot quicker and more effectively, given that you are so highly incentivised?

MR DEPPE: That's a separate point which will be addressed later in the presentation, and I think it more appropriate that we deal with it at that time, because it's quite a complex --

MR HALL: I could give you a summary on that point at this time. In summary the position of the applicant on that point is that while they have an incentive to maximise gas sales and liquids sales to start earning a return on their investment, that incentive is not as -- has been depicted by some of the parties who have made submissions, so strong that the applicants will sink their further investment irrationally or imprudently, in particular without an appropriate risk return and marketing programme associated with that to recover that investment. So the incentive is there, but it has to be carefully managed.

MR STEVENS: I understand that point, but my question I guess; if the incentive there is you're still carefully managing it and it still remains there, how does that affect your desire to get through the gas balancing arrangements and the other agreements more quickly than you would -- if there's an incentive there to manage it, does that mean that you are also incentivised to manage that process a lot more quickly and rationally?

CHAIR: Can I record, for the record, that it was Mr Hall who spoke to the last question and this one.

MR HALL: Thank you. In summary our position on that is that the timeframe we have described for completion of the tasks required to implement Scenario 1 marketing is a timeframe that takes into account the incentives that the parties have to earn revenue, and it will be part of our submission which I'll come to later in the day that in fact there is a good prospect that the time required to complete those tasks would be greater than that which we have described for the Commission.

MR STEVENS: Thank you.

MR DEPPE: One point I should point out is that -- and it's jumping ahead slightly to the next point, but it does refer to the last question, and that is the issue of liquids.

Different fields have different liquids ratios and so therefore in Pohokura's case it has a very high, rich, in other words, a large amount of liquids and for that reason there is perhaps somewhat less incentive to go off to liquids in some gas fields, whereas in others it's significantly higher.

Just returning to the exploration point which is that Pohokura will compete with exploration; a very key point is that, and I understand a very difficult point for the Commission to estimate, and this is how much exploration is going to be discovered in the next decade or so.

Now, one of the things which is -- I've been around for some 20 or 30 years in commodity markets and I've written an international newsletter on the subject for many years, and back in the 80s we were saying we're gonna run out of oil, and the reason for that was the decline curve; we weren't taking into account sufficiently the amount of exploration. Now of course exploration has advanced with new technology and we're now exploring in places that we couldn't before and we are discovering reserves at a much more rapid rate, and so we have not run out of oil.

Now, interestingly -- a similar trend I notice in New Zealand where in 1997 in Energy Outlook, we actually forecast that the production of gas in the year 2000 would be 207 petajoules; it was actually 230 petajoules. In that same year, Energy Outlook 1997 we forecast that the reserves in the year 2010 would be 89 petajoules. In fact Pohokura, of course, was discovered after that date and the Commission have now estimated 154 petajoules in 2010. Now, of course, as we move on we will in fact discover no doubt more gas reserves and it will be somewhat higher than that, but, of course, it is quite difficult to do that estimate.

CHAIR: Can I ask you a few questions on that. I mean, it's a difficult area. The Commission has looked at this matter more than one time, and frankly we see some of the official estimates and often think they do look low.

However, I would have thought your own experience of trying to project what reserves are even in known fields turns out to be fairly difficult. Sometimes it's higher, sometimes it's lower.

Can I just -- I just wonder, the two observations about in the past it turning out to be much higher than earlier thought, is there not -- what's the probability of it also turning out to be much lower in terms of the future? Is it an evenly balanced probability? I mean, there's going to be an error; is it evenly balanced which way that error is going to go?

MR DEPPE: Well, I think your question was really about the reserves in a particular field, and indeed there are statistical technology which we do apply, and fairly highly sophisticated technology to estimating the fields that are in discovered fields. But really, we're talking about something here which is indeed more difficult to estimate, which is exploration. The only thing we do know is that there are going to be wells drilled, there probably will be more wells drilled as economics improves, and so you would expect logically that there'd be more discovered. How much precisely is a difficult estimate.

CHAIR: That seems to be built into the projections, but why do we necessarily assume the projections underestimate as opposed to overestimate? How do we know?

MR DEPPE: Indeed, we don't know and that's the precise difficulty, and I wouldn't pretend to know. Indeed, every Energy Outlook that comes out, comes out with different numbers. But interestingly, the trend has been that as they get closer and closer to the present the numbers always tend to go up.

So in other words, we're seeing a trend whereby people are conservative in the beginning, which is quite understandable, they look at the reserves that are there, so the long life fields would tend to be taken into account and they would take into account less of exploration. So that's quite a natural and a planning sense, because you don't want to bet the nation on reserves which indeed are not there, so that's quite natural for Energy Outlook to do that, it's quite natural for the Commission to do that as well, but indeed that is probably -- we all know that that's probably not going to be the case, but we know that there's a higher degree of estimation about that forecast.

CHAIR: Do you think there'd be any argument for the Commission to go away from the official estimates?

MR DEPPE: Well, I think it is relevant to look at the recent history and the trends that are there, and so, if we look out a decade or so from today, in that timeframe the share of Pohokura is approximately 25 -- starts off at about 25% and increases to about 35%. So in other words, the period beyond that is -- there's bound to be some discoveries in that period, how that will occur and when that will occur is indeed unknown, but in a entire decade I don't think in the petroleum industry in New Zealand we haven't had one, generally more.

Interestingly, there have been three discoveries in the last six months which we've tracked and noted. They were

fairly small; Kahili, Kauri and Surrey.
CHAIR: So given the official number, what do you suggest the Commission adopt as a reasonable estimate?
MR DEPPE: Well, I think the approach which CRA took was that they tended to only look out a reasonable period of time and beyond that period of time the degree of estimation becomes quite difficult. Indeed by then the Pohokura Field will be -- a significant amount of its reserves will be depleted by then in any event.
CHAIR: Exactly.
MR DEPPE: So the degree to which it is -- and of course the contract terms probably would have contracted into that period in any event. So, indeed the degree to which that is a problem, in the long-term is a problem, is minimised.
CHAIR: I guess then -- I wonder what the relevance of the point is if it's all going to happen to be of much interest in terms of the constraint. Any potential constraint we want to look at in this case, what is the relevance of how much exploration there will be that will lead to fields that are going to come into play long past the point at which we're worried about Pohokura?
MR DEPPE: The relevance to Pohokura is that the possibility -- and this gets to the threat of competition being escalated, being very significant -- is very high in exploration, because Pohokura is indeed not a very big field in international terms, it's quite a small field -- in international terms, because we're only talking about 700 petajoules here. Maui was 5,000 petajoules, and indeed Maui is not a very large field nowadays in international terms.
So, if we discover another field, it only needs to be 1,000 petajoules, and that's indeed the kind of structures

that we all target off-shore -- in fact, we don't target much less than 1,000 off-shore because, as we know, that Kupe is uneconomic, and so smaller fields are uneconomic off-shore, so we have to target large fields and so therefore the possibility of a large field being discovered is a huge motivator to Pohokura to get on with the job, get the thing developed and get the liquids recovered. The liquids are a driver -- indeed, all the participants have mentioned that, and that's indeed public knowledge.

CHAIR: Can I ask you a question. Why did the applicants not factor in any benefits from liquids when you put in your application? [**Pause**]. Why was that? I'm very curious about that, why you did not attribute any benefits in your application to liquids.

PROF EVANS: May I respond to that? There were no detriments in our evaluation and, therefore, any benefit of a significant benefit was sufficient to carry the day, and so, at the outset the actual details associated with what the benefit number would be, so long as we were satisfied that it was in the interests to have on the benefit calculation Pohokura to be operative as soon as possible, that was sufficient. And so, we didn't explore a range of other issues that could have attended to getting a sharper estimate of the benefit.

CHAIR: You have given thought to the fact that there was benefit from it?

PROF EVANS: Oh, yes.

CHAIR: At that time, and you decided that it wasn't material enough to put into the application because you had so much benefit already and no detriments?

PROF EVANS: We had no detriments and the benefits were really insignificant as we calculated and we knew that the addition of the liquids would only enhance the benefits because they are, as we've termed it in our later report, stationary; so presumably it's profitable to take off the liquids whenever you do it and so if you delay it, it's going to be at some cost. So we knew that by adding in the liquids it would not reduce our benefits.

CHAIR: But you weren't concerned with dealing with benefits that someone else might identify?

PROF EVANS: Well, in order to come up with detriments one needs a specific definition of what they are otherwise nothing can be calculated.

CHAIR: No, that's not my point. Whatever the detriments were you knew you'd have enough benefit to outweigh it, whatever they were. But you didn't think you needed to trouble yourself with, how much is the liquid estimated to be at benefit now?

PROF EVANS: It's in here.

CHAIR: I can't remember off the top of my head, but 20 million or something...? [**Pause**]. That's fine, we can come to that later, it's just a question; I have wondered why the applicants themselves attributed no benefit from that in the first round.

PROF EVANS: The aggregate benefit from three years is reported in our last report as $361 million, of which 168 is attributable to gas, and we were confident in our initial submission that the detriments associated with joint marketing were not significant, but we had to satisfy ourselves, both on the gas as well as the liquids, that there were benefits to rapid development, early development of the field, and the fact that with liquids you know that there's going to be a benefit from the earlier development just by the very nature of the international market in which they are traded. All you have to establish is the benefit attached to bringing Pohokura on earlier rather than later, which we did.

CHAIR: Thank you. Sorry, we can go back to your presentation.

MR DEPPE: It is an important point that the -- and the context that we were just discussing was liquids as attributed to welfare calculations, however the liquids actually assist you in respect of the competition argument, in other words, whether competition is lessened or not simply because the marginal revenue that the joint venturer will earn from liquids, particularly in the first years, in fact exceeds the revenue from gas.

So, it is in fact -- gas then in other words, is a by-product in the first few years in the way I would refer to it; subsequently it becomes less, but --

CHAIR: Can I just ask you a question on that. If that's the case, is it the contracts for the liquids that matter in order to get the threshold -- meet the threshold contract level to develop the field?

MR DEPPE: Well the liquids market is an international market and there are no constraints on us being able to sell that.

CHAIR: Yes, that's exactly my point. So, it is the liquids in the first few years that will drive the economics of developing this field, and there is no problem with you selling your liquids on the international markets?

MR DEPPE: Correct.

CHAIR: So is there really a problem about being able to sign long-term contracts in order to develop this field, and to protect your investment risk?

MR DEPPE: I'm not sure I understand the question.

CHAIR: Well, what I'm asking you is, is if liquids drive the results from this field in the initial periods, in other words, it will determine whether you are getting a sufficient return to sink further money into developing the field, and there's no constraints on selling liquids and there's a ready market for it, is there really an issue about the riskiness of your investment in this field to bring it on line?

MR DEPPE: Yes, definitely, because of course as we know because we've got an off-shore field, Maui, and the liquids don't definitely just come, we had major problems developing the oil project in Maui B, we had in fact had major drilling problems, and so in fact we had significant delay as well.

CHAIR: But the liquids come with the gas, is that right? The liquids come with the gas; you can't have one without the other?

MR DEPPE: That's correct.

CHAIR: So if you get the gas you're gonna get the liquids?

MR DEPPE: This is an off-shore development, developed in a very inhospitable environment, so the construction and the continued operation is at -- there's a much higher risk attached to it than both on-shore fields would have.

CHAIR: But, you know, if you get the liquids you'll be able to sell it. There's a market for it as you just told me --

MR DEPPE: Correct.

CHAIR: And in the first few years --

MR DEPPE: But indeed if we can't sell the gas we'll have a problem.

CHAIR: I understand that, but you just told me you don't have difficulty selling the liquids. Do you have any prospect in the next few years of not selling your gas given excess demands for gas?

MR TWEEDIE: The issue more correctly should be put in the context that if there's a delay in us getting gas to market, there's a delay getting liquids for sale. The whole issue is about delay, its separate marketing creates an environment for delay. You have accepted that. We claim you've got the timing wrong. So, the two do go together; gas is the driver to get the liquids to get them to market, but equally it's the driver to determine the project economics, the investment decision, the timing etc, etc.

CHAIR: What I think would be very useful to us if we could get the profile of the returns you project from this field, liquids compared to gas; how much in the first year, second year, third year, fourth year will the liquids contribute compared to gas.

I think the Commission would benefit from seeing that, because I must have missed something here because I didn't realise how much the economics of developing the field in the first year depended on liquids.

MR DEPPE: We have provided that to the Commission.

CHAIR: Have you? Okay, good. I'll have a look at it and if we need further information I'll come back to you on that, thank you.

I'll let you proceed with your presentation.

MR DEPPE: Yes, that's it.

MR SALISBURY: My name's David Salisbury I'm with OMV.

What I wanted to talk to you about was --

CHAIR: Sorry David, just before you go on, I should ask whether Commissioners have any further questions at this point, and staff, experts, any questions on the industry background? [**No comments**]. No, okay.

MR STEVENS: Just one small question; there was a comment that the separate marketing created an environment for a delay. I wonder if later on in the presentation you can pick up on what you mean by the environment for delay?

MR TWEEDIE: We will do.

MR SALISBURY: What I wanted to talk to you about is a comparison of the proposal with the counterfactual when looking at the competition effects and I'll start out with a summary of the points that I would like to develop through this presentation.

Firstly, and contrary to repeated statements and submissions, Scenario 1 is not three independent sellers. In actual fact in our view what you end up with is three very highly co-ordinated sellers, and what is more, they are very highly constrained because of the arrangements we have to put in place between the Joint Venture Partners and I'll develop that point a lot further.

It also needs to be remembered that the reason you end up in that situation is, we continue to be the three joint owners of a single field producing from a single pool with a high degree of uncertainty and a high degree of risk. Therefore, once you understand that point you therefore conclude that there is not going to be enhanced competition under Scenario 1 marketing.

In actual fact in our view what happens with Scenario 1 marketing is that you constrain producer flexibility. We have an incentive once we've built facilities to have them operating as near to capacity as possible because we want to monetise our investment as quickly as possible. It is our submission that the arrangements we will have to put in place between each of the Joint Venture Partners will actually constrain our capability to achieve that.

Secondly, it increases risk. It increases risk for the participants in this joint venture and it increases the perception of risks for explorers conducting business in New Zealand.

It will impose additional burdens of the contract mechanisms that we're going to have to put in place between the Joint Venture Partners, and that's going to give rise to increased cost, the time delay, and I think a very significant point; the wider industry is watching what is going on here, and it would be our view that, if joint marketing is not authorised, or it was authorised on unacceptable conditions, that would have a significant deterrent effect for future investment and explores in New Zealand, which in large part is undertaken by very small companies who don't have access to the sort of resources that we have access to and we will find it very very difficult, as we will develop later in the presentation, to proceed with separate marketing.

I think we conclude that it's a very simplistic argument that three sellers will be more competitive than the Joint Venture Partners acting collectively, and we conclude with the summary that once it is clearly understood how Scenario 1 -- and I use "separate marketing" in quotes because people are attributing separate marketing to Scenario 1, but of course it's not, the independent seller is; so it's not truly separate and you end up spending a lot of effort to accomplish precisely nothing.

CHAIR: I think as a matter of record we simply must ask why, if this is so clear-cut, that it's necessary to proceed on this basis? This Commission was told several years ago that this was not the intended approach for this field, and I just, you know, still have a lingering doubt in my mind about why it's gotten harder rather than easier, or more desirable to jointly market.

MR SALISBURY: I'm not in a position to talk to that not having been present when those earlier statements were made to the Commission. I can comment that from the detailed work that we have done recently, we have this view now and perhaps it's the case that with the further work that's been undertaken the problems have become more evident to people. Because certainly from the perspective of the applicants, it's only when you get down into the detail of what we're talking about that you really start to understand the problems, and at a high level, a simplistic level --

CHAIR: I'm sure that when we put these questions to one of your partners they weren't an inexperienced player in this field. On the contrary, they have ample experience, off-shore and on-shore. So, you may not be able to answer it, but I think the applicants have an obligation to address the matter because it goes to what you are presenting to us here.

MR TWEEDIE: Can I say something on that point. There have been three joint ventures and I can say unequivocally like David, from our point of view, today, you may have looked superficially at this early on saying, well of course you can sell gas separately, and a lot of people are still doing that unfortunately.

We've actually had to apply our minds to what is involved, and we'll take you through some of this in greater detail because it's huge, but what bothers me the most is the massive learning curve we've got -- go up. We have all been used, in this gas market and we're no different from

Australia on that front, to selling -- operating joint ventures and selling gas jointly, to suddenly make a step change to separate marketing is a massive, complicated, difficult exercise.

I know some people say, well, that's your problem, but it's everyone's problem, because frankly it involves significant delay. We have to go up a massive learning curve, everything will have to be scrutinised by legal advisors, it will be contractually extremely complex, and our submissions will bring that out in further detail.

CHAIR: Is there no experience in New Zealand with subject marketing?

MR TWEEDIE: There is none. None whatsoever.

MS BATES QC: Can I follow up on that Mr Tweedie, because it puzzles me why the terms of joint venture were for separate marketing.

Had you not actually given the matter some thought, if it's such a new departure, why did you have it in your agreement?

MR TWEEDIE: The terms of the joint venture were originally struck by Fletcher Challenge -- in fact, none of the partners that are here today were the people who struck the original Joint Venture Agreement. Again, I can only offer what I would view what drove Fletcher Challenge and its partners then, who were BHP and Preussag to -- again, you are very used to having separate marketing for liquids because you can store them, you can get them to ports, you can have parcel sizes that get on ships, you can manage that, and that is -- when you put joint ventures together I have to say most of the time we're chasing oil anyway so that was the driving force, and that is quite normal in

Joint Venture Agreements for oil, and coal and so.

But for gas the norm has always been joint marketing, and I don't believe anyone in those early days addressed the issue closely. In fact, the joint venture didn't specifically say you would have separate marketing, it kept the option open, and that would inevitably have led the joint venturers, as we have had to do, the new parties to the joint venture, to closely look at the practicality of doing it.

MS BATES QC: Yes, but it wasn't until some time after that you became aware of the contractual position, that you moved to actually make an amendment to the agreement.

MR TWEEDIE: Well, life isn't just some static process. I mean, it's a linear thing. As we get closer to doing something we've got to address directly these issues, and clearly when we put our minds to it -- and this will all come out in great detail as we proceed through -- that the difficulties are not to be underestimated, and I would hope at the end of our submissions you equally will be better informed about the difficulties associated with separate marketing than you may be at the moment.

MS BATES QC: Yeah, no, no, I appreciate that, but you understand when the Commission's been previously advised that in fact separate marketing was feasible and viable, we need to ask you; well, has there been a change of mind or did you not think about it when you first advised the Commission?

MR TWEEDIE: I can only say, everyone at that point in time, and the joint venturers that set the joint venture up, it was looking at a very helicopter point of view, they kept all options open. It is only when we have got into the detail that we have seen precisely what's involved.

MR SALISBURY: I'd like to talk to that point because, if I might change hats for the moment I was actually at Fletchers and negotiated that Joint Venture Agreement so I can offer some insight as to how it ended up in that form.

It is a standard form Joint Venture Agreement. As a matter of form, and as Richard said, you go out and you usually explore for oil, not gas. You rather hope not to find gas a lot of the time because of the problems that are encountered and you do leave open the fact that as joint venture participants you're entitled to your separate share and then you worry about how to deal with that separate share later.

In the New Zealand context it's always been by joint marketing. I must say at the time we were negotiating the Joint Venture Agreement we used very much a standard form model and that was the approach that we took.

I would add one other comment which was, we did look at the possibility of a gas marketing forum being incorporated into that joint venture with possible majority decision-making rules and all of the Joint Venture Partners shied away from that and said that they preferred to preserve their position and deal with gas as and when the situation arose.

So, I don't think it's valid to interpret the parties had a view there would be separate marketing of gas; in actual fact it's rather the reverse.

CHAIR: We're not interpreting that. We were told by one of the parties here that that was the intention, and I think it would be most helpful if Mr Jackson addressed this matter because he is with the company who made this submission to the Commission in the past, so I would invite Mr Jackson to address this matter.

MR SALISBURY: Look, I accept that, but I will point the parties to the negotiation of the JVOA, which was the specific point I was answering, and Fletcher Challenge Energy; not Shell, Todd or OMV, the parties that sit before you today.

MR HALL: One related point which is that insofar as the amended agreement is concerned it would not be correct to characterise the Joint Venture Agreement prior to the amendment as one that stipulated separate marketing and to characterise the amendment as one changing that from separate to joint. Rather the view was taken that both separate and joint marketing were options available to the joint venture under the agreement prior to the modification, but that it -- there was an opportunity to make the agreement clearer and more specific than it was, and that was the reason for the amendment. The amendment was not effected to change a stipulation from separate to joint, rather to make the provision clearer and to make the implicit explicit.

MR JACKSON: My name is Murray Jackson, I'm with Shell Petroleum Mining. There will be an opportunity for the Commission to ask Shell separately outside this Joint Venture Application, but I can make a couple of general points. Firstly I think as a general proposition there is a natural disposition for mining companies to prefer separate marketing.

CHAIR: Can you explain that to us, please?

MR JACKSON: Well, I think every mining company would prefer to present itself to the market and negotiate with its particular customers. So, I think -- and you will have seen this in the COAG -- the review, the Energy Market Review in

Australia.

Most companies have that natural predisposition that they would like to market on their own account rather than jointly.

CHAIR: Why is that? What is the benefit to the companies of doing that?

MR JACKSON: The benefit to the company? I think it's representing -- every company has its own marketing disposition and would like to express itself to the market separately, but I would like to make the point that it's a general proposition that is -- it goes to the -- it underlines the difficulty in the New Zealand context of separate marketing that, notwithstanding our preference for separate marketing, we are standing here with the joint venturer seeking joint selling.

I think it's fair to say that the difficulties of joint selling by the people who were representing Shell a couple of years ago underestimated in the New Zealand context the difficulties of separate selling.

There's also issues about the definition of separate selling and I think in some contexts separate selling in the minds of some parties can mean joint selling.

CHAIR: Was Shell new to the market several years ago?

MR JACKSON: Sorry?

CHAIR: Was Shell new to the New Zealand environment two years ago?

MR JACKSON: I think I'd like to defer, I'd like to stand with my Joint Venture Applicants on this particular one and I think there will be an opportunity for the Commission to ask Shell's counsel later.

CHAIR: That would be helpful, thank you.

MR SALISBURY: What I'll continue with then is the comparison of the proposal with the counterfactual, getting down into the sort of detail that we consider evidences that there is no competition differences between the two.

Now, if we look at joint marketing and sale, and there has been the comment that this is marketing by one entity rather than three, I guess it's a rather trite observation to point out that there being three Joint Venture Partners and, therefore, it's not in actual fact one entity.

But there is a very important component to that statement, and that is that there are three parties who are required to co-operate and agree on all aspects of the development and operation of the field. We all have our own commercial interests, we have our own portfolio of assets outside of Pohokura, and we all strive to manage and enhance the value of the investment that we have both in Pohokura and elsewhere.

Now, those different interests incentives and views mean that there is a ongoing competitive tension within the Joint Venture Partners, and I am in no doubt that at the time we go to market on a joint basis, the joint arrangement will represent a compromise between the positions of all the Joint Venture Partners.

CHAIR: Can you describe to us how that process works, of coming to that compromise?

MR SALISBURY: In a general sense?

CHAIR: Uh-huh.

MR SALISBURY: Well, it's a process that involves -- typically you have the operator, in this case Shell Todd Oil Services do a lot of detailed work, sub-surface work, facilities design. We each have an oversight role on that and we tend to be more or less hands-on in different areas depending on where we feel we can best add value, where we have more or less confidence in the work being done by the team, matters that are more or less important to us in terms of our own internal investment criteria. For instance, going to our board for a final investment decision, we're going to have to express confidence in the sub-surface model in view of the reserves that are being presented and the uncertainty around that, and so therefore we need to understand all that information. And likewise the other partners will have similar drivers.

We then have our other competing commercial imperatives. We may have capital constraints coming from our parent companies, funding requirements, funding hurdles that we have to cross, rates of return that are required. In the end we get the detailed information, we sit down, we review it, we may have different points of view, and we eventually reach a compromise.

CHAIR: Does your position in other fields, and the incentives that may or may not create -- must create different incentives for you, the different parties in terms of timing and various other things; how does that play into this?

MR SALISBURY: Well, within the Pohokura forum at the moment we're all driven to get this filed on-stream as soon as possible, so I don't think that's a particularly relevant consideration at this point in time.

CHAIR: So you have a lined incentive now to bring this field on?

MR SALISBURY: Absolutely.

CHAIR: As quickly possible?

MR SALISBURY: Yes. Well, at least I believe so, and I notice, the heads are nodding.

CHAIR: Why is that the case in terms of your company? Why is the timing right for your company?

MR SALISBURY: From the perspective of OMV, we've invested some hundreds of millions of dollars into the acquisition of an interest in the Pohokura Field and we are incentivised to get that field on-stream as soon as possible to monetise the investment and get a return on the dollars that we have outlayed.

Now, having said that, and going back to the point that was made earlier, is that an overriding incentive, and no, it's not; of course, we have to move forward in a commercially prudent manner and have regard to earning an acceptable rate of return on a risk adjusted basis. So, we're not going to take unacceptable risks, but we have invested a lot of money and we want to monetise it as soon as possible.

MR STEVENS: You mentioned in the previous slide that there were some risks associated with the separate marketing. What were they that you could identify?

MR SALISBURY: Perhaps, I'll be coming to that in a lot more detail as I go through, if that's right all right?

MR STEVENS: Yep.

MR SALISBURY: A very general comment is that you do get a misalignment of incentives. At the moment we're all incentivised to maximise the value of Pohokura because we all take our equity percentage; there's no difference.

When you move to a Scenario 1 marketing situation, you actually do set up arrangements by which we can actually maximise the value of our individual interests, which means we might take value off Joint Venture Partners; that's normal business practice. I mean, we would be put into a position where, to optimise the value of our investment, we will look at all avenues to extract value.

MR STEVENS: To compete?

MR SALISBURY: To compete, exactly.

CHAIR: So you think you can achieve the same value within this arrangement that you could have individually?

MR SALISBURY: Sorry, if we go down the route of...?

CHAIR: The Scenario 1.

MR SALISBURY: That we would get the same value as we would with joint marketing? No. For the first reason that there's going to be a substantial delay before the field comes into production, and that's of enormous concern to us. And secondly, once the field is in production we are going to be managing a much more complex set of arrangements, and it would be my personal view that we're going to end up with a much larger team of people, we're going to be looking not only at our interface with customers but more closely with our Joint Venture Partners all the time, and there is a much greater scope or value erosion, as well as increased cost, as well as delay in the start --

CHAIR: When we read some of the overseas evidence it suggests the key factor to developing a field quickly, say under a Scenario 1 type situation, is whether the Joint Venture Partners have aligned incentives, and you believe you do?

MR SALISBURY: I think that is only one component though, and later on we will be touching on -- I think you might be referring there to some of the Australian precedents. I think that is a factor with a number of other relevant conditions that make separate marketing feasible, and we would differentiate those.

MR TWEEDIE: Can I say, we've got a lot of incentives today because we're assuming we're proceeding on a joint marketing basis.

If the Commission comes down with separate selling, the position where it will have to face separate selling, alignment could well evaporate very very quickly, because we will then be seeing our joint venturers as potential, potential parties who could seriously erode value out of our share of Pohokura.

CHAIR: They would compete with you?

MR TWEEDIE: Well, it's not competition in that sense. You could say it's the other way, they're thieving our gas; it's theft rather than competition. I call it theft. They've flogged our gas, they haven't paid for it and we've got an internal scrap -- you've only got to look at the sorts of -- it's not directly, but litigation, you've only got to look at Greymouth Petroleum and Indo-Pacific right now, who are dragging themselves through the courts, two little companies on a dispute that is hugely value destructive. You've got gas being shut in, production being held back.

I will predict, very confidently, that is precisely what will occur with separate market -- if we go with separate selling with Pohokura. It will be ultimately value destructive for the partners, value destructive for the nation and will involve a serious delay with significant economic repercussions to the nation if we go the separate selling route.

CHAIR: I don't know where "thieving" comes into economic models, but we'll ask Professor Evans when we get there.

MR TWEEDIE: Trust me, we all know what "theft" means if we're indulging in it.

MR SALISBURY: I don't think it's an economic model, it's a practical reality, Richard. There's a diagram or a picture that we've put up on the overhead --

CHAIR: You don't have copies of that, because I think at least one of my colleagues can't see that. Do you have copies? It would help with the presentation.

MR SALISBURY: We do. It was a very simple diagram, it was only intended to represent the point that has been made which is we do need to co-operate and agree on issues of marketing, sub-surface development, but we do retain our separate commercial drivers and we do need to reach agreement that allows us to move forward.

MS BATES QC: I just want to understand this a little bit better at this point about the alignment and misalignment.

Because you're saying, if there's separate marketing there's likely to be a misalignment incentive, whereas that's not likely to be the case if there's joint marketing. Just putting it very simply?

MR SALISBURY: I mean, there is still competition within the joint venture competing interests and that forces us to have to co-operate and agree, which is why you do get on-going competitive tension in a joint venture forum.

The difference is that when we develop the field jointly and we go out and we get -- we have a gas contract and we're selling 100 terajoules a day of gas, I get my proportion at share and the other companies get their proportion at share and there can be no gaming between the partners --

MS BATES QC: Just let me take it slowly.

The misalignment of incentives from separate marketing, I understood you to be saying that comes about because you will have regard to your other gas interests and maximise the whole position having regard to the -- no?

MR SALISBURY: No, the point about separate marketing is that --

MS BATES QC: Where does the misalignment of incentives come from?

MR SALISBURY: It's the fact that we have to implement all of the balancing mechanisms, which is not just a gas mechanism, it's balancing all of our rights across all of the aspects of the joint venture. Instead of being an equity proportion in everything that happens, we then have contract arrangements that try to keep us in balance, you know, in equity proportions.

Those contract arrangements are going to be complex and they are not going to cover all matters that arise, and inevitably there is going to be some winners and some losers through that, you know, as the field unfolds and production occurs, and that's the misalignment; it's the fact that instead of being able to concentrate and sell your gas to a customer and know that whatever happens you get your equity share, I will be selling gas to a customer and all the time concerned about what my Joint Venture Partners might be doing as well and whether at the end of the day the contract arrangements we've put in place are going to balance our rights across the field over the field life.

I develop this a lot more through the rest of the presentation.

MR TWEEDIE: I could also add though, you're going to get more likely -- with separate marking if you go down that route, there will be gaming going on between partners and their relative portfolios of gas.

MS BATES QC: That's the point I'm pursuing.

MR TWEEDIE: No, you're right. Right now with joint marketing we've got competition between fields and it's very hard, I can assure you, to game your portfolio of gas when you've got joint ventures at different joint ventures; parties within separate fields.

But if we go separate marketing we would be definitely looking at our portfolio, our bank of gas; that could definitely lead to gaming, it could definitely lead to a party taking a quite different strategy with regard to the timing of Pohokura development and the quantum of gas that Pohokura ultimately produces.

That does not occur when we've got joint marketing of gas at Pohokura, so there's a lot of inefficiencies and disincentives to act in the interests of the Pohokura development you will tend to look more closely at your own position and your bank -- your portfolio.

MS BATES QC: Do you agree that it might be a matter of degree? Because whatever is the scenario, you'd always be having regard to your total portfolio when you're making a decision surely?

MR TWEEDIE: No, I reject that because you've got -- in working in a joint venture you've got contractual obligations. Normally joint ventures, there's a provision that says that the joint venturers have to act in the best interests of the joint venture and maximise the commercial advantage of the joint venture to all the joint venture parties. You've got some very clear fiduciary contractual obligations to your partners to maximise the value from that field, and you are not doing it if you are looking over your shoulder at your other interests.

MS BATES QC: Just let me take that a little further.

So, you have an obligation, you say a fiduciary obligation to the other joint venture parties. Now, how does that affect your obligation to your shareholders, your normal director obligations to act in the best interests of the shareholders in your company? In other words, which obligation takes precedence?

MR TWEEDIE: They don't normally. What we're used to doing, joint marketing, the way we run -- have run these businesses in New Zealand, the joint venture nature of operating these upstream oil and gas businesses is well understood and to answer your question, there's normally no conflict.

MS BATES QC: There's no conflict?

MR TWEEDIE: I have not yet had a position where I have had a problem with my board that has had a quite separate interest, business outcome, business requirement, that conflicts with the -- with our obligations to our partners in terms of the fiduciary obligations within a particular joint venture.

CHAIR: I'll ask Commissioner Taylor if you'd like to follow-up.

MR TAYLOR: I was working down the line that Ms Bates was as well.

Mr Tweedie painted quite a horrific scenario unfolding under separate marketing, of theft and litigation and contractual dispute situations that, because there's been no separate marketing of gas in New Zealand, it hasn't happened here.

Are you able to point to examples off-shore where the whole relationship has broken down in the way you characterise?

MR TWEEDIE: Well, I mean --

MR TAYLOR: I'm not arguing the theory of what you layout.

MR TWEEDIE: Well, the simple answer to that, and to add to our knowledge and experience -- I mean, about as far as we go in looking at anything in Australia, the model of separate marketing doesn't exist there.

I mean, this Commerce Commission in New Zealand is breaking new ground in Australasia. The US; I know nothing about the US, it's a totally different market, it's far larger, it's far deeper etc, etc. There is no experience of -- so we're looking at what may happen, what we would expect might happen, and I'm quite comfortable in our assumptions and concerns.

MR TAYLOR: I can see that; I was wondering whether Mr Berry might have done any research on the sort of doomsday forecast you have...?

MR SALISBURY: I'd offer up an analogue situation when you try to divide a field between three companies and what happens when they inevitably get out of alignment on their off-take, and that's the Maui situation and what you see going on between the purchasers of that Maui gas, and I believe the word "theft" might even have been used in that forum, Richard.

MR TWEEDIE: Yeah. Contact and NGC would claim Methanex has stolen their gas, and they probably have.

MR SALISBURY: But it's the problem when you try to assign an equity interest in something via a contractual mechanism.

CHAIR: Are you sure you want that on the record?

MR TWEEDIE: No, I'll be told later.

CHAIR: Well, it's there now, so...

MR TAYLOR: Yeah, that was where I was heading.

MR STEVENS: Just a follow-up question. It really was the discussion that there might be a value destruction in the joint marketing in that you are unable to combine effectively the gas that you take out of the joint field with your other interests elsewhere. How does that compare with a value destruction under separate marketing?

MR TWEEDIE: Could you repeat the question?

MR STEVENS: I may have misunderstood what you were describing before, but what I understand was that there was a certain amount of -- you are unable to take into account the gas from your other field when you're dealing with it under your joint marketing arrangement. To that extent there will be certain value destruction to those parties who have gas elsewhere and if they were able to take the separate marketing gas out of this field they might be able to effectively game it better and combine it with gas elsewhere and get a better result as opposed to a Joint Venture Partner who hasn't got the opportunity to do that.

My question really was, how do those two value destructions compare overall?

MR TWEEDIE: I mean, you have to come back to the starting principles in your -- joint venture, in each joint venture you are in, what your obligations are there to each joint venture, and they're very clear. I mean, joint venture agreements have a very standard form and there are very clear legal obligations to each other.

If you try and subvert that obligation, you run a contractual risk, one. Two, you will never never easily be able to work with your joint venturers. You have to put as a primary position the business of that particular joint venture and put behind that your interests in another field if there's a conflict.

So, you have to look at each joint venture, your position, and each joint venture on its own merits.

MR STEVENS: So what happens if you're in the joint venture but you decide that you want to separately market, and how do you deal with that issue then?

MR TWEEDIE: Well, no one has had to face that experience in New Zealand to date. This is the issue before us today, and I can say there will be a massive sea change in behaviour if we have to separately market Pohokura gas. That will have -- I mean, we'll be going through this in greater detail what we've got to go through, but where you have trust and goodwill between partners -- to operate in a joint venture environment the first thing you've got to have is trust, you've got to have a massive degree of goodwill, you've got to be prepared to compromise; you've actually got to be prepared to put your own self-interest behind the common interest of the joint venture, and that's not just on commercial issues, it goes to the operation of the field.

After all, we're going to be spending close to $1 billion in developing this, and you've got to have confidence in your operator, you've got to get -- there's a wealth of things that you are forever, I have to say, compromising self-interest to the benefit of the joint venture, because if you didn't do that nothing would happen, we'd be totally dysfunctional and we would wreck value for us all, and that's how joint ventures work.

Good joint ventures work very well and they are very rewarding to work within, and thankfully mate, all our joint ventures in an upstream basis are like that, but I can safely predict, if we go separate marketing in this, dysfunctionality will prevail with all the negative detriments that will be associated with that.

CHAIR: I'd like to take one more question from Ms Bates and then we'll return to the presentation.

MS BATES QC: You have said quite a lot about the contractual obligations to the Joint Venture Partners under the Joint Venture Agreement. Would you not agree that those obligations do not change in legal terms whether you're separately marketing or joint marketing; you still have the same obligations under the joint venture, do you not?

MR TWEEDIE: Those joint venture provisions will still be there, but if we are effectively -- we have statutory -- well, through, let's say the Commerce Commission, a statutory or intervention that will effectively invalidate some of the provisions in the joint venture -- well, that will be, I have to say, the net effect.

MS BATES QC: But it won't invalidate the provision that says that you have to act in the interests of the joint venture, surely?

MR TWEEDIE: Well, the interests of the joint venture, you would have put us in the position, frankly, where the interests of the joint venture is non-alignment; separate marketing does not, does not sit with a common interest and alignment, so we will be non-aligned.

MS BATES QC: Are you saying, though, that you will not observe your contractual obligations to the same degree if you are forced to separately market? Is that what you are saying?

MR TWEEDIE: If you ask me my position today, and I certainly haven't discussed this with my joint venturers, my immediate response to your question to be that there would be an implicit variation to our obligations to each other.

MR SALISBURY: I think Richard is right, it's a challenge to the fundamental premise of the Joint Venture Agreement and what you are highlighting is a conflict between the fact that the essence of a joint venture arrangement is indeed to co-operate, but if we're forced to go down a route of separate selling we're actually being set up to conflict.

I would suggest the outcome of that is likely to be along the lines that Richard has articulated, probably because you would have to reconsider the whole basis of the joint venture relationship, because you've challenged the fundamental premise of it, you've got to --

MS BATES QC: Going back, I'll try not to protract this, but going back to the original agreement before the amendment came in, and there was some discussion about whether you had the option to joint market or not, but the term in the agreement was that -- just let me find it for a moment. [**Pause taken while referring to documents**].

"That parties shall have the right and obligation to own, take in kind and separately dispose of the share of the total production". That was the original term. Subject to a proviso that said, "If natural gas was discovered it might be necessary to enter into special arrangements".

So, in that first Joint Venture Agreement there's actually no direct reference to joint marketing, so I find it very difficult at that point to say that it was fundamental to the joint venture that there be joint marketing. It can't have been the case, can it?

MR SALISBURY: Well, actually, I disagree and I go back to the point I made earlier, which is, this is based on a standard form document. The way it works when you are negotiating these agreements is, you have so many problems to deal with at the time you're putting together an exploration joint venture, plus you're going out to drill wells that might have something like a 1 in 10 chance of success; you don't worry about all eventualities.

MS BATES QC: Well, that's my point.

MR SALISBURY: To keep up the context of the Joint Venture Agreement, what you do do is preserve to the partners the entitlement to their share of the off-take and decide later how to deal with it.

Now, the way that has always worked in the market in New Zealand is, you've then entered into joint arrangements. So, I think it's important not to read in fact, or to try and take that clause out of context, of the industry context, and read into it circumstances that simply were not present when it was put in place and, you know, are not helpful to help interpret.

MS BATES QC: Even in the amendment to the agreement the proviso allows you the option to joint market. Now, if joint marketing is so fundamental, why do you leave yourselves the option of separately marketing under your own agreement?

MR SALISBURY: Well, the only reason for that is acknowledging we're heading into an authorisation process and we can't be quite sure what the outcome will be, although we have very strong views on what it should be.

CHAIR: I think we'll proceed with the presentation if we can, please.

MR SALISBURY: The next aspect that I'd like to look at is to go into some detail on the counterfactual and to actually get into some of the -- eventually we'll come to a table that tries to go through a gas contract clause by clause and looks at the difference between what we're talking about with joint marketing and what we would end up with under Scenario 1 and whether there is any competition difference.

I build the platform for that by starting a general discussion about the counterfactual. For the purpose of this hearing we have accepted that the most likely counterfactual is Scenario 1 marketing. Now, there is a common assumption by those who have opposed the application that there will be substantive differences between joint marketing and what we call Scenario 1, and I use again quotes "separate marketing" and it's a key assumption and that's why we wanted to investigate it and see how separate Scenario 1 marketing in fact is.

It's our conclusion that it's a flawed assumption that there are any big differences whatsoever, and the implications that flow from that misunderstanding are really quite critical to the analysis of the application.

So I just pick up on the description that's been applied to the counterfactual, I think this comes from the Draft Determination, and certainly I think records the general understanding of people who have put in submissions.

That is that the joint venture purpose will agree on the development profile and gas output of the field; that we will separately sell our proportion of the gas in line with their equity ownership of the field, and I take it that that means that there's an acknowledgment that inevitably on a day-to-day operational basis we will get out of alignment but we will contract, or put in place some mechanisms that will try to achieve alignment over the life of the field so we'll get our equity entitlement.

The third point is that we will put in place measures which will address the problems associated with separate marketing.

I note that it says "including a gas balancing agreement"; we'll go into this in a lot more detail later, but a gas balancing agreement is only one component of it. If you bear in mind again that we're dealing with something that is kilometres below the earth's surface, there is huge uncertainty on sub-surface risk, we have differences of opinion on facilities design, we will have different customers who might have gas specifications and so forth, different off-take rates, certainly we have different commercial incentives.

We have not only a gas off-take but we have liquids off-take as well. We're looking at Commonsate(?) as well as LPG, and we need to balance our rights over all of that, it's a build investment which is multi-faceted, and that's what we're trying to balance our rights over, not just balancing the gas, but we come to that a little bit more later.

So, if we turn that around, what Scenario 1 marketing is going to require us to agree on is all key development and production matters. This is simply necessary for us to develop and operate the field which continues to be owned on a joint basis.

Then on top of that we're going to put in place contract mechanisms which are going to try and balance our rights and obligations between each of the Joint Venture Partners across all of these other aspects.

And, these mechanisms are required because inevitably we are going to get out of alignment on a day-to-day operational basis and are going to need to have balancing mechanisms put in place.

It also reflects the fact that inevitably as we start producing from this field and selling separately, we are going to get out of alignment with incentives as we've talked about already. We would characterise the difference as changing the incentive from maximising the project value, which is, where we're all aligned and none of us benefit disproportionately, irrespective of what happens, to maximising our share of the project value.

Now, I want to go into a bit more detail on the contract mechanisms. They are going to have to address as between the Joint Venture Partners all of the key contract parameters that we're going to have to deal with for development and operation of a gas field.

There's a very pragmatic reason for that. Before I can go out to market and offer a gas contract to any one of the purchasers I'm going to have to be sure as between myself and my Joint Venture Partners that the terms on which I'm prepared to supply that gas to a purchaser are actually going to be acceptable and enforceable against my Joint Venture Partners.

It's no good me going to a customer and saying I'm going to offer you a profile at X terajoules or petajoules a year with a swing factor of plus or minus 50% and I go back to my partners and they say no, no, we're not going to over-build the plant by that much capacity for you to be able to provide that swing to your customer; in actual fact we all had in mind a much smaller plant capacity with a much smaller swing factor.

So, before I can enter into that contract with my purchaser I have to agree that parameter with my partners. I'll go into this in a lot more detail as we go through the terms of the contract, but you will see it holds true for every key commercial term of a contract; because I simply can't afford to be out of alignment with my partners at the time I enter into a third party arrangement. It exposes me to too much contractual risk.

And if it's also going to be the case that, not only do we have to protect ourselves in our ability to supply purchasers, but we have to protect ourselves in our rights and obligations between our Joint Venture Partners because we have to be assured that we are going to get our equity share of the value out of this field at the end of the day.

So when we put up a diagram that depicts the situation that's going to eventuate we end up having -- this is the building on the earlier diagram and showing some of the additional steps that are going to be required -- but we end up having three sets of marketing knowledge.

Now, it is the case that we all have different marketing knowledge today, and we're all party to contracts that are confidential from the other Joint Venture Partners. But nevertheless as regards Pohokura marketing, if we're doing it jointly we will have a shared set of information.

If we go out to markets separately we are going to have three sets of information, and so we're likely to have differences in information. We're going to have the different commercial models and parameters that drive our company, and we're actually going to have to develop different sub-surface models as well.

Because if I'm going to negotiate a contract with Shell and Todd to allocate the proportion of the field value, I'm going to be trying to put in place contract mechanisms that I feel best protect our interests, and to be able to do that I'm going to have to understand the sub-surface of this field in detail, and to enable me to do that I'm going to have to build in detail a sub-surface model sufficient to enable me to negotiate and reach commercial conclusions. Sitting on the opposite side of the table from my Joint Venture Partners. We're going to have to put in place the arrangements that balance the rights between the partners and we have those depicted as a gas balance arrangement. We'd probably have to have a revised JVOA -- we've touched on that already -- revised Operator Agreements. We're going to have CapEx and OpEx allocation agreements, we're going to have liquids uplift arrangements, and then we're still going to have to agree on a development plan and production, because ultimately we come down to one development from one field with one production profile.

This diagram is designed to further make the point and to show, we see quite a shift happening. When we are joint selling the three of us co-operate and agree on development of the field and then we enter into negotiations with our buyers, and that determines the gas contracts.

If we go down the Scenario 1 route, we have to agree all the key development and production parameters plus all the key gas contract terms between ourselves before we can go to the market, again for the reason that I have to be assured that when I offer a term to a purchaser or enter into a contract with a purchaser, I can actually comply with that term and for that reason it has to be enforceable against my Joint Venture Partners. So we have to have considered it.

So in effect you shift the negotiation upstream, so the three Joint Venture Partners end up setting all of the key parameters that are going to govern the gas sales arrangements and those end up becoming constraints and imposed on the buyers, and we'll go into that in some detail as we go through the contract terms.

So, looking now at what does it mean in practical terms; well, to answer this, as I've mentioned already, we'll go through a table and it will look at the gas sales parameters and how they would be determined under a joint sales basis and Scenario 1 basis.

The comparison is premised on the discussion that's just gone before; joint marketing, we co-ordinate development, production and marketing. Scenario 1 marketing we co-ordinate development, production and all of the arrangements we have to put in place between ourselves to balance our rights and obligations and be sure we can comply with our gas contracts.

We've separated this table into physical and then other terms, and I'll start with the physical terms. I don't intend to go through all of them, but maybe pick out a couple of examples. If I went through all of them, that would actually be a gas contract negotiation.

But, if we start very simply. If we start with the total quantity. Now, for joint marketing the total volume is set by the recoverable reserves, and the annual and daily contract volumes are going to be set by gas contract negotiations.

If we look at Scenario 1 marketing, the total volume is still set by recoverable reserves; there is only ever what there is in the field. We don't increase the quantity of gas that is ultimately available to the market by going down the Scenario 1 route.

The annual and daily contract volumes are then going to be set by agreement between the Joint Venture Partners and we're going to have to agree the development and operation parameters and then with iterative discussions we would imagine with the buyers. But the total volume that ends up being supplied is no different.

The production rate. If we look at the joint marketing situation we set the production rate by agreement. If we go into Scenario 1, we still have to agree the plant capacity to be able to agree the facilities design, the CapEx budget, the OpEx we're going to be in for. We are agreeing the plant capacity and, therefore, the production rate we're setting a cap on.

In actual fact, and I point in out a little later with some of the other points, we think that because of inefficiencies the plant would be operated less effectively if we go down the Scenario 1 route than if we go down the joint marketing route and we'll end up with spare capacity that we're not able to utilise on a day-to-day basis which will in fact restrict the rate at which the gas might otherwise go to the market. Remember, once we have built the plant we have an incentive to utilise the plant to the maximum capacity. Spare capacity does not make money for us, it is just a wasted investment.

We've gone into this in the level of detail, if you could just go back to understand. For instance, when we look at a seller maintenance obligation. Now, under joint marketing we're going to set that by agreement, but we have regard to the facilities design, to the design of the off-shore wells and we have a requirement for maintenance; it is what it is.

Exactly the same situation applies if we're in the Scenario 1 situation. Our maintenance is what it is because we've agreed the facilities design, we have agreed the well design and the off-shore platform design and pipeline design and, therefore, we are physically constrained by what we can offer into the market. It is what it is. We've set it by agreement.

Coming on to some of the non-physical terms. If we look at the nominations regime. Now at a practical level we're going to have a field sitting off the coast of Taranaki, a production station just on-shore in north Taranaki operated by a single operator, and they're going to be trying to manage on a day-to-day basis the physical production from the plant and the rate of gas off-take and will be helping us by notifying us the extent to which we've received nominations and how our customers are performing.

If we go into the joint marketing route, we will simply agree a nominations regime and the operator will implement it. If we go under the Scenario 1 regime we're going to have to agree the same nominations regime because we can't have an operator sitting there with multiple different nominations regimes trying to balance the rights of the partners.

So, if I'm concerned about what is the plant capacity and my ability to change nominations and how those rights are influenced by the activities of my partners, before I go out to a purchaser I'm going to set that regime before me between myself and my partners. I have to, because I don't want my contract with my customer saying you have to give eight hour's notice to change your nominations by this much, and one of the other partners thinks, gosh, if they're going to be that lenient I'll give my customers one hour's notice and put operational challenges on the operator that then come back at cost to me as the other Joint Venture Partner. So, we end up setting that sort of thing, again, in advance.

Liability for failure to supply; I had this discussion with someone the other day and thought it was an interesting example. If we are selling jointly we will negotiate with our purchasers liability. If we are under the Scenario 1 regime and we fail to supply, what is the liability we might offer to a purchaser?

Well, one of the reasons that we might fail to supply is one of my partners has over lifted and I have to protect myself against that. I might not be able to deliver to my customer because one of my partners, through their customer, has lifted too much gas.

So therefore I'm going to say to my partner, you need to compensate me, I want a liability mechanism. That partner is not going to go for an open-ended indemnity that will allow me to pass on any level of liability I like to my customer. So then we're going to have a negotiation and logically it's going to set around some form of liquidated damages limited to the direct loss.

Now when I go out to my customer and I say, if I can't deliver you on a certain day because somebody else has over lifted on the field, I'm not going to offer them more in the way of damages than I can get from my partner. I'm not going to be able to offer them unlimited scope to negotiate because that's not going to be acceptable to my partners, they have to tie off that risk at the time we're putting the arrangements in place, so therefore I will go out to my buyer and I'm going to say, look if I can't supply you on a day because the gas is in there because somebody has over lifted, then the most I can offer you is X, and the reason for that is that's the most I can get off my partners, and I shouldn't be exposed to more liability than I can get compensation for from my partners.

So you start constraining very strongly the terms on which you can offer the gas to your purchaser because you have to be able to protect your position amongst the Joint Venture Partners.

An interesting one when you look at the nature of contracts in New Zealand is, what is the ability to deal with reserves risk? Now, if we're in a joint marketing situation the Joint Venture Partners are aligned and, therefore, we can have a discussion and whatever happens with regard to reserves risk the extent to which we keep it, we're in alignment.

If I go separately to a purchaser and let's say that purchaser actually is -- I want them to take some reserves risk, I have run into some practical problems, how does that play through? Can I give them access to reserves information? The Joint Venturer Operating Agreement makes that information in the first instance confidential to the Joint Venture Partners, so I can't provide that information to my purchaser unless I have the agreement of my Joint Venture Partners. Now, if they have a different model of reserves risk, they won't give their agreement.

Let's say one of the mechanisms for managing that reserves risk goes along a Maui sort of situation, which is a redetermination mechanism. Well, my partners who are not party to that contract may have no interest in a redetermination whatsoever, let alone opening up the field to a discussion in some sort of an independent expert forum or something like that involving a purchaser with whom they have no interest whatsoever. So, therefore, I'm going to be contractually constrained in my ability to deal with reserves risk because I have to have regard to my obligations to my Joint Venture Partners.

I'll touch on one more; buyer force majeure, and I mean, these things end up to being quite controversial in practice when you're putting in place a gas contract.

Now, in the joint marketing we'll be able to sit down, and I'll be able to say to a buyer and say what are your force majeure constraints -- actually force majeure and maintenance; what are the situations where you might not be able to accept delivery of gas, and we can have a negotiation.

If I go separate marketing, I'm going to be constrained in my ability to make up gas and so forth; I don't want to be getting too far out of balance with my partners, but my partners and I will have agreed a series of events which we consider is acceptable for buyer force majeure.

But we can't go along and have a buyer say, I have an event, a force majeure, I can't uplift gas which is outside of anything you and your Joint Venture Partners ever thought of and I'm now going to not uplift on a certain day, that gives you significant imbalance problems between you and your partners. So, we're going to have to set in advance those issues of force majeure, under lift by purchasers and then how we're going to deal with it in the gas balancing arrangements before we can enter into those terms with purchasers.

That's probably enough, it's covered a bit of a gas contract, but the comparison highlights that as you go through all of the key gas contract terms there really is either no difference, or if anything the Scenario 1 marketing ends up being more constrained than the sort of arrangements we would be able to enter into if we were to go down the joint marketing route.

And for that reason it is simply not correct to state that Scenario 1 is in any meaningful sense analogous to independent or competitive marketing. It simply cannot work that way. Therefore it's quite inaccurate to characterise the proposal as against the counterfactual as the most obvious impact of the arrangement of the gas from the field would be marketed by one rather than three entities. It's really not that simple.

I'll just go through very very quickly because I've made the points already, but if we look at the impact on pricing. Under joint marketing and Scenario 1 marketing the quantity has been agreed between the Joint Venture Partner. No Joint Venture Partner can increase its revenue or market share by undercutting the other Joint Venture Partners. I have going forward 25% or 26% of the field. Regardless what happens I have 26% of the field, there is no benefit to me in trying to undercut the other partners and get 30% or 40% of what this field might produce because ultimately we have to balance amongst ourselves.

Then we come to the issue, what is a likely balancing mechanism? Well at the moment it's hard to see that there is going to be a source of gas which we could utilise as a ready mechanism where all the partners have an interest in equity proportions sufficient to cover the risk of getting out of balance physically on the gas from the Pohokura Field. And we will be driven in the negotiation s to look for some form of a cash balancing mechanism, and we've debated this one a lot internally, and you go around and say, what would the cash balancing mechanism be? At what price would I accept cash from my Joint Venture Partners if they've used my share of gas from the field?

And the answer becomes, I'm not going to lock in a price because if that's below the market price and if it gets below the market price my Joint Venture Partners will be encouraged to use my share of the gas, and then pay me a lower price. And it wouldn't be higher than the market price because I'm not going to pay more to one of my Joint Venture Partners than I got for the gas when I may well not have known I was going to be out of balance at the time I used that gas. And inevitably the gas balancing mechanism's going to come down to the market price, with some degree of difficulty because we don't have a liquid spot market or a spot market in any real sense in New Zealand to know what that market clearing price will be.

So we're going to be logically driven to a market price as the cash balancing mechanism, but with no ready mechanisms to determine what that market price is. The discussion we've had internally to date, we come to the view that you would probably end up having to disclose the terms of your contract, so you find out what the price actually was at which the gas was sold and settle on that basis.

If we look at the contract terms: As talked about in some detail, by the time we've been required to co-operate and agree all of those arrangements in the level of detail necessary to support our investment in the field and our ability to contract with third parties, there can be no significant difference on any of the key terms that we go out to market with. I mean, it might not matter what the invoicing period is or something like that, but on the key terms of quantity, rate, gas specification, gas quality, timing for when the field commences production, we're going to be agreed on all of those; we have to get the Scenario 1 marketing to work in the first place.

And once we've got to that point we all have the same contract constraints. So let's imagine I go out to the market and try to be more aggressive, more favourable to a seller than one of my partners. I already know they can undercut me because we've had to set the terms between ourselves and they can go out with slightly better terms.

Let's say I go out to the market with terms that are more beneficial to a purchaser than those I've agreed between myself and my Joint Venture Partners. All I do then is lose value because I know that I'm going to have to compensate my partners for the difference. So naturally the contract terms are going to settle around those terms that we've had to agree between ourselves.

I want to touch on the effect of the Scenario 1 on the development of competitive markets. Firstly, and repeating a point that I've made several times already, this will not be three sellers. So, it does not give added depth to the market. What it is going to be, is three highly constrained co-operating producers from the same field selling gas into the market. In actual fact there's going to be no increase in quantity, but with the additional contract constraints that will get in the way of our ability to operate a plant at capacity, contract with flexibility, which is most likely to stimulate the New Zealand gas market and increase competition.

I'll give an example, and this is getting into operational practicalities. On a day this plant has some spare capacity. We don't have real-time metering and reconciliation procedures in New Zealand, and nor do I think it is likely that that will be achieved any time soon. In fact it's being discussed in the Maui forum because it's -- one of the blocks to a gas balancing system is how readily reconciliation of balancing can occur.

So on a day there is spare capacity in the plant but I don't know on that day -- I've got the nomination from my customer, but I don't know how much gas they've actually uplifted. So whose is that spare capacity? Is it OMV's, is it Todd's, or is it Shell's? And we want to sell that spare capacity, we go out to the market, there's a shortage of gas that day and we want to do a spot sale of gas. Who does the spot sale?

Let's say that OMV says I'm going to do the spot sale, and then subsequently finds out actually my customer was lifting at my equity level of the field, maybe even above. And, therefore, I've actually just sold some gas for Todd and Shell, and so we're going to have to have the balancing mechanism apply. But on any given day that is going to restrict our ability to go out to the market with the spare capacity.

Now, the situation with joint marketing, there's spare capacity in the plant, and there is an opportunity to make a spot sale. We're incentivised to get the gas out of the ground, to get the liquids and to use the plant to the maximum capacity and, therefore, the three of us will enter into a joint sale on a spot basis to increase the rate of gas off-take from the plant.

CHAIR: Mr Salisbury, I just want to interrupt for a minute. I'd like to just check, I'd like to carry on for another 15 or 20 minutes, if that's all right with the transcripters.

What I'd like to do is interrupt you for a minute and allow Commissioners an opportunity to ask some questions. I think it's been quite helpful for you to take us through the sort of detail that you have and we have been, as you know, been requesting that sort of detail.

I might ask the first question. It does seem to me that what you have presented suggests that your potential customers should feel that what -- your proposal is a good deal for them, that their interests as well would be served, and I just wonder, you know, why do you think that a number of them don't think that? Why are they objecting? Why are they concerned about the terms and conditions that they might get under this proposed arrangement compared to what they would get absent it?

MR SALISBURY: I think my honest answer to that is, it's a knee-jerk reaction, it fails to understand the detail of what is being discussed, and it's using --

CHAIR: So they don't know what's in their own commercial interests?

MR SALISBURY: -- and it's using this forum as a negotiating ploy to try and impose conditions on the contracts and the manner in which we might eventually conduct our business. I think that's evidenced by the assertion rather than detailed argument that's been made in a lot of the submissions in response to our submission. A lot of sweeping statements, and by the concentration, as I understand it of the other submitters from their memos that they have filed, on conditions.

CHAIR: Can I just -- I want to talk to you about some of the concerns that they have and give you an opportunity to respond to them.

One of the concerns is about the ability of the applicants to place restraints on resale in contracts. Now, it seems to me a reasonably valid concern.

Is it not the case that you would have more latitude to do that under this arrangement than under Scenario 1?

MR SALISBURY: No, I don't think it is once you go through all the contract terms in the arrangements we would have to put in place between ourselves, but I might answer that point somewhat differently by noting that a lot of the customers that we would look to supply to are wholesalers and, therefore, a restriction on on-sale would make no sense.

CHAIR: So, leaving aside the legal issue that Dr Berry raised, you would have no trouble then with a constriction or a condition which said that a condition on this -- if we go down that path, and I'm not prejudging it now -- but it sounds to me that the applicant would not have difficulty with a condition that said that there could be put no restrictions on resale? Just in principle, because you seem to be suggesting it wouldn't be rational for you to do so.

MR SALISBURY: No, I'm suggesting that it would normally not be something we would do, but there might be situations where we would consider it warranted, depending on how the negotiations went with the customer. Remember the customer has market power and leverage as well.

CHAIR: In what conditions would that be? Can you give me a sense of when you might do that, and then I would like to ask you whether you would also do it under Scenario 1.

MR TWEEDIE: Could I just offer something. I think we've said in our submission that it wouldn't be unreasonably withheld, but we've stopped short of saying, where the issue of on-selling will in all cases be allowable. We've said it would be unreasonably withheld.

CHAIR: So, when would it be reasonable to withhold?

MR TWEEDIE: An example would be, it could be reasonably withheld is the following situation. I mean, we have got really two main aggregators -- they call themselves aggregators of gas in the downstream market; Contact and NGC, and they have quite significant market power.

If, for example, one of them chose to bid for all or the bulk of the gas at a superior price, they could in fact control the whole downstream market.

There is a very real issue from a pro-competitive stance that it's not -- it may be the situation that a cussed party that wants to be totally an aggregator the whole time and effectively bid for gas, control the gas -- effectively the gas supply, that has in fact negative consequences for competition.

CHAIR: And that would -- if you turn down a higher price in order to protect competition in the market?

MR TWEEDIE: I'm saying that, for example an electricity generator, you could see a situation if he needs gas specifically for a power station, that the gas that goes to -- it is more efficient and sensible all round to build a contract around the supply of gas to that power station.

If a downstream customer or an aggregator is really dealing in the industrial market where he will have a number of customers, clearly his ability to on-sell goes without saying, he has to have it to be able to move gas around a number of customers.

But there can be situations where you've got a big load going to one customer that has specific arrangements with regard to transmission, maybe distribution and all the contractual arrangements that go with that supply, a provision for not on-selling is reasonable.

In fact in the marketplace today NGC for example regularly puts in its contracts because we have got a number of contracts with NGC that do explicitly prevent on-sale.

CHAIR: Can I ask you about another point that's been raised. It's been suggested that the arrangement would allow terms and conditions that put lesser supply obligations on each of you than would occur if you were in a Scenario 1 situation, and I again would like to hear your response to that.

It doesn't seem to be an unreasonable statement to make, that there could be a difference and that can be material to -- I mean, you've presented the opposite, that actually their security of supply would be stronger under the arrangement. Some of the other parties are arguing just the opposite; that when they face 1 instead of 3, taking your comments about 1 and 3, but that that will leave them in a worse position.

MR SALISBURY: Well, we will be constrained in the Scenario 1 situation by the physical limitations of the plant, and that will determine the constraints that apply to our ability to supply a customer and we would also be negotiating liabilities for failure to supply.

But those very same issues arise between the Joint Venture Partners when we're having to settle the terms and agreements between ourselves and which we'll go out to the market and end up setting -- you know, the terms and conditions are premised on the physical plant capacity and so forth.

What it seems to me is happening here is, the comment I made earlier, why are we getting strong objections? I think some of it is so that we can try and negotiate terms in this public forum.

CHAIR: What I don't understand is, why do these terms need to be negotiated in this public forum if there is no issue in terms of the relative position of these people on these non-price terms and conditions in the counterfactual as opposed to the factual? Why is it necessary to do that?

MR SALISBURY: Commercial strategy, it's always nice if you can get an added advantage over people you're having to deal with in business.

CHAIR: So, they are at a disadvantage under the proposal?

MR SALISBURY: No, I'm not saying that they're at a disadvantage, I'm saying they're seeking an advantage.

CHAIR: What advantage is it that they're seeking that they won't have under the proposal?

MR SALISBURY: Well, they're seeking a discussion on terms and conditions to constrain our behaviour to their benefit, whether those terms and conditions are warranted or not.

CHAIR: Why do they need to do that if there's no difference between the terms and conditions that they would have under the factual and counterfactual; why do they need to do that if it's virtually the same? Why is it necessary?

MR TWEEDIE: Can I offer one example where the downstream users have got to accept a major shift in their ability to get gas. For example, the Maui Field has been a massive reservoir that downstream users have been able to pull gas out of to meet their short-term interruptible needs for electricity generation, and the fact that we've been able to do that with Maui has been a huge benefit to everyone that we've had such a large field with such capacity to meet hourly and daily quantities that the buyer has required to meet his interruptible needs. Now, that will not be physically impossible post Maui. We have not got the ability to provide that interruptible supply in the future from the gas fields that will be in production post Maui.

Now, the buyer has had some difficulty, buyers have had some difficulty accepting that. So, we are in a continuum of change and some of these buyers will -- have not yet understood or accepted what life post Maui in fact is going to be.

CHAIR: Is this --

MR TWEEDIE: And there is a transition going on in their thinking there.

CHAIR: Can I ask you, just as a point of clarification; is this the concern over high take obligations?

MR TWEEDIE: That would be one issue, yes.

CHAIR: I mean, that's what you're describing; that you could tone it down and then --

MR TWEEDIE: If you're an electricity generator and you've got a dry winter and you've got -- you've got a dry winter like we've just gone through, you're wanting gas on an interruptible basis, hourly and daily, on a basis that you can't predict months, certainly years ahead, and with Maui we've been able to provide that. Post Maui we won't be able to.

CHAIR: Thanks for that. I might just ask my colleagues if they'd like to pursue questions at this stage. [**No comments**].

MR JACKSON: I'd just like to make a couple of points, if I might, on behalf of Shell here. I think I can identify with customers to a large extent; in the same way I made some comments earlier about separate selling, there is a natural initial and superficial disposition to want to be independent and I think, unlike Shell, has a predisposition to want to market its products separately. The customers will always want choice, we all in our commercial settings want choice. But it overlooks the fact that in the New Zealand context separate selling is not feasible, so when they are pushing and seeking this separate selling it is an illusory concept that they're comparing with a real concept.

In addition, I would like to say that the opportunity and perhaps even the incentives in a Scenario 1 type selling regime might be that these particular terms might need to be greater. It might be more important under a Scenario 1 selling regime to have a very fixed, inflexible regime. So --

CHAIR: So I just wonder, Mr Jackson, why would you think they would prefer choice? What does choice give them?

MR JACKSON: I think producers like choice in customers, if -- it obviously would be a competitive situation and similarly I think customers would like, if they can, to have choice between fields, and I think there's a --

CHAIR: But what does that give them? What does choice give them? Why do they seek to have it here?

MR JACKSON: Umm...

CHAIR: We've been told there's no difference in the outcomes in terms of --

MR JACKSON: Well, it might be that the characteristics of the field, or one field from another field, if I may talk generally in the gas business, can offer them more than another.

For example, Maui was a very --

CHAIR: But they're not asking for different fields here, they're asking for different --

MR JACKSON: But what can be offered into the market is a function of the field more strongly than it is of the joint venture. Maui was able to offer a very flexible arrangement because of the nature of its reservoir.

CHAIR: Can you tell me how much your terms and conditions vary for your customers across contracts, and what are the -- how do they vary? Do they vary by the sort of things that your potential customers here are concerned about? Do your contracts vary?

MR JACKSON: Yes.

CHAIR: Are these non-price terms and conditions?

MR JACKSON: They certainly do.

CHAIR: Can you give me a sense of, in what way they vary?

MR JACKSON: Well, they vary where they can vary because of the field and the status of the project.

During the plateau period the take-off pay on Maui was quite high, but now it's declining relative to the available capacity on any day. The take-off pay component, I would imagine, would be half of what the field could deliver it today.

CHAIR: Do on-sell restrictions vary?

MR JACKSON: Kapuni is a very well-established field and the take-off pay criterion is very small relative to that field because it's long established, it's no longer the key economic driver. The take-off pay was very important at the outset of the field; it is no longer.

CHAIR: Do the conditions like on-sell restrictions vary in your contracts?

MR JACKSON: Well, certainly we, within Shell, manage contracts

with varying positions on that, yes.
CHAIR: And what about around the issue of the ability to vary the terms of your requirements on you in terms of supply, does that vary by contract?
MR JACKSON: We, yes, I think it does because ultimately the contract has got to support the development of the field, and the field has different characteristics; it might be very productive or it may not be, it might be capital intensive, it may not be.
CHAIR: But it doesn't vary by the relative degree of market?
MR JACKSON: Yes, but people nevertheless would seek those sorts of flexibilities. Whether or not it's economic to provide them is another thing.
MS BATES QC: Are the difficulties related to joint marketing restricted to the marketing of gas? Why do they not apply to the marketing of liquid?
MR JACKSON: Because liquids have the opportunity to provide storage very cheaply; gas doesn't have that opportunity. They are readily linked with the world commodity market and the quantities that we trade here are infinitesimally small relative to those markets. So those two features alone in terms of just focussing on only one aspect here, the balancing aspect, make it much simpler, the issues are not great; we're not so concerned with making up gas.
MS BATES QC: Easy to find a price?
MR JACKSON: Easy to find a price, and if someone is short of gas on a day they can access a market -- or, if they are looking at a commodity that's hooked into a large market, there's always the aspect, if they have a customer to buy it from from some other source rather than the field.
MS BATES QC: So it's a supply and demand issue?

MR JACKSON: It's more than that. If you've got a contract and you've made a commitment, you can meet it by various means. Your only choice with Pohokura is to supply from Pohokura; there is no choice.

MR TWEEDIE: And you can store it as well, as you can't with gas.

MS BATES QC: Thank you. In the application there was a report from CRA and at page 5 of that report it gave very simple definitions of joint marketing Scenario 1 and Scenario 2, and I just want to ask you if you still stand by those. "Joint marketing involves co-ordination on both quantity and price. Scenario 1 involves co-ordination on quantity but not on price".

Are you still -- I won't go into Scenario 2, but do you still agree with those definitions?

PROF EVANS: Yes, I think we do with the caveat that co-ordination under Scenario 1 necessarily involves a view and some co-ordination with respect to price insofar as it involves balancing arrangements and insofar as it is an issue in deciding the profile of the off-take of the field as a whole.

So, the joint venture will have a view about the price path of gas and other paths. What we were trying to capture in specifying it this way was that Scenario 1 was basically a situation in which parties were -- had contracts in some way that they could co-ordinate among the joint venturers and that all that would be left for the Determination would be the placement of those contracts by individual parties with Consumer Affairs.

MS BATES QC: Just getting to price; are you saying that the joint venture arrangement necessarily leads to some co-ordination as to price? That's just the nature of the beast?

PROF EVANS: Yes.

MS BATES QC: So, when you -- you took us through the various terms of the contract and whether they are more or less competitive, and when you came to price you said no difference. That's what you say, as to price there will be no difference. Have I got it wrong?

MR SALISBURY: I was talking about the price that we're going to have to balance between ourselves.

MS BATES QC: But if you are looking at whether something's competitive or not, what matters so far as price is concerned is the price to consumers.

MR SALISBURY: Well, that is true, but -- and I wasn't specifically talking to that point, but we're setting quantity, we're setting all key contract terms, we have to, we're going to be going out to market with a clearing price if we get out of alignment between each other which is going to have to be a cash balancing mechanism. So really, there is not going to be incentives on us to compete on price --

MS BATES QC: So, whichever way you go, there will be one price; is that what you're saying?

PROF EVANS: Umm --

MS BATES QC: Because, this is important.

PROF EVANS: No, I absolutely agree. The cash balancing arrangement means that there has to be some agreement on some sort of transaction cost for price, transfer price --

MS BATES QC: Between yourselves?

PROF EVANS: That's right. So the question is, what is the outcome if the sales prices attached to the contracts are different from each other, given that they have this balancing arrangement? It seems to me that there could still be some differences, but they would be quite minor; and the reason being that, if I was selling you gas, for example, at a particular price that was different from the transfer price that I had in amongst the joint venture, then it would impart an incentive that you wouldn't like and which I wouldn't like that might mean that overs and unders, you know, would not be priced properly within the joint venture, it would provide different incentives for overs and unders within the joint venture arrangement.

In other words, to get the opportunism as we like to call it in economics, to a minimum you would not want those prices to be much out of alignment across the different contracts.

MS BATES QC: So the joint venturers would not want the prices to be out of alignment, would they?

PROF EVANS: That's correct, I think.

MS BATES QC: But the consumers might not have the same view.

PROF EVANS: That may also be correct, so in other words --

MS BATES QC: So --

PROF EVANS: No, no, there's a couple of things here. One thing is these contracts come with different terms and conditions and what one would like to see is the terms and conditions enforced. It may be, for example, that a very cheap supply of gas from one of the parties actually carried with it a very strong liability component, because it was not in accord with the agreement that had been reached on the balancing between the two, and it imposes risks within the parties.

So, in general I think for all the reasons given, that the prices will be very close to each other, one could expect this, and close to this balancing price.

MS BATES QC: And, correct me if I'm wrong, that arises from the whole of the joint venture agreement and its terms rather than the term just specifically relating to whether it's joint or separate marketing?

PROF EVANS: That's right, it arises because of co-ordination issues to make this thing actually work and sustainable into the future, and it goes to the contractual issues which we'll be discussing subsequently.

MS BATES QC: I just put this to you. Is it at the end not arguable that it's the whole of the Joint Venture Agreement -- the Joint Venture Agreement has anti-competitive effects irrespective of whether it's joint or separate marketing?

PROF EVANS: Well, I intend to go through the competitive implications of the two approaches in my presentation, but certainly what we're looking at is a counterfactual between the two in which there's essentially no difference in the competitive implications; I agree with that.

But that comes about because of the counterfactual. Had we gone to counterfactual Scenario 2 for example, which I would not recommend, I was apropos an earlier question you asked, there is some literature on the sort of delay that one gets if you have to negotiate contracts with asymmetric information in oil fields.

I didn't mention it earlier because it relates to Scenario 2 rather than Scenario 1, but it's reported in one study that where they have the equivalent of joint marketing the contract takes six months to put together. Where they had separate marketing, and it wasn't just separate marketing it was more separate than that, they had separate extractions, well, it took more than seven years on average.

MS BATES QC: And I can understand that as a public interest argument and the necessity perhaps to reduce delay, but I'm really trying to focus on competitive effect here, and I see them as two separate issues and that's really why I'm asking you about the totality of the Joint Venture Agreement.

Does it not necessarily mean there is some anti-competitive effect, albeit that it's in the public interest, that it goes ahead because a field's developed and supplies gas?

PROF EVANS: Well, I think the whole -- the totality of the thing is just driven by this common pool problem and the need to manage the field as a whole, and that is just intrinsic to the problem.

Now, if you back off having a joint marketing arrangement the first thing you ask is, well, can we back off this just a little so that the parties can sell different contracts to different consumers, and that is Scenario 1, but it is an extremely constrained scenario and not all that different from the joint marketing proposal, except that, to put Scenario 1 in place would require a lot of time and negotiation for all the reasons that are coming out here today.

CHAIR: I'm just going to ask Commissioner Stevens to follow-up on that and then I'll give us all a break for lunch.

MR STEVENS: It's really just a quick follow up question, or two questions I guess.

The first one, when you mentioned in terms of separate marketing, if one Joint Venture Partner wanted to sell at a lower price, that would impose risks between the parties. Could you just explain what those risks are between the parties that you were referring to?

PROF EVANS: Oh, not just joint venture parties, it would be a risk on the other side of the contract as well.

If you have the balancing price; suppose I agree that the balancing price should be $3 or whatever, and I know I have a contract that says I have been fortunate to sell my contract at $4, which is higher than that. Now, I will try to fill my contract as much as possible and I may use opportunism, or "theft", in order to get gas at $2 from my other party and sell it on to another party at $4 from within the contract. And the trouble is -- I mean that can actually occur -- the trouble is, all parties anticipate that that can occur so they're trying to reach contracts that they allow parties to go out with and sell to their customers where those incentives are not -- you know, are minimised, and so you end up with two ways; one is, you end up making contingency arrangements within the contract and one of them is, to try and get prices that are close to the transfer price.

MR STEVENS: I guess, what's to stop a party, though, under-selling at a price, say, combining it with gas from other fields and, therefore, capturing a client because they're able to combine gas from elsewhere together with gas sold out of Pohokura at a lower price?

PROF EVANS: That's definitely a possibility, absolutely, but they're still going to have to pay the transfer price.

MR STEVENS: That's correct, but if they capture the wider market they could be able to get that within the overall price they're achieving elsewhere.

PROF EVANS: No. Well, when you say capture the -- they're not going to get any more output from this, they're just going to get a fixed amount of gas out of Pohokura at this price.

MR STEVENS: I guess what I was exploring is, that they may not get any more gas out of this, but perhaps they could combine it with gas from another field that they may own.

PROF EVANS: That's right.

MR STEVENS: And which may not be fully utilised, and by combining the two be able to actually achieve a price path which will enable them to sell out at a cheaper rate from Pohokura than their other partners.

Is that a possibility?

PROF EVANS: It certainly is a possibility that a party would combine their interest with respect to other fields under separate marketing, and that certainly is an issue.

If they're selling at a lower price than the transfer price then it's going to cost them some money, and you have to ask whether overall they're not going to be selling at a price in the market that's pretty close to what all the other gas prices are, even though there may be particular advantages associated with the particular uses and combinations that they put together.

MR STEVENS: Thank you.

MR DEPPE: Just one further point. Of course, this will have an impact on the buyer contracts as well, because of course, if you are taking from other Joint Venture Partners, you are taking from buyer's contracts. So, it will have a ripple effect through to the buyers, and so the buyers will be impacted on, on that.

CHAIR: Okay, thank you very much. I propose now to end this session, and I would like to start at 2 o'clock if that's all right with the transcripters.

So, we will not be able to go long over time today because one Commissioner has another engagement. So, if everyone is agreeable we will return at 2 o'clock, and I'd just like to thank the applicants for the presentation so far and willingness to take our questions. So, thank you very much.

Adjournment taken from 1.00 pm to 2.00pm

CHAIR: Okay, welcome back from lunch, and I will officially reconvene the Conference, and Dr Berry, if you could remind us where we are at in the presentation, thank you.

DR BERRY: Good question.

CHAIR: We like to ask challenging questions.

DR BERRY: I think there's just a few wrap-up comments from David Salisbury and then we'll move on to Professor Evans.

CHAIR: Just while they're finding the right slide, I'll just mention, my intention is to break for tea at about around 3.15 to 3.30, somewhere in that hour, depending how things are going.

MR SALISBURY: There are just a couple of slides to pick up on some final points and then some summary slides I'd like to talk to.

One of the issues that we're looking at here is, what is the effect of joint marketing on development of competitive markets in New Zealand. And the view we would offer up is that, if Scenario 1, separate selling is forced into the market before the market structures are there, that would actually support separate marketing; then in actual fact what it's going to do is just simply put in place the contractual constraints we've talked about.

I would add that an adverse decision here would be seen as a regulatory constraint on further exploration activities and investment in the upstream industry in New Zealand and would actually harm rather than assist the development of a market.

I go back again to the point, which is that we will be so highly co-ordinated and constrained with Scenario 1 marketing that it's really not correct to state that there are then three sellers and that that gives additional depth to the market which would stimulate the development of an upstream market. We would come from the point of view that the upstream market will best develop competitively by exploration and finding new oil and gas reserves and then bringing those into development.

On the other side, authorising joint marketing will allow us to bring Pohokura into development early; it will avoid unnecessary cost risk and delay, it will avoid the imposition of a further regulatory hurdle on the upstream industry.

And I make the point here that the upstream industry really does operate on a global basis. The company I represent has activities worldwide and we look around the world and decide where we are going to invest, and a decision is made, are we going to invest in New Zealand, Australia, North America, South America; it is a global market being run by, in my case, a company that's based in Vienna. And so, therefore, they are looking at these things at quite a high global level, and any significant movement in regulatory risk which would be seen in this case to increase market risk would be a significant deterrent to new investment in New Zealand.

And I would suggest --

CHAIR: There's just -- I would like to ask you how well that sits along the notion that when you were exploring for gas, some parties were exploring for gas long ago and when the original agreements were put down it wasn't considered to be of any great urgency in considering whether you would market jointly or separately or anything else, and now suddenly at this point in time this is of a huge moment.

MR SALISBURY: At the time that we were putting in place the Joint Venture Agreement for Pohokura the companies around the table then did not have regard -- I've already commented on that -- to the possibility of separate marketing of gas. In fact we were sitting there in the context of 1995 with no experience of separate marketing of any gas in New Zealand, and indeed I think the common presumption by everybody was that it would be joint marketing.

I'd make the point that when you're entering into a JVOA and you look at the terms on those JVOA, a lot of them have to do with exploration appraisal and development. You have so much going on in the early stages of that business, you don't try to write a document that's going to cover the life cycle of the business, and there are certainly holes in the document and there are industry understandings about how the business will play out.

MR STEVENS: I would presume though that if joint marketing or separate marketing is so fundamental that, when you actually do determine the Joint Venture Agreements, that you at least will address the fundamental terms in your agreement; and I agree that the non-fundamental terms you probably want to sort out as you go on, it's just that suddenly it becomes a fundamental term now and it wasn't a fundamental term then, where I thought it would have been a fundamental term then that you would have turned your mind to.

MR SALISBURY: We left open the possibility of dealing with gas as we saw fit at the time and the presumption amongst all of the partners I am sure around the table -- although of course I only represented one at the time -- was that there would be joint marketing.

The reason it's an issue now we've become aware in the Pohokura context of the possibility that joint marketing could be seen to lessen competition and, therefore, we applied for the authorisation. But at the time we were sitting there negotiating that JVOA, we had bid on four off-shore permits and we were trying to put in place a basic business arrangement that would allow us to proceed to explore four permits; we didn't have discovery, we weren't particularly targeting gas, we had a lot of other issues we were contemplating at that particular point in time.

MR STEVENS: I guess you can understand my confusion, if it is so fundamental and that all the parties presume that it would be joint marketing, that you wouldn't need to specify separate marketing in your Joint Venture Agreement.

MR SALISBURY: I already touched on the fact that that is simply a holding pattern, and the presumption by everybody was that there would be joint marketing, and I think the JVOA left it open that that is how it would work.

MR SALISBURY: Chris wants me to reinforce the point he made earlier. The Joint Venture Agreement didn't stipulate that we had to go down the route of separate marketing; it actually just left it as an issue to be addressed that we would, if we found gas, sit down and discuss how to deal with the issue. I would suggest that if you look at JVOAs that are standard across this industry in New Zealand, you will find those are the standard terms, including in JVOAs, where there is joint marketing of gas.

MS BATES QC: The actual wording of the agreement, as I'm sure you're aware, is that there was a right and obligation to own and take in kind and separately dispose of the share, being subject to a proviso that said it may be necessary for parties to enter special arrangements for the disposal of natural gas.

I think what you're saying is, despite the fact that this clause says what it says, that the understanding of the parties was not as it appears on the plain meaning of the document.

MR HALL: To clarify the answer I gave before, that's not what I was saying. I'd rather -- I considered the proviso to be the key provision there and it -- in my view it clearly states that what arrangement the parties will enter into so far as the marketing and sale of natural gas is concerned is an entirely open question.

Now, that position was duplicated when the Joint Venture Agreement was amended in slightly more detail. The amendment simply provides that the parties will enter into such arrangements as they may decide on. It made clear and express what we say was previously implicit, that those arrangements that the parties might in the future enter into could include joint marketing.

MS BATES QC: It provides expressly for joint marketing; the amendment says, 'these arrangements may provide for joint marketing'.

MR HALL: The distinction I'm saying is, prior to the amendment it was implicit that the parties could either separately or jointly market. After the amendment it's express, they can jointly market.

To be frank with you, one of the reasons for making that express was because the Joint Venture was aware of the issue of price fixing and it needed to be clear in the Joint Venture Agreement that s.31 protection would be available. So, we take the view that it was implicit before and we simply made it express.

MS BATES QC: Yes, I can understand the argument that it was implicit, but -- so the obligation to separately market, the obligation, what did that relate to?

MR HALL: It could have related to any of the products from the field, and the proviso specifically refers to 'natural gas'.

MS BATES QC: If you wanted to do that.

MR HALL: Exactly.

CHAIR: I'd like to follow-up the point that you make about this arrangement being advancing competition in the gas market, and other parties have suggested that if the Commission authorises this arrangement on the grounds that it's too difficult for you to put in place separate marketing, there'll never be any incentive for anyone to do what needs to be done to allow separate marketing in the future.

And I think that this is a serious matter because we may encourage exploration, but if actually there's always an incentive to jointly market and we've got a few players in the market and you have no incentive to put in place what's necessary in order for separate marketing to occur, it seems to me we've got a little bit of a bind there and I'd like your comments on that please.

MR SALISBURY: There is a bit of a chicken and egg situation and we accept that. I mean, the evolution of the market does require at times that you take steps that will help with the evolution of the market.

But we would make the point now that when you look at the counterfactual trying to impose Scenario 1 marketing now, which is not true separate marketing, we're going to end up so highly co-ordinated and constrained that it doesn't give us additional depth to the market, and all it does do is impose contractual barriers to our ability to deal with our gas in a short-term and more flexible manner and it will discourage exploration. Now is not the time to try and regulate evolution.

CHAIR: When is the time to -- I would put to you that you're asking -- what is being suggested is that this Commission authorise something that is otherwise not allowed, and we are not seeking to regulate this market directly. On the contrary, you've come to us with an application.

So, leaving that point aside, when is the right time? When will it be the right time in New Zealand for this Commission to say, no, we will not authorise joint marketing?

MR SALISBURY: If I just answer; we've come to you for an authorisation because we were well aware of an industry perception that joint marketing might give rise to issues under the Commerce Act and the need to have the hearing as we are now and have the issues debated in public so we could get some certainty for the Joint Venture Partners and also for purchasers going forward.

CHAIR: I understand that. My question is, when will the conditions be such in New Zealand that we would get to the situation where allowing these sorts of arrangements actually promote competition in these markets in the future?

MR SALISBURY: There is not a set deadline or a timeline that we can give you to answer that.

CHAIR: No, no, I want to know what the conditions might be.

MR TWEEDIE: There is an answer. The answer simply is, as the ACCC and we're going to hear later in the COAG report, that there's been quite a lot of report done in Australia that identifies some of the fundamental preconditions or conditions precedent before you could seriously focus on joint marketing and some of them, and not all of them, would be a liquid market that for example a spot market that allowed gas to be traded efficiently and effectively on it, many sellers and many buyers, a very open and flexible transmission and distribution regime; storage, storage would be an issue certainly in the US, so there's a number of very clear principles that have been identified.

My understanding by the ACCC and certainly Australian authorities are present in markets that have the sort of depth that I'm talking about, for example in the United States of America, that is totally different. So, to answer your question, when New Zealand gets to that position, and it can only get there if there is a lot more gas and the economy grows etc, etc, when New Zealand gets to that position, certainly separate selling becomes a more -- more of a real issue in this market then it is today.

CHAIR: So, who's going to make that happen?

MR TWEEDIE: The simple answer to that is, probably we need a lot more gas discoveries. We certainly need -- I mean, you've heard and you're going to hear further about the serious implications if separate marketing occurs for exploration. I can certainly say for my company that particularly if you are a smaller player -- and in the

New Zealand scene compared with our partners we're the only 100% New Zealand owned company, and compared with OMV and Shell we are small.

The exploration scene in New Zealand comprises mainly small companies. If they can't joint venture by joint venture efficiently and effectively get their gas to market as a joint venture, I tell you unequivocally it will be a serious turn-off to putting high risk exploration dollars in the ground.

CHAIR: I'd like to put the question to Professor Evans. At what point, professor, do we have a situation where the companies who are doing the exploration have an incentive to put in place the things that are required in order to support a competitive gas market? At what point do the incentives shift? And, will they ever have the incentive if they can always come before this Commission and argue it's all too difficult?

PROF EVANS: Well, a gas market, as with any market, is sort of a continuum. It is a continuum in the sense of starting off with two players on either side of the market to 1,000 players on either side of the market. If we had 1,000 players on either side of the market and substantial reserves of gas, there's no question.

If we have three or four players in the market, on either side of the market, that's no question either; that's more of a contracts kind of a market. You're only going to get a spot market where we have large, really large reserves and vigorous use of gas and many players buying and selling gas, and potentially buying and selling gas. In between those two we have a variety of arrangements that are going to be -- we're going to have to live with. And New Zealand is so small it's not clear how long we're going to have to live with it.

It seems to me, if our population stays the way it is and our demands for gas stay the way they are, even if we were to find much more gas, it wouldn't be an automatic move to a spot market of the kind that we see in the US or the UK.

Now what I planned to do was to talk about the competitive implications of joint marketing, and one of the competitive implications I want to talk about is exactly the development of a gas market because it doesn't -- for example, if you can offer long-term contracts that have resale clauses attached to them, then you're in -- you're creating another seller of gas. And so, in that way if you can facilitate that operation, in the context of the New Zealand market, it is facilitating competition and the development of the market.

CHAIR: Would you see the provision for resale as being critical to the argument holding that these arrangements can support the development of competitive markets over time?

PROF EVANS: I think, having a set of contracts for which reselling is possible would generally be the outcome and would assist the development of the market, but I don't think necessarily that all contracts should.

I would like to go through that in my presentation about the way in which contracts can assist the development of the market.

CHAIR: We can come back to that, but there was one question that I ask, which was; at what point do the companies that do the exploration and development such as we have before us today, at what point do they have an incentive to put in place the market arrangements to allow separate marketing, or do they? Is it something they will ever have?

PROF EVANS: Well, the market development is a -- there are private good aspects to it and there are public good aspects to it. The private good aspects are that, as people trade more and as you get more people trading, you get markets that exist, even if you don't see formal exchanges. However, as the market develops there are rationales for putting a formal exchange in place.

Now, when we think of a market it typically consists of the trading that goes on on both, between the different sides of the market, and it includes contracts and it can include a spot market if it exists. It seems to me that a market has to develop with sufficient reserves in the case of gas and players on both side of the market in order for a spot market to evolve.

As we see individual amounts of gas being sold in the short-term, for example if they're overs and unders David mentioned, the idea that they want to use the capacity of the plant, in which case they would like to be able to sell any excess capacity at any point in time, even on the short-term, that is the beginning of a spot market. And so I would -- I see this as an evolutionary process and I don't see anyway of defining a point in time when one switches over in process.

I would also make the point, which I guess is sort of clear to everyone I suppose, and will from my presentation, that I would prefer a joint venture to own Pohokura than one player, in the sense that that is the alternative. If we wish to have discovery in New Zealand for players and if they find it difficult to contract in the absence of joint marketing, that we would be more restricting our attention to having one player, and it's not at all clear to me, looking at the broader context, that we would end up with a more competitive market that way. I allude to this on the way through.

CHAIR: Okay, thank you.

MR JACKSON: I'd just like to make a point about the incentive. I believe all mining companies in general have the incentive now to develop separate selling, but it's the impracticability or infeasibility in the New Zealand market which prevents us, and I think that is the key point for us, is that it's simply not practicable now to consider these kind of contexts. In markets where it is feasible we would like to do that, but we'd rather have a joint development than no development.

In addition, I understand that in fact the premise, the goal of separate selling per se is really a question for the economic experts, but there is no competitive difference; so the condition of, or the assumption that we should be aspiring to separate selling seems to be questionable, and I invite the Commission to look at that.

CHAIR: I just want to follow-up one matter and I'll address this to Mr Salisbury. You've put a lot of focus on the need for joint marketing and the damage that would be done to incentives if separate marketing was required. I wonder how consistent that is with OMV purchasing shares in Pohokura without knowing what the outcome of this process would be?

MR SALISBURY: Well, there's a business risk inherent in the purchase process; the asset became available, part of an international deal, and OMV bid on it.

CHAIR: But it didn't stop you from making the investment, did

it; the uncertainty?
MR SALISBURY: At that time, no, it didn't, but...
CHAIR: The same goes for Todd; Todd increased its share in the face of uncertainty.
MR SALISBURY: But we believe there are very strong reasons why we should be allowed to joint market, if it eventuated that in fact we were not able to joint market then the risk would materialise and I think they would have a significant impact going forward.
MR HALL: Of course those investment decisions are made in the context of a judgment on the risks associated with the particular matter, and in this case of course Todd, and one assumes the Joint Venture Parties, formed the judgment that on the preponderance of legal and economic evidence, the risk that we will not be able to implement joint marketing and move our gas to the market in an effective way is small.
MR TWEEDIE: And there is also the point that, in making the investment decision we were always confident that Pohokura one day will get into production, so we're not betting the company on nothing happening, we're quite confident one day it will get there.
The question will be, and that's one of the key issues before this Commission, is when? And that's where we say it's going to take longer, and though our company will suffer a negative on that, the nation suffers a far greater negative, and that's the key issue challenging this Commission.
CHAIR: I'll see if there's any further questions and we'll carry on. [**No comments**]. Okay, thank you.
MR SALISBURY: Well, actually it was just a couple of summary sheets reinforcing the points that we've discussed through

the morning. Firstly, joint marketing is not marketing by a single entity, and it's not valid to record it as such. It does require -- a Scenario 1 marketing does require us to agree on all key development production and gas marketing arrangements. It is in no sense therefore independent and competitive market, it is in fact highly constrained and we have to be highly co-ordinated.

The upshot of that is, we end up going out to the market with less flexibility under Scenario 1 marketing, and the quantity of gas that we're going to be selling under Scenario 1 marketing is not going to be any greater than it would be under joint marketing.

In fact, for the reasons that we've talked to earlier, I would think we're going to have a lot of practical difficulty filling our plant to capacity or near to capacity that we were likely to do so, and we're actually likely to find we have less Pohokura gas getting into the market on a day-by-day and year-by-year basis. There is really not going to be any substantial difference in the price in the contract terms that we would be offering into the market. We have the same -- we have an equity interest in the same field, subject to the same risks, same development concepts, same production profile and agreed contract terms between the three of us that allow us to go out to market separately.

In fact when you go through that, all of that, plus the regulatory hurdle of getting approval in the first place -- and I would suggest approval also for the arrangements we will have to put in place for Scenario 1 marketing, because we would have to come back and revisit the Commission, I would expect, because of the nature of the high degree of co-ordination and agreement on price and other contract terms between the Joint Venture Partners, that will be a significant barrier to investment in New Zealand.

So it really is summarised by a couple of points; insisting on Scenario 1 marketing just does not enhance competition, it doesn't give increased depth to the market or bring new gas to the market, but if it is forced into the market right now it's our view the one thing that it will do is harm the development of the market. Thank you.

DR BERRY: The presentation now has Professor Evans talking to the question of joint marketing involving low detriments.

PROF EVANS: Thank you. I'd prepared a set of notes that I will present and read from to facilitate this process, and I wonder, James, are they available to the Commission? His shoe laces are tied together apparently.

There are two broad areas. The first is the ability -- two broad areas that go to the question of detriments. First is the ability to write and enforce contracts and, given this ability, the benefits and detriments, if any, that flow from the joint marketing arrangement. And I'll argue that contracts for sale of gas must precede the development of the field; that joint marketing without conditions is essential for the security of contracts; that secure particularly long-term contracts are in fact pro-competitive; that competition is not in fact lessened by joint marketing, and I bring all those together in point 5 that there are no detriments to joint marketing.

The first point is the one about contracts being necessary for development, and I base the arguments here on the observations that the Pohokura Joint Venture Parties have to sink, and I mean sink both under the water apparently as well as in an irreversible investment; very substantial capital for extraction.

Secondly, the Pohokura Joint Venture Parties face two broad categories of significant risk; the first is market risk. The products that are being produced here suffer commodity price risk and that exists for all the products, including the liquids for the products of Pohokura. Attached to these risks are there upside as well as downside. In the case of the demand and supply of gas, it's really no different. It also has a commodity for which there is commodity price risk. It also has an upside and downside potentially, although we look at the present future, and looking at the demand situation one might well argue that it's in the supplier's camp to their advantage, however, there are substantial players in both the gas and electricity industries whose change decisions could affect this position.

So the first thing is that there is substantial market risk. The second point is that there's field risk. This is the risk of reserves and it's the risk of the cost efficiency of the field not being what the Joint Venture Parties anticipate it will be over time. Throughout the life of the field they'll be learning about its characteristics and its productivity and the costs that it requires to get the gas out of the field, and those uncertainties are really real uncertainty at the time one establishes the capital investment or capital project to extract gas.

My next point would be, it's normal, prudent, commercial practice to cover these risks with sales contracts before investing, and commonly these contracts will be of a longer duration, or at least some of them will be. Such contracts are required prior to investment by equity holders and lenders alike. Contract commitment is required, particularly where contracts are required before investment for the avoidance of hold-up. This might apply also to long-term contractors with purchasers who themselves contemplate sunk investment. For example, a generator that wants to establish a generation plant, a thermal generation plant, will want to assure themselves that they have a supply of gas before they invest, just in the same way as the Pohokura parties would like to have contracts that cover the outflow of gas before they invest in extraction.

If they delay till after they've invested in extraction, they're vulnerable to hold-up.

Now, even in the presence of a spot market, contracts of reasonable duration can be expected to be essential elements of commercial practice with price risk and irreversible investment. A spot market is really useful, it provides a price and it provides quantities, but the -- what it does reveal is the price fluctuations. It does nothing to protect the cashflows.

So, just as in the case of the electricity market, long-term contracts are useful for managing price risk. Gas will produce of the order of 50% of the revenues of Pohokura and there's no spot markets, thus contracts to the satisfaction of JV parties need to be in place before extraction investment goes for approval by the Joint Venture Parties.

Now, I'd like to return to a question that was raised earlier about the role of liquids in all this. We see here that the liquids will produce of an order of 50% of the revenues and gas of the order of 50% of the revenues. With a very large investment of this sort one would be looking to cover a large fraction of the revenues to eliminate as much risk as one could from those revenues, at least to recover the cost with a margin of extraction.

Now, in the liquids market there's possibility because the liquids are internationally tradable and they're a forward market in liquids, it's possible to hedge out price risk in the liquids markets. In the gas market it's not possible to do that, the New Zealand -- the gas market is specific to New Zealand and it doesn't, as we've discussed several times today, it's not a thick market, it doesn't even have a short-term spot price let alone a forward curve, and so it's not possible to hedge out the risk associated with gas.

The alternative way of doing this is with long -- with contracts that cover off the risk of the revenues. So, I would expect, and have no problem with the proposition that the gas contracts are an essential part of releasing gas from the Pohokura field by virtue of their support of investment in that field and the surety it gives the parties in order to justify the level of investment.

MR STEVENS: Just a point of clarification, if I may professor, in terms of the liquid sales and the margins that's able to be made on those; would that be able to -- how much of that would be able to mitigate the risk in the gas market not being as liquid?

PROF EVANS: Well, I don't -- even if you were able to, say, get a hedge over all the liquids, that's only half of it. And one would be looking -- I don't know, it's a matter -- the acceptance of risk is a matter of the appetite of the company, whether it wants to be a risk-taker or whether it's prepared to cover off most of the revenue in order to provide surety for its lenders; it's just going to depend an awful lot across institutions.

MR STEVENS: I guess my question was really coming to, does a profit -- in real simple layman's terms, does the profit you make from the liquids mean you can go ahead and make the investment on the infrastructure to extract? That's what I was trying to get my head around.

PROF EVANS: It's not so much the profit that's the problem. The problem is managing the risk. Prices are going up and down all the time. So that, if you can have a long-term, or a contract with some other party for a fixed price, then you've got the surety of the revenues into the future. If you have a guess and prices are going up and down; you make the irreversible investment, they go down, you may go bankrupt. So it's not the profit so much, but the level of risk.

MR STEVENS: But assuming -- let's take a large leap of faith here and say that we can contract out the liquids market into the future at a given price in the future liquids market; will that be sufficient to cover the decision to extract?

PROF EVANS: I think both will need to contribute to cover the cost of the investment. The investment -- it's sort of -- you make the extraction investment and it leads to a joint product of gas and liquids, and I imagine, I'm not certain about the extent to which one or other contributes to the revenue, except we know that roughly half the revenue comes from one and half the revenue comes from the other, so it makes sense that gas will be important in order to cover off the costs of extraction.

MR STEVENS: I guess the reason for my question is that, I'm not too sure which speaker earlier mentioned that gas is effectively a byproduct, and my simple view is a byproduct means that it's not necessary for the actual main production.

MR TWEEDIE: That's around the wrong way. We've got to have the gas production to get the liquids. We can't produce the liquids without producing the gas. So the gas comes first, the liquids come second.

The issue of hedging; you can't hedge -- certainly we can't hedge out liquids very far. For forricks(?) risk, US dollar, New Zealand dollar risk we hedge out and the banks will go really at the moment no more than about five years.

As far as oil risk, the forwards market that we trade in, we hedge in, tappers(?) goes out about two years. We could never get, on the markets that we hedge on, anything like a cover on price that would give us any security relative to the investment.

MR STEVENS: Thank you.

MS BATES QC: Professor Evans, how would you compare the risk profile between liquids and the gases? Just to say what I mean is, in gas here in New Zealand we've got a situation I think where demand exceeds supply. I don't think that's the same scenario for liquid, is it?

PROF EVANS: No, I doubt it. I think the -- liquids are internationally traded, so they're just the commodity, so their price is whatever it is and you can buy and sell on that market especially given that we're so small.

MS BATES QC: So, how do you think the differences in demand and supply for each affects the risk profile?

PROF EVANS: What is happening in New Zealand is, the gas market is evolving from the take or pay arrangements that existed with respect to Maui in the first place. So, the question is, what revenue -- and so the market is evolving, we don't have a spot market, so we can't refer to a price series that bounces up and down.

MS BATES QC: Right.

PROF EVANS: But conceptually that's what's happening because you have demanders in the market that -- demand and supply in the market is changing probably slowly in the gas industry, although as reserves become more sure, we learn more about the reserves, the reserve situation itself will impinge on the price, or the value of the gas that we can recover into the market now.

MS BATES QC: So, am I right; the less gas you've got, the higher the price you'd expect?

PROF EVANS: In general, yes.

MS BATES QC: So would it be fair to say the risk profile is probably less for gas in New Zealand right now?

PROF EVANS: That's a judgment call.

MS BATES: Well, that's what I'm asking your opinion on.

PROF EVANS: Well, I am honestly not certain, and the reason is that we have some -- one very large gas consumer which, if it was to stop consuming gas right now would release more than the Pohokura -- total Pohokura off-take. So, that is a risk that we face.

MS BATES QC: You're talking about Methanex, right? In what circumstances do you think Methanex would stop?

PROF EVANS: I imagine that -- Methanex is a commercial entity and it will stop when the price of methanol is such that it's no longer worth producing in New Zealand. If its surety of supply and/or the price of gas in New Zealand rises, then methanol will be evaluating its position here.

CHAIR: What happens if Methanex goes out, is there still not going to be an excess demand for gas, even without Methanex?

PROF EVANS: I'm not arguing that there's not, looking forward on the history of New Zealand's gas market, likely to be what we might term scarce supplies of gas, I'm not arguing that at all, I'm just arguing that there's volatility as well.

CHAIR: But you do expect there will continue to be scarcity even without Methanex? Do you accept that?

PROF EVANS: I'm not prepared -- I do think that the gas market is certainly in turmoil, that it looks as though the gas supplies certainly will not be in the immediate future what they have been in the past. All I'm saying is, in this environment there is still a range of uncertainties.

MS BATES QC: Just coming back to, how would you compare the risk profiles?

PROF EVANS: Well, what I'm saying -- you're saying, well -- I think you are saying, well, the price is likely to go up, the price is -- looking at the scarce looking forward, and looking forward I think that there certainly is scarcity in supply relative to demand.

What I'm saying is, that's just one aspect. When you're managing risk there's a lot of volatility around that, even if you anticipate an increase in price in the future, that there is a great deal of uncertainty about, you know, just how that --

MS BATES QC: Are you talking about something like risk around costs rising, that sort of thing?

PROF EVANS: No, it's much bigger than that, that's the trouble with commodity markets, you know about --

MS BATES QC: Sorry, go on.

PROF EVANS: Normally you're correct, costs do vary as well, but they vary as a rule more predictably than commodity markets which are notorious for their volatility.

MS BATES QC: Yes, but we haven't really got a commodity market for gas in New Zealand, have we?

PROF EVANS: No, that's right.

MS BATES QC: So that's why I'm trying to understand what you mean by the risk of variation of price in the context of the gas market.

PROF EVANS: Well, we can't observe a price in the gas market, but we do observe -- we do know that there's demand and supply in the gas market, and where you get demand and supply intersecting you get a price. It's just that in New Zealand we don't see that price because we haven't had a formal -- and we haven't had too many players on either side of that market. But nevertheless, what it represents is still volatility in the demand and supply of gas over that period, and if we were to measure it by means of a price it would be volatile.

I'm saying -- I'm not denying your proposition that it is likely that in the next few years that there will be some excess or some increased squeeze on gas -- gas demand will be at least gas supply, put it that way, and one might see a trend even, but one could see that there will be volatility around that trend if one was to plan for the future.

MS BATES QC: Would you accept that the volatility would be less than the volatility in the liquid market?

PROF EVANS: I think it's a different animal, because there's going to be volatility in the prospect of being able to obtain quantities of gas; whereas in the liquids market there's no question about being able to obtain quantities of liquid if you're prepared to pay the price. The problem is, in the gas market there's volatility in the potential supplies of gas as well.

MS BATES QC: So, you mean there could be more supply or less supply; you're not sure?

PROF EVANS: That's right, as reserves change and as discoveries and as different players who use gas make different decisions and switch to alternative fuels, it is quite a volatile situation, although we all know, I think, the importance of --

MS BATES QC: Probably not straight away I wouldn't of thought, would it?

PROF EVANS: I think it is, but it's a commercial judgment.

MR TWEEDIE: I was just going to support Lew and say that the unknown out there, I mean, is -- I mean, we're in the game of exploring for gas, and it's a real unknown. I mean, you -- somebody could find another Pohokura tomorrow, we didn't know we were gonna find Pohokura until we find it. Somebody could find another Pohokura, there is exploration going on in New Zealand and it's continuing. There's a very real risk that what may look like the position you're describing today flicks quite quickly to something else.

For example, paint the scenario, we find another Pohokura, somebody finds another Pohokura this year and at the same time we've got Kupe, the Government owned Kupe waiting to get into production. And we've had this before where we've very quickly gone into a significant gas over-supply position.

That is, for example, why the Think Big projects were set up by Prime Minister Muldoon when he was Prime Minister, why we set up Petrochem, we set up what is now Methanex, the Motunui synfuels plant, those were all set up because we had a major over-supply of gas. That could very easily occur in the foreseeable future. We can't say it can't, nor can we say it can.

MS BATES QC: You must have some industry knowledge about the level of exploration that's going on?

MR TWEEDIE: We have, yes.

MS BATES QC: And indeed you must be doing some yourselves, are you not?

MR TWEEDIE: Yes, and there's some deep water acreage that's being put out for bidding.

MS BATES QC: So, future planning; have you actually made any predictions as to what's going to happen?

MR TWEEDIE: I've been around it long enough, I believe it when it happens. Explorationers will sit elegantly and eloquently tell you now that they have got all sorts of things that are coming out of the wells they're planning to drill. It really is something you can't satisfactory predict. But what Lew is saying is absolutely correct, that it is risky, there is very significant risks for us in Pohokura that the game changes very soon, very quickly.

MS BATES QC: That's what -- I'm interested in this argument because we're being told that it's very much -- I'm not saying we don't accept -- it's very much in the public interest to develop Pohokura as soon as possible because of the shortage of supply of gas. It doesn't seem to sit very comfortably; the game could change at any time. So, if it could change at any time, how risky actually is it?

MR TWEEDIE: It's the lead times from the point of time that you get an exploration licence to discovery, to development, you

could in some cases take anywhere up to 10 years.
MS BATES QC: I understand that. Therefore, when you're assessing the risk on gas and the prices, you know that these are going to be long lead times, so you've got a period of time surely where your risks are relatively low on the price fluctuation?
MR TWEEDIE: There is a lag in timing, but in the meantime you can have, like we are seeing at the moment, small discoveries coming into production quite quickly; there is acceleration programmes going on with existing fields. So, it is a dynamic environment, but no-one could safely sit back and say with the competition with other fields -- I mean, we've pointed out to you that Pohokura's only about 30% of the total gas production market. There is competition from other fields and the Pohokura Joint Venturers will not be taking that competition lightly. It is serious competition.
MS BATES QC: But we've also -- I get back to the public interest factor which is so important in this one, and it's -- you know, how important is it that we do this now if there's a real prospect of other gas coming into the market?
PROF EVANS: I would respond to that by saying that the Commission's calculations and our calculations about the social cost of delay suggests that delay has a cost to it. It's just a question of -- and in that environment I think the Commission gets further than CRA did, but we just, I think, looked at trying to estimate the positions in 2009 and that was sufficient to lead to a benefit to bringing Pohokura forward.
MS BATES QC: I accept that delay has a cost but what seems to be driving Government is the scarcity of supply and how

important it is to have further supply coming on.
PROF EVANS: But that's reflected in those calculations.
MR SALISBURY: I'd just like to quickly endorse what has been said by Professor Evans and Richard.

Market risk in the New Zealand gas market is a key factor and we shouldn't lose sight of the fact that we're going to be investing in a field which will have a life of some 15 years, we're required to -- we're investing in it now, make an investment decision early next year, not see any monetisation of that investment for another two years further down the track, we're in a geographically isolated market where any significant discovery can swing us from an under-supply to an over-supply very very quickly, and that gives rise to a very real market risk, and working for companies that are based outside New Zealand, gas market risk is a key factor that we look at all of the time.
MS BATES QC: We're talking about New Zealand, and I have some real doubts as to whether the game can change that quickly given what Mr Tweedie has said about the time it takes to actually get the gas to market. So, you may have a new discovery, but then it's still going to be years out before it comes on-stream and really affects what you do.
MR SALISBURY: It's a speculative game. Westech announced, I think it was earlier in the year, that they had a Maui sized structure just off the coast of the East coast of the North Island. Irrespective of what we think of that structure, if they were right and they drilled that up this year they might conceivably be able to get that into production over the next few years. And that could have a significant impact on what we're doing in Pohokura in the earlier period of field life. It is a very risky proposition, we don't

know for sure whether those fields exist or not.

MS BATES QC: I can understand that, but then how does that sit then with the Government policy?

MR TWEEDIE: The Government policy is, as Professor Evans said, the issue before us every time comes back in the short-term to delay. If we go down the separate selling route, we say -- we're going to debate that further with you as we go through this -- delay is a given.

Now, you've accepted that too, the question is the quantum of delay and in the short-term we in New Zealand are facing potentially dry winters before Pohokura gets on to stream.

MS BATES QC: I do understand that, Mr Tweedie; what I'm trying to get to is how risky and volatile the price actually is over this period for the gas market? Given that exploration, even though it might be going on, gives rise to substantial lead times before the gas actually goes to market, I can't see that you're at such risk of the price going down

MR TWEEDIE: It gives -- there are substantial lead times with large fields. The larger the fields the longer the lead times. If you look at Kahili, I think it is with Indo-Pacific and NGC, that's getting into production, there's a petajoule or two of production a year, it's getting into production very quickly.

So, smaller fields don't take that lead time. Some of the on-shore discoveries, Remu(?) would be another example, can get any production in very short periods of time. When I'm talking about the long lead times I'm talking big capital investment decisions around a billion dollars and in the off-shore environment, I'm not talking about the short-term, the smaller fields that will get into production in a few years.

MS BATES QC: But it's the big one that needs to fill the gap that the Government Policy Statement sort of revealed, isn't it; the smaller ones aren't going to help all that much to mean there's no shortage, are they?

MR TWEEDIE: They will, they'll all contribute, and if in fact there remains a price risk and a shortage of gas potentially, as we are seeing today, Genesis will switch to coal. That backs gas out of the market. They're planning to base load Huntly on coal, and are importing coal from Indonesia. That actually backs gas out of firing the turbines at the Huntly Power Station.

Contact have just completed resource consents to get its New Plymouth Power Station peaking, particularly peaking, operating on distillate. That backs out gas. So, we have the situation that it's not just a gas market that has no substitutes, there are fuel substitutes. You've probably read regularly about Solid Energy proclaiming endlessly that coal is unloved, ignored far too much and there's a lot of scope for coal.

Now, that may have political ramifications, but it is a competitor to gas. Most electricity generation turbines can fire on gas or distillate, so there is the clear issue that there are substitutes to gas and that adds to the supply and price risk.

CHAIR: I think, Dr Berry, we'll proceed with Professor Evans' presentation and see if we can get through that by the tea break, if that's all right -- if he can remember where he is.

PROF EVANS: He certainly can.

So, I conclude; the gas contracts must be in place before investment in extraction takes place for the reasons given, especially with the fact that we have an irreversible investment and a range of risks.

Before I leave the topic I also want to talk about the issue of the duration of a contract. Gas sales contracts can be, as we all know, of various durations and the duration is properly a commercial decision that will be driven by factors that include the firm's appetite to risk, the extent to which the Joint Venture wishes to push the boundaries of the capacity of the field, and the price profile that is anticipated for gas.

Without anticipating the Joint Venture Parties' views, I would argue it likely that a field would offer contracts of various durations. Some even as long as the prospective life of the field and others long enough to provide surety of supply for purchasers who themselves have prospective sunk investments with long physical lives, such as generators.

In short, one would expect a portfolio of contracts the shape of which would depend on the state of the market at the time the contracts are agreed. When I refer to the term contracts subsequently I'll be referring to a portfolio of contracts that would be attached to a field.

I'd like now to turn to why joint marketing without conditions is essential for the existence of contracts. Again, I start with a set of observations. First the Joint Venture Parties have very different actual and potential business interests, they have come together essentially for the particular purpose of harvesting Pohokura.

Under the Joint Venture Agreement the final investment decision and decisions to enter any joint venture sales contracts require unanimity. There's a common pool problem exacerbated about the level of reserves of Pohokura.

There is no gas spot market in New Zealand, nor is there likely to be a liquid one in the foreseeable future. Contracts have to be in place before extraction investment takes place. Revenue from opportunism by any one joint venture party, vis-a-vis the other parties, is pure profit; because by that stage the costs involved in the venture are sunk.

Now, these points combine to make separate marketing a challenge to contract for. Consider for a moment the process. Under separate marketing Scenario 1 the Joint Venture Parties simultaneously have to agree the design of the fields profile off-take and set agreements among themselves on various matters, e.g. For overs and unders where it's expensive, as David said, if not unrealistic to imagine that these can be monitored continuously.

They also have to agree on sales contract terms within the JV parties. As David said the contracts have to be consonant with each other in order for the field to be operated as one entity.

Fourthly, they then can go out and arrange sale contracts with other non-JV parties separately. I use the word simultaneously to look at those four bullet points. It would be an iterative process because the parties seeking gas would have their specifications they'd like met and the parties would have to -- the JV parties would have to ensure that they were consonant with arrangements within the JV so that they could be delivered.

This simultaneous interaction occurs in a situation where 1) the ultimate size of the field is unknown, and 2) the cost and performance of the field is uncertain and will vary over its lifetime. The incentives are for each party to pursue their own interest, each party understands this and seeks to address the opportunism contractually before any decision is taken or agreement is signed. So, under separate marketing we have the uncertainties that attend the field and we have the uncertainties, or less uncertainty about the incentives for each party but the uncertainties about how each party is going to behave according to these incentives.

Each party will understand this and try to address the opportunism before any decision is taken or agreements signed. I think what is critical here is the effect of anticipation; looking forward, if there is any significant reason to expect a contract not to be secure at some point in the future, the contract will be changed before it is written; that is, even before the contract is drafted, the future contingencies will be incorporated in it in an effort to handle the foreseeable event.

If the foreseeable event cannot be treated satisfactorily from the point of view of all parties the contract may not be put in place at all. Conditions placed on joint marketing that extinguish the authorisation contingent on future events will often obviate joint marketing authorisations before the contract is actually written; ie, that is the condition, although it becomes operative in the future, will return the stage to separate marketing before investment takes place.

I'm just stressing here that at the time the contract is written -- and by the term 'contract' here I'm thinking about the arrangements in which joint marketing or separate marketing are imposed before investment takes place; at the time these agreements are entered into these contingent events and possible events of the future will be impinging on the arrangements directly themselves well in advance of the events, and in fact before the contracts are being signed if the Joint Venture Parties are wise.

And, given the factors that I've indicated about uncertainty, about the scope for opportunism, this is the source then of the time and effort that's required in order to get arrangements in place under separate marketing.

The future events are those that you're trying to contract for. You can't contract for them completely but you'll try if you can foretell that they will likely occur.

Two more points about the ability to enter arrangements in separate marketing. Firstly, because of unanimity, hold-up in intra-joint venture negotiation is possible and because of uncertainty there's potentially value in being the last of the Joint Venture Parties to agree. If there's uncertainty about the outcome, and because your vote is needed in order to get agreement, then it's in your interests very often to be the last to sign and the last to agree.

The second point is that the absence of a spot market in New Zealand does not exist in obtaining agreement, as we've indicated before, because it doesn't provide -- we don't have a verifiable outside price outside of the Joint Venture for overs and unders; as well as, we don't have an assured place to place gas or obtain gas in overs and unders.

All these factors combine to imply that writing contracts to enable separate marketing would be fraught and time consuming in the New Zealand environment.

I'd now like to make a different point. That is one that was alluded to by David. That is that, in order to handle the issues that are posed by separate marketing the nature of the contracts themselves might well be changed. If it were feasible to enter contracts under accept separate marketing, the set of possible contracts that are available for purchasers will likely be reduced. I've got four reasons listed here.

One is, they will be changed in ways that handle the opportunism by other parties within the joint venture, and that might require increased specification of contingent possibilities. You can't leave as much to agreement in the future as you would in a joint marketing if you were under separate marketing.

Secondly, you might want to think about how the arrangement could handle the consequences of opportunism; for example, perhaps reduce the off-take of the field as David actually intimated as there is less control of a field whose reserves are uncertain and perhaps -- whose reserves are uncertain under separate marketing.

Another possibility would be to potentially have fewer contracts that have resale clauses in them as an aid to monitoring off-take under each contract.

The third possibility, or the third issue that arises is the question of what level of contracts each Joint Venture Party could actually have. There would -- in terms of reducing the opportunistic interaction among them it would be ideal, so to speak, if we could match the contracts to the ownership shares. But this would mean that the contracts would be almost identical in every respect because it would mean that the contracts would have to have the same rates of off-take.

However, without this, opportunism would be -- among the Joint Venture Parties could be really strong. If one party said, well, I don't want to be a party to this field, I'll take all my gas in the next five years and you other two parties, you can go over here and you can have gas up to year 18, the other -- I'll have a large volume and I'll just take the share of the field as we know now and then several things -- there would be several issues.

One is that we don't know actually the reserves of the field, so it's most unlikely that parties would agree to such an arrangement. Secondly, the firm that takes off the gas in the short time might overrun its off-take, and with no solid balancing arrangement, as might be provided through a spot market, might benefit from that and that would create opportunism.

The way in which that would be handled at the beginning of the arrangement, at the time the arrangement is designed, is to design contracts that prevent this happening or lessen the likelihood of it happening, but then that just means that the contracts each party has look a lot like the contracts the other parties have with the same off-take, same rates of off-take etc.

This leads to the outcome that it would limit the ability to have a portfolio of various contract durations, as I've suggested would be ideal from a field of this kind.

So, my summary is that joint marketing by the joint venture is essential for timely contracting for the sale of gas and that separate marketing would result in a long delay and narrower contract possibilities.

CHAIR: Can I just interrupt you for a moment?

MR TAYLOR: Professor Evans, I just want to make sure I understand at the top of page 4 of your notes, the paragraph at the top. I just want to make sure I understand where you're actually going with it; I'll play back what I -- if I'm wrong you'll straighten me up, it introduces such uncertainty as to perhaps make it so difficult to write contracts that might not actually take place, or there's such a long time in getting there?

PROF EVANS: It could be -- it would take time to get there, but it might be such that it's just not worth a candle, and suppose -- if I use that last example, suppose that there was some event that's six years in the future that goes to the field in some way and affects the contract, it might, and that one party has a contract that extends for six years and the other parties have a contract that extends for 18 years. Now, you wouldn't be waiting until you were into the contract in order to solve the contracting problem. That whole contracting problem has to be solved before investment actually takes place.

MR TAYLOR: And it's the result of the conditions introducing uncertainty?

PROF EVANS: They do have that effect, but that's later on we'll talk about conditions, but a condition may have that effect of -- suppose there is a condition -- just to anticipate, suppose it is said that joint marketing is authorised for six years, then the Joint Venture Parties will look around and say, well, after six years there's a presumption or potential presumption that the reasons why joint marketing was enabled no longer exists and therefore it is a possibility that contracts might be breached after six years. Now, it's year zero, I'm going to figure out what I'm going to do now about that. That's the main point.

MR TAYLOR: I understand, thanks.

CHAIR: Can I just see if there's any -- [**No comments**]. Okay, go ahead.

PROF EVANS: On point 3, I'd just like to talk about the role of contracts and competition. The ability to write contracts of varying duration, I'd argue, is pro-competitive for a couple of reasons. First, the ready ability to write a general portfolio of contracts upon the discovery of gas will enhance the economic and commercial value of the fields discovered, and thereby enhance entry into the discovery and production markets for gas. This point's been made already.

The reduced value arises because of the time cost of negotiation, the narrower range of contracts and potentially reduced performance of the field that would arise under an inhibited ability to write contracts.

Many Australasian oil and gas exploration companies are very small and the New Zealand gas market is tiny on a world scale. Because of the size of the gas market per se, participation by small firms is important for competitive exploration. This local interest is likely to be an important adjunct to larger international companies' exploration for liquids that are internationally tradable. Joint ventures in oil and gas exploration are common, and are critically important if small local companies are to participate.

They're also the norm for large companies. The approximately 1 billion that will get Pohokura to market is about a third of the equity value of Lion Nathan and Carter Holt Harvey and a tenth of Telecom. I'm informed that

Todd's share of the further expenditure required is a high percentage of its shareholder's funds.

Furthermore these relatively large sums do not include the costs that have gone before and that hopefully will follow afterwards. That is to say the drilling of dry wells, seismic acquisition and processing.

Thus the search costs that preceded the finding of Pohokura, Pohokura should be making some contribution towards and so revenue from successful fields have to meet the cost of the development of these fields.

Institutional restrictions that limited the marketing, and particularly that of joint ventures of gas from successful fields, are likely to adversely affect the value of discovered fields and exploration and potentially the focus on exploration for gas for the New Zealand market. Ultimately this would adversely affect competition in that market.

MS BATES QC: Can I just ask a question Professor Evans, does that mean that -- is that because of the increased costs that you see joint marketing having?

PROF EVANS: It's the ability I think looking forward of a firm that's contemplating discovery of a field in New Zealand, if a firm or a group of firms to be able to write contracts in relation to that field, once they've discovered, or if they've successfully discovered it, in a way which gives quite a wide range of contracts that are available for the use of the field.

So, if we have, say, separate marketing insisted upon that restricts the range of contracts and induces the extra time that it would take to get them in place in each circumstance, that would inhibit the interest of parties, especially joint venture parties, since it only applies to joint ventures in the field in the development and the exploration of the New Zealand market.

And it seems to me that the real issue here is one of dynamic efficiency, there's only real justification for looking at the -- or only way to view the gas market is a way -- the exploration end of the gas market, I keep going backwards, is that of dynamic efficiency, where we want entry, we want to find more gas, we want it done in a way which is done by private sector interests.

And in the New Zealand context I think that it's facilitated by joint ventures for two reasons. It allows smaller firms to participate and secondly it allows New Zealand firms to participate. So, anything that inhibits the joint ventures management of the field it will inhibit that process.

MS BATES QC: So if it becomes difficult for joint venturers and more particularly difficult because they have to market separately, then the argument goes that other people will be put off forming joint ventures to do explorations and get other joint marketing and joint venture contexts going. What I'm talking about is, do you see the market as a number of people who are all in joint ventures and joint marketing, is that right?

PROF EVANS: I think it would on the joint venture front, yes, I do.

MS BATES QC: So that's how you see it as increasing competition by promoting the setting up of more joint venture exploration?

PROF EVANS: And ultimately the discovery of more gas, yes, absolutely.

MR STEVENS: And not necessarily the same joint venture mix I presume.

PROF EVANS: Not at all, no. They may even be all Australian joint ventures -- no. But joint because it's very common in the industry, the risks are such that -- and the capital investment is such that even large companies, typically in joint venture arrangements.

MS BATES QC: If you're one of the first in there, you do have a pretty -- you might have a pretty good ride for a while until somebody else gets in there and competes with you which may be well down the track.

PROF EVANS: The question is what is meant by "getting in there first" because if you look at the figures that I think Todd presented, it was something like 12 or 6 percent of the holes that they drilled they found anything in, you know, they first got in there years ago drilling. So, we need success every so often otherwise there will be no drilling.

MS BATES QC: I mean I'm really talking about in terms of the joint marketing, you might have the field to yourself for a while.

PROF EVANS: Well, I think I would argue that joint ventures are different than single firm ownership. There's tensions within joint ventures that are not there within joint ownership and that joint ventures are actually really a very useful competitive tool actually, where you can have otherwise competing companies come together for specific purposes and for specific, you know, that actually call for multiple ownership of some kind, and that actually -- this is in the gas market I think in the exploration market -- I think that joint ventures can be very pro-competitive.

The second point I was going to make was the point alluded to again before, that if a significant component of gas is put out under contracts that permit resale, joint venture parties have indicated that contracts they offer will not unreasonably restrict resale, there will be in the market a source of gas available for various uses at the discretion of other than them, other than the joint venture parties. This occurs for the period of the contract, the longer the term contract you're at least as likely to enhance competition as short-term contracts.

CHAIR: Do you think it's appropriate for the Commission to rely on that sort of behavioural undertaking?

PROF EVANS: I'm not someone who would suggest the Commission's, you know, approach to this. But I do think that the terms and conditions of contracts are a matter for the commercial negotiation Determination. I do think one might well expect to see some of those contracts have resale clauses in them and I do think that where you have those sorts of clauses in them they have the effect that I've just described.

CHAIR: And if none of them had it in it?

PROF EVANS: Well, then it wouldn't have the effect; the second point here, the first point would remain. It doesn't -- yes, that's right.

In sum in the New Zealand context enforced separate marketing will at a minimum delay contracts, B, restrict the form, perhaps even the resale possibilities, and C, on all the arguments not improve the establishment of wholesale gas supplies over that of joint marketing.

Now I'd like to turn to the question of whether competition is lessened or not by joint marketing. Now the first paragraph we've already touched on in the last section. Joint marketing will, on the arguments relative to separate marketing, facilitate the establishment of contracts of various durations and that this is pro-competitive and will enhance dynamic efficiency.

I now look at the situation of static competition or static efficiency and consider whether joint marketing inhibits competition given the current static state of the gas market. For this purpose I define competitive enhancements within the context of standard or textbook oligopoly to occur whenever increased individuality of actions has the potential to increase levels of economic activity, in particular output.

Now throughout much of economics there are various models about supply and demand and all that, and economists are typically very strongly in favour of competition as a general principle -- not typically, I think completely in favour as a general principle.

And the issue there is that with more competition there's more individuality of actions, and that typically in markets of a static textbook variety of supply and demand markets, the more that takes place the larger the output that's produced or some change in economic activity occurs, that enhances welfare.

Now I just start considering this issue in the terms of joint marketing and separate marketing, and just reiterate to start with that the Joint Venture Parties have very different actual and potential business interests and that they've come together essentially for the particular purpose of harvesting Pohokura. Thus the formation of a joint venture creates an additional different entity in the market.

Where it contains parties that have other positions in the market, joint marketing has the effect of constraining the aggregation of market positions over that which would be available under separate marketing. This factor suggests that joint marketing would be neutral towards, or perhaps even enhance static competition in the market.

I now turn to the question of how does separate marketing and joint marketing, how do they fit the models that we use to look at things like oligopoly, monopoly and perfect competition.

Firstly I make the point that joint marketing versus separate marketing is not copied well, or mimicked by a single owner versus separate independent firms. In fact, joint versus separate marketing is completely at variance with and cannot sensibly be analysed by standard monopoly and oligopoly models of markets. I provide some background for this suggestion by the following three points.

First of all the capacity of the field is uncertain and limited and therefore the field itself is not, to coin a term, a widget producing enterprise for the standard textbook models in which output choice is open and limited only by the cost structure and the size of the residual demand facing the firm.

For Pohokura ultimately the size is limited by the size of the field and that's nothing that the -- there's very little that the Pohokura partners can do about that.

Secondly, the fact that gas is in essence a joint product with other products means that the price of and the demand for gas per se is but one factor in the decision about the level of off-take. There is a -- joint outputs from Pohokura involve liquids as well as gas, and so the individual influence of the price of any of those elements is less than it would otherwise be.

The fact that with uncertain prices and uncertain demand for all the products of the field, the timing of extraction is likely to be as important a decision as the level of off-take, and it's the timing of the field that the parties have control over.

Now those three factors place very considerable limitations on the application of standard oligopoly models because they reduce the role of the gas price in decision about the rate of off-take from the field, although the gas price is still important. However, taken together they are of much less importance than the fact that under both separate and joint marketing the output level of the field is set jointly by agreement of the JV parties.

That completely eliminates the relevance of monopoly and oligopoly models in comparing the factual and the counterfactual. There is no monopoly power issue, no monopoly power difference between the factual and the counterfactual.

If we imagine for a moment that Pohokura was a widget producing enterprise and consider the separate marketing decision. If the output and decision in which the parties sit around the table and say let's agree now on the level of output and then we'll go out and sell it; that is no different at all than them just sitting around a table and agreeing on the level of output and saying well, we'll just jointly sell it.

It is no different whatsoever in the output choice or the process of output choice. If separate marketers sat around the table and said, right let's agree that this level -- on this level of output, they would not, I would argue, necessarily produce more output, even in the widget producing enterprise, because if they produce more output there'd be more -- there'd be a lower average price emanating from the arrangement.

So, even in a standard hypothetical firm that textbooks used, in an oligopoly situation, if the oligopoly players sat around the table and chose the level of output it wouldn't be larger than that which would be suggested by a joint marketing approach.

Of course we know Pohokura is nothing like a widget producing enterprise. For a start it has all the issues that I mentioned before about the capacity of the field, the uncertainty of the field, the joint products and all that. However I conclude that separate marketing can in no way be approximated by entities that are independently setting price and output and that competition is not lessened by joint marketing for those reasons.

In point of fact there's no rationale I'm aware of that that suggests the proposition that annual field output would be larger under separate and joint marketing. Indeed as suggested above, output might even be lower.

I conclude that the analyses, for example that of NZIER that represents separate marketing as if it were oligopoly, let alone NZIER's very competitive model, in that the flow of output is larger under separate marketing, are not relevant to any aspect of the comparison of the factual and the counterfactual.

The textbook model of competition and its effect on output within the market is completely irrelevant in the comparison of joint and separate marketing, because under both the level of output is jointly chosen by the joint venture parties.

Absent any rationale to the contrary I'll presume that the Pohokura output will be the same over time under either form of marketing, even though it may well be higher under joint marketing.

This sets us up now to look at whether there are detriments to joint marketing.

CHAIR: Can I just interrupt you for a moment and see if there are any questions, and I think what I might suggest we do is take a 15 minute break, if that's agreeable with everyone.

I just want to signal before we do that I may have to interrupt the applicant's presentation to allow time for the Petroleum Association to speak today, and I intend to do that at 4.30. So I ask that people be flexible with that, because I believe there's a difficulty with the Association appearing tomorrow, is that correct? Is someone here from the association? Is that right?

MS OWENS: That's right.

CHAIR: If that's agreeable, okay, we'll come back in 15 minutes.

Adjournment taken from 3.38 pm to 3.55 pm

CHAIR: Okay, we'll reconvene the meeting and I think the applicants prefer to vary the order at this point.

DR BERRY: If we may, we'd like to introduce our visitors from the Sydney office of Westpac, they have a flight commitment later tonight, so if we can have them now that has a benefit, I think, for all involved.

I'll introduce them briefly as I mentioned in the introductions. We have Mr John Ballantyne on my left together with Mr Patrick Cocquerel, so we don't have any particular slides for them, so I'll just speak to the letter that is before the Commission as part of the submission, make a presentation and then take questions.

CHAIR: Sorry, the names were?

MR BALLANTYNE: I'm Jonathan Ballantyne.

MR COCQUEREL: And my name is Patrick Cocquerel.

CHAIR: Okay, please...

MR BALLANTYNE: Thank you. Just as a matter of background, my name's Jonathan Ballantyne, I'm from the Westpac Sydney office, I'm in the Project and Structured Debt Group there. Our main task/role there is to structure non-recourse financings for projects right across the infrastructure energy utilities sectors, both in Australia and New Zealand. Patrick?

CHAIR: Can you tell us what your relationship is with the applicants?

MR BALLANTYNE: Our relationship with the applicant; Todd is a customer of Westpac on a corporate basis. My personal relationship with Todd is, I've met Todd in previous roles with previous other banks but, as far as depth of relationship with the applicants here at the Commission, meeting them in the -- yesterday, so very limited.

MR COCQUEREL: And I work also in the Sydney office in the Energy and Resources Department. I joined Westpac a few months ago to focus more on the oil and gas business, and my background is in banking and spent the last four years in Houston, Texas doing essentially a reserve base financing and oil and gas financing.

MR BALLANTYNE: What we'd just like to outline is the key requirements that we would see, on a very generic basis, the key requirements that a project would have to have to structure a non-recourse project finance.

CHAIR: When you say 'generic' what do you mean by that?

MR BALLANTYNE: Specifically, we don't have details of the Pohokura project, so specifically we can't address structuring of finance around that. We're wanting to look at just broad issues that need to be addressed when structuring project financings.

CHAIR: Is that the sort of financing you do for the likes of Todd, non-recourse; is that the only form?

MR BALLANTYNE: That wouldn't be the only type of financing that Todd would look at, but just on that point I am not in a position to speak on any other types of financing other than just project financing because that is my specialty.

MR STEVENS: What about Patrick; is he able to help us with anything apart from non-recourse financing?

MR COCQUEREL: They are all in the way of financings, yes.

MR STEVENS: So, you'll be talking to those will you?

MR COCQUEREL: I could try to answer a question that you may have about oil and gas reserve financing, but I think we were asked to come here today to make some comments about the -- probably one of the most common ways to finance these type of projects, which is non-recourse financing.

CHAIR: I think -- I presume you're here as experts, so I guess all's fair at this point in terms of questions; that may be what they've asked you to come and speak on, but we may address other matters to you for your response.

MR BALLANTYNE: We would endeavour to answer them, but if we feel there are questions that are best deal dealt with by our Wellington representative that works with Todd, we'll defer to him if that's okay.

CHAIR: If it's not within your expertise, we don't expect you to answer, but if it is within your expertise we do expect you to answer.

MR BALLANTYNE: Okay. When looking at project financing, the key issues there are the certainty of the net cashflow that the project will produce. By that I mean the cashflow after recovery of all costs, revenue less all costs. The cashflow that would be left to service debt and provide an equity return.

Certainty of that net cashflow is, really, we look at about five broad factors to assess that certainty of cashflow. We look to strong sponsors, in this case it's the -- particularly the Joint Venture Partners or their parents, and for responses to be strong it needs to be technically and financially able to operate -- be the field operator, and to perform the role as joint venture partners, so we'd be looking at previous experience in those areas and the current state of those -- the financial and corporate structures of those entities, but then from there we would move on to certainty of the petroleum reserves. And by certainty there we'd be looking at the nature of the reserve, the quality of the reserve, the quantity, the production profile.

At this particular point in time we have no knowledge of this particular project, how that particular project's reserves would fit as far as certainty. We would need to go through a due diligence process where we would engage petroleum experts to act on behalf of the banks to revisit the information that would have been gained by the Joint Venture Parties in their exploration and development work.

The third point is certainty of cost. Now, by this we look at the -- I mean, the development capital costs, then the ongoing operating costs and then potentially the administrative costs and costs such as taxation, Government royalties, etc.

The fourth point is certainty of revenue. There we, in the case of commodity type project financings we would be looking to either a product that could be sold into a deep liquid spot market with developed forward sales potential and developed hedging market. The alternative, and it's probably more applicable here, would be robust long-term contracts with financially secure counter-parties, parties that could honour the contracts over their entire term.

The fifth point we require certainty with is certainty over security of the assets. This is really the backstop that the banks are looking for, and when the project hasn't performed and they're in a position where they need to enforce, we need to be sure that the regulatory and legal arrangements that are in place allow us to gain control over the assets without diluting the value of those assets.

The assets that we'd look to in this case, specifically this type of financing, would be the petroleum mining licenses and the off-take contracts, we would feel are the assets that we need to be sure that we have security over and that those contracts remain, those contracts and licenses will remain in place and have the same value after we enforce.

So that's just broadly how we would approach looking at the aspects that -- approach that we'd look at when approaching a project finance. We would now really like to just speak about the three conditions that have been attached to the determination and just give our view on why they could affect our -- the certainty of the cashflows that this project could generate, if you would like to ask questions on this point?

MR STEVENS: I wonder if I could just ask a small question, Mr Ballantyne. Do you, in terms of the non-recourse financing, how do you secure security over the assets -- are you talking about financing all of the Joint Venture Partners as one and getting them to come to terms agreements, or are you looking at financing one Joint Venture partner, and then, how do you look through to the security aspect of that?

MR BALLANTYNE: That's actually a very detailed question on how you would look through to the security aspect of it. We can do it both ways. In this particular instance I guess we're thinking of, financing is associated with each individual Joint Venture partner on a -- specifically tailored to their needs.

That type of financing, those type of financing arrangements have been fairly common in the Australian environment and have been done in the New Zealand environment as well. It becomes a -- there needs to be a complex system of cross-charges etc and agreements put in place. This is part of the whole expansion of the joint venture agreements that would have to occur at the documentation stage.

MR STEVENS: Is a non-recourse loan a common way of doing something similar to Pohokura?

MR BALLANTYNE: Yes, it would be.

MR STEVENS: So, Westpac takes an equity risk as part of the process?

MR BALLANTYNE: Not an equity.

MR STEVENS: Sorry, in terms of the financing then, do you finance the bulk of it, or part of it?

MR BALLANTYNE: In this case we would potentially look to provide financing, depending on which way one of the Joint Venture Partners would want to go, we potentially provide an underwritten financing for that whole debt proportion of their Joint Venture share.

MR STEVENS: Which is a quasi equity risk then if you're financing the bulk of it?

MR BALLANTYNE: No, we would be expecting such a financing that there would be a level of equity put into the project directly from the Joint Venture Party, then there would be a level of debt which we would provide; the actual ratio of that will depend on the details of the financing.

MR COCQUEREL: Can I may make a comment on reserve base financing in general, whether it is recourse or non-recourse?

Basically reserve base financing is a cashflow financing. You look at the cashflow that's going to be generated from the assets from the project. So it's a modelling exercise where you project -- you need to ascertain the volume of reserve under the ground, the nature of those reserves, the quality of those reserves and you project -- you have a production profile over the life of the production. And you go down from the top line which is the volume multiplied by price which gives you the gross cashflow and then you would deduct from there the capital expenses, the operating expenses, the production taxes, the royalties and you have a net cashflow value.

All we do in the financing is take -- is offer a financing which is a percentage of the net present value of those cashflows. To answer your question, therefore, we only provide debt, and what may vary is going to be the percentage of our lending against those cashflow.

If we are financing 100% of those cashflow we take more risk than if of course we were financing only 50% of those cashflow. The decision on the percentage that we're going to finance will depend on the nature of the reserves, are they proved in America when you finance an existing field that has been producing for quite some time which we call PDP, proved, developed, producing.

Your level of risk against those cashflow are lower than if you were to finance a cashflow on the field that is not developed yet, or that has not been in production for some time, because you don't have the historical production to ascertain the certainty of your cashflow in the future.

So the two main components if you want to have a review will be the certainty of cashflow, what level of certainty we have that that cashflow is going to exist, and we're talking about something in the future, so it's never sure, we have to lower the risk of this uncertainty, so the certainty of the cashflow in the future, number two. And, number two, the percentage that we're going to effect to the net present value of those cashflows.

So, to go straight to the point of one of the decisions of the Commission, or one of the proposed conditions, which is to limit the sales agreement to five years, that would limit us as a finance -- as a banker, as a financier, that would limit our capacity to lend only against the five years of cashflow, of net cashflow. That would limit, if you want, the amount of money that we could lend against that project.

In other words, I don't know the production profiles, the life of the reserve of Pohokura, but if it was 15 years and we were only going to be able to take five years of cashflow, that means that our financing would be limited roughly to one-third, or you have to take the present value calculation, but let's say one-third or 30% of the outlay necessary to amortise the initial cost of the project. Does that make sense?

CHAIR: Has Westpac been involved in financing any projects in Australia where there was a time limit on the authorisation? Do you know whether any of the transactions you've been involved in were subject to a limited authorisation?

MR BALLANTYNE: I can't actually comment on specifically whether there have been any petroleum assets financings associated with that. I do know that in the case of the large infrastructure projects where the Government is granting concessions for 25 years-30 years to operate tollways or railways, where there's been a construction development period, there have been set dates put in place whereby the concession would be terminated if the construction was not completed by those particular dates. But where that has been the case, there have been extensions allowed for that date as a result of force majeure and the force majeure clauses have been worded depending on the type of project that it is; they would be related to the risks associated with that project. So, if we were to develop this to use the oil and gas project as an example, there would be things -- there would be the weather risks associated with the project of putting the platforms in place, that would be force majeure, there would be issues such as associated with the actual technical -- the drilling of the wells etc, that would be classed as force majeure and they would be negotiated, they would be negotiated terms.

CHAIR: What my question is, if you want to go back and ask in Sydney, you can always let us know, but are you aware in Australia how the banks have handled financing in the cases where authorisations in the gas area have been limited to something like seven years?

MR BALLANTYNE: I don't believe there would be set unextendable points.

CHAIR: But you don't know how it's been handled in the Australian context?

MR COCQUEREL: Again, it's cashflow financing. If you limit to seven years you can only finance seven years of cashflow. If you limit to ten years, you can only finance to 10 years, if you finance two years you can only finance two years.

CHAIR: Sure, I understand that, but it still begs the question whether then some other means of financing is used, and it's difficult for us to know whether this discussion about this type of financing is relevant at all and whether in Australia different approaches have been used.

So, I'm struggling a little bit to know whether what we're talking about is relevant or not, because there are certainly cases off-shore where authorisations have been limited and the key question to us is, what impact has that had on financing, and I just don't know.

MR COCQUEREL: We don't know of any case because I suspect there are no cases where you can arrange a financing for 10 years of cashflow when you only are sure to cover five years of cashflow. I don't see how a bank can take this kind of risk, unless it's mitigated by some cash payment.

I mean, again, we can finance 30% or 20% of a project.

I don't think it makes a lot of sense for the customer or the sponsor, but if we are limited to that amount of cashflow, that's all we can finance. That's true for Westpac, it's true for any other bank, and it's true for New Zealand, Australia or all over the world. I think that would be the same situation.

MR STEVEN: Have you come across a situation where they've limited in terms of the gas quantity, because I presume -- sorry, I won't presume, but in calculating the cashflows that you normally do, you're obviously making a judgment call as to what gas is going to come out of the ground and then that will determine the cashflow and then from that you NPV it back to today.

But in determining that first basis of the gas that's available, do you discount a certain amount of gas as possibly not being there and, therefore, there's a core amount that you say, well, we believe on the balance of probabilities or whatever that that will be there and the rest of it may or may not be there. Is that how it works?

MR COCQUEREL: In some ways it does. I mean, the way -- in America where my most recent experience is, the reserve are classified, as I was explaining, you have the PDP, the proved developed producing, then you could have the PDNP which is, proved developed, but not yet producing, and then you have the proved and undeveloped which we call the PUD, with a Texan accent I guess, and obviously the amount of money and the percentage of the advance that the bank would lend would be lower as your level of certainty would be lower. So, for example on PDPs you could be lending 60% against the future cashflow. If it is a PDNP you would lend over 20 or 30%, and if it was a PUD you would lend only maybe 10%.

MR STEVENS: So, for example, hypothetically in this situation you might be able to determine a block of gas which the banks are comfortable that they will lend a percentage on that but a balance of it they're saying, we don't know whether it's there or not there, therefore one condition may well be to limit joint marketing to that section because the balance of it is going to be discounted in any event.

MR COCQUEREL: If there is a risk that the reserve is not there; there is a very high probability that we are not going to finance it.

MR STEVENS: Thank you.

MR COCQUEREL: We don't have detail about -- again, about the specific project number 1; and number 2, the size of the market in Australia and New Zealand for oil and gas is limited in size and we don't have the benefit of an in-house petroleum reservoir engineer.

But again in America where the market is much larger, banks have owned the -- as employees they have a reservoir engineer whose job is to do exactly what you describe there, to assess the value of the reserve under the ground and to assess the probability of those kind of reserves to recalculate on a regular basis the value of the security against the value of the amount that has been lent to the companies.

CHAIR: Presumably, if you don't have it in-house you bring it in.

MR COCQUEREL: We use outside engineers, yeah; we use outside consultants.

MR LAUNDER: I just wanted to confirm then that, if you were approached by a client etc, you would carry through a due diligence part yourselves, and that may take some time and you would obviously assess all the information that was then provided to you, and ultimately come up with some sort of decision as to whether the bank would finance it or not; is that correct?

MR BALLANTYNE: Yes, the bank tends to, in all aspects of due diligence which tends to use outside consultants, so there's a process that we manage there, and then that -- all of the risks and conclusions from that due diligence are then aggregated, summarised and put forward to our credit committees for decision. That due diligence process cannot occur until all of the issues associated with the project have been finalised. So, off-take contracts, technical design of the fields, the structuring of the Joint Venture agreements, the authorisations etc are all in place, can do initial work but we cannot finance it -- we cannot finalise it until all of those issues are finalised.

MR LAUNDER: I don't know whether you can answer this; roughly how long would your due diligence process for a -- sort of, a project of this sort of size or this sort of thing take? How long would this take for the bank to do?

MR BALLANTYNE: I have seen -- it depends on the quality and the complexity of the documentation. Now, the more complex obviously the documentation, the longer it's going to take, but if you -- if I had to guess, at best four months, but more likely six months; due diligence process.

MR STEVENS: Sorry to revisit this question again, just to clarify it just one last time. If one of the conditions that the Commission may seek to apply is to say that we will allow joint marketing up to a certain percentage of the gas in the field and after that we will require separate marketing and that percentage then is within the more provable reserves that you calculate, then the fact that we're requiring separate marketing on the balance won't concern you as much because the probability of income from that is a lot lower. Is that what you were agreeing with previously?

MR COCQUEREL: We would look at, again, the certainty of cashflow, so we would take the Joint Venturers that we are discussing with and we would look at what amount of gas or liquid has been agreed, has been sold, has been contracted, and at what price, and that the cashflow we would take into account. Everything that is not sold or not contracted would have no value or a very reduced value compared to what is contracted, and obviously they can only contract what is existing in terms of reserve, so we would make sure they don't contract more than the reserve that has been estimated, but I'm sure that would be the case.

MR BALLANTYNE: And the issue where there's a problem, so you've limited the time period for the --

MR STEVENSON: I was on the basis that there was no time period limitation; the hypothetical question was, if there was no time period limitation, but we were limited in terms of quantity as to what was able to be joint marketed, and would that effect -- have the same effect? I think the answer that I got was, it really depends what the impact is on the cashflow.

MR COCQUEREL: The other point we wanted to comment on is the timeframe that could be an obligation for the Joint Venturers to start production. Obviously, in any case that would be an issue for financing in the sense that, if there is any chance for the Joint Venturers to lose their production licence, because they are not able to meet certain timeframes to start production, that would be a risk that the bank would not be able to assume, I guess, from the outset.

MR STEVENS: Likewise, I presume if there was a strict timeframe the banks would be pleased on the basis that there would be a high incentive for that income to be generated in the earlier periods where there's less NPV discount.

MR COCQUEREL: Sure, but the bank also I guess would take the risk of financing a project worth $1 billion with the possibility for the Joint Venturers to lose their licence to produce and, therefore, to generate the income to repay it.

So though we would really, I guess, be happy to see the Joint Venturers being able to produce and repay the loan as soon as possible, if there was any chance or risk that the Joint Venturers would lose a production licence and not being able to generate the cashflow to repay the $1 billion loan that we have outside, out to the Joint Venturers, that would put us in a very difficult situation.

I guess the third point that we wanted also to comment on is capacity to assign the authorisation to a successor, and obviously that is part of our security package. If we were to lend to any of the Joint Venturers, we would need to have the capacity to get access to their portion of the production licence. In the case of that company defaulting on the loan, we would have to be in a position to get access to that portion of the production licence in order to sell it to, I guess, to another party and recover the loan that has been made in those initial agreements.

MR BAY: As a bit of a clarification to Mr Stevens' questions on reserves. You indicated there'd been declining percentages from proven developed reserves down to PUD reserves as far as which the bank would lend. What's the bank's policy on reserves that would fall under the probable and possible category of reserves?

MR COCQUEREL: There's no written policy as such. Every case is different. Every situation is assessed on its own merit. But you can take as a rule that as a bank we would certainly look essentially at the proved reserve as the base for lending.

There is a complex mechanism, I'm not sure we want to go into the full detail of tell(?) financing or not financing. It's a complex system by which again its a bank trying to secure itself by financing part of the reserve, and the part of the reserve we finance is the most certain part of the reserve and the amount of financing is based on the cashflow that is generated by this proved reserve portion.

MR BAY: So, fundamentally you'd look at restricting the financing to the majority of what we call the 1P reserves on the proven?

MR COCQUEREL: On this side of the world we talk about 1P and 2P, yeah, that's correct, we would like to limit our financing mostly to the one key portion of the reserves.

MR BALLANTYNE: But you need to take into account that depending on the terms under the off-take contract and the price that's being received for that production, it allows the bank to push the boundaries, whether it's totally in the P1 reserves or whether it's potentially using some of the P2 reserves as the buffer for the financing. If there is high -- a lot of money is being paid that gives us high financing ratios within the financing, then potentially we can push the limits.

MR COCQUEREL: There is no strict rule, because it will depend on the operator, it will depend on the contracted term, it's going to depend on the quality of the off-taker; it's going to depend if it is gas or if it is liquid, because obviously as we have heard before the market risk is substantially different. So, there are many many elements that would come into consideration for us to decide what kind of percentage would be lent, if you want, against the reserves.

CHAIR: I think Commissioner Bates has a follow-up question.

MS BATES: It really refers to your colleague, Mr Ballantyne, Michael Cleary, who was interviewed by one of our investigators earlier in the month. He was asked, and I'll quote the notes from the interview; "if non-recourse financing in situations such as this project is normal, or if there are occasions where there is other security offered in order to obtain finance."

And this was the answer he gave, he said; "that there are various ways to fund such projects and it depends on the sponsor." he said that; "Shell for instance funds projects on a corporate basis, others on a project limited recourse basis. A large sponsor tends to be funded on its balance sheet whereas a small company tends to have non-recourse funding."

I'd just like to ask you whether you agree with your colleague on that statement.

MR BALLANTYNE: I do agree. The reason that the smaller -- well, the smaller company will have to resort to non-recourse financing, is potentially its balance sheet is not large enough. The quality of the assets associated with that balance sheet may not be the same as a Shell etc. They may also be tied up with other non-recourse financings. So the best assets that the bank has to focus on are the particular assets of the project that they are then looking at.

MS BATES QC: So is non-recourse financing more expensive for the company?

MR BALLANTYNE: It tends to be, when you just look at the pure margins, more expensive but when you look at the total equity return and hence the price that the consumer would potentially pay, no, it can be a cheaper option.

MS BATES QC: Do you agree with that Mr Cocquerel?

MR COCQUEREL: Absolutely, yes. I don't know if I give you have the impression I wasn't agreeing but obviously we would love to do project financing with Shell, for example, but they probably have a capacity to borrow money in the market at a cheaper cost than maybe we do, so they probably would not need this kind of financing.

MS BATES QC: Right, so --

MR COCQUEREL: So project financing is often used, as Jonathan was explaining, for smaller sized companies.

MS BATES QC: Mr Ballantyne, if I could just get back to -- so I can understand what you said. I don't quite understand the argument that it all ends up the same to consumers. The non-recourse financing is more expensive, is that right?

MR BALLANTYNE: You potentially pay a higher margin for the non-recourse financing, but it comes down to the equation of how you gear the project. Equity tends to be more expensive than debt, so the more debt you can put into a project the cheaper the total finance -- cost of capital for the project is cheaper the higher gearing it goes.

MS BATES QC: But there's a bit of a higher risk isn't there?

MR COCQUEREL: Can I try to answer the question differently. If you are Shell, project financing is a more expensive form of financing, probably, probably; not in all cases, you may use project finance for other reason, for contrary risk or for different kind of reasons. If you are a small sized company, project financings might not be more expensive. So when you ask is it more expensive or not, it depends for what type of customers.

MS BATES QC: But as I understand it, what you're saying for smaller companies, is because of their asset structure, it's often not an available option for them to do anything else but take the non-recourse loan financing.

MR COCQUEREL: That's quite correct, so there are different reasons to use project financing.

MS BATES QC: That's right, but if you're a big healthy company with plenty of other assets then you might not go for non-recourse because you don't have to.

MR COCQUEREL: That's correct, but you can also be a small healthy company and decide to go project financing.

MR BALLANTYNE: You made the statement that project financing is more risky.

MS BATES QC: I wondered, it was a question really, it was a question, sorry.

MR BALLANTYNE: The thing that banks usually gain out of project financings that they don't potentially gain -- have when they're just financing a corporate is that the financing is usually fully secured over the assets of that project, whereas if we were just advancing money to a big multi-national it would be an unsecured funding.

MS BATES QC: You mean you wouldn't take a debenture? You'd give a totally unsecured loan?

MR BALLANTYNE: To a large corporation, yes, they're a common basis to provide corporate financings.

MR COCQUEREL: We still need approval from the credit committee.

MS BATES QC: I would think so.

MR COCQUEREL: For large corporations, for large investment companies, non-secured financing is the norm.

CHAIR: Can I just check if there are any further questions?

DR BERRY: Can I just raise one point there. The question was raised about other examples in Australia where there have been fields with time limitations as to them, I take it seven years related to Northwest Shell, which as I understand it was seven years after the field had been in -- it had been in production for nine years and related solely to an expansion of that field, and as far as I'm aware I don't think there has been a Greenfields off-shore field in Australia developed up against the clock of something like a five, seven year, whatever term limitation. So I think the search for the precedent may prove to be fruitless.

CHAIR: We can check up on that. Any further comments from the Westpac advisors? [**No comments**]. Thank you very much. I'm mindful of the fact that we're approaching 4.30, or we're on 4.30 and we were going to break for the petroleum exploration association, and I would suggest that this is probably a good opportunity to do that, Dr Berry if that's okay with you.

So, we'll just take 2 minutes, please don't everyone leave, we won't take a formal break but we'll just get a shifting of who's sitting at which tables, please.

***

PRESENTATION BY PETROLEUM EXPLORATION ASSOCIATION OF NEW ZEALAND

CHAIR: Okay, I think we'll reconvene and I'd like to welcome the Petroleum Exploration Association of New Zealand, and you may not have been here earlier but I think you're familiar with our processes and procedures, you know that we try where possible to keep the proceedings fairly informal. There won't be any cross-examination, but the Commission will ask questions and so will our staff and our own advisors.

I also would like to point out that, while Commissioner Bates had to go, she will read the transcript in the morning, and I wanted to give you an assurance of that. So, I will hand over to you, and if you wouldn't mind introducing yourselves before you speak, and you will probably be aware that you need to speak somewhat slowly for the transcripters.

MS WELSON: Perhaps if I could just lead off and introduce myself; I'm Elisabeth Welson from Simpson Grierson and appear for PEANZ. Also with me is Don Morgan who is the Chairman of PEANZ and also the Chairman of Swift Energy New Zealand Limited, and next to him is Dr Mike Patrick who is the Executive Officer of PEANZ.

Mr Morgan will first give a brief introduction of who PEANZ is and then I will just provide an overview of the PEANZ submission and would welcome any questions that the Commissioners might have.

MR MORGAN: I presume everyone knows what the letters stand for, but I'll repeat it; it's the Petroleum Exploration Association of New Zealand. We, with very few exceptions, have a membership that represents the majority of all of the exploration companies in New Zealand that have interest in New Zealand, whether they're based here or not; there are some US members, there are some Australian members in that.

I think it would be appropriate for me to say that some of the issues that I've seen that the Commission has in the draft go beyond what I would like for PEANZ to deal with, or to answer with. Making reference to any specific commercial issues, we want to not comment on those, it's not appropriate for us as an industry organisation to do that, and if there is one that should appear during our discussions here this afternoon we'll identify it as such.

Elisabeth, I'll let you go ahead with your opening remarks.

MS WELSON: The first and the overriding comment that we want to make is that PEANZ does support the development of a more competitive gas market in New Zealand. What it disagrees with the Commission's preliminary conclusions on is that joint marketing by a gas field joint venture -- in this case obviously we're concerned about Pohokura, but on the Commission's reasoning that could apply to any number of gas field Joint Ventures -- that such joint marketing would be likely to substantially lessen competition.

The Commission in the Draft Determination identifies, I suppose, two primary factors that it sees as leading to that lessening of competition; these seem to be, there would be reduced options available to gas purchasers and also that there'd be a delay in the development of a competitive gas market, principally a spot market or an unders and overs market.

Both of these conclusions seem to be different faces of the same coin in that what we seem to be talking about is that, by increasing the number of sellers in the market, albeit in this case when you're talking about sellers from a single field, that joint marketing will somehow give sufficient depth to the market that would stimulate the development of a competitive market.

PEANZ believes that the key driving force that will develop a competitive market is not so much joint selling -- or, sorry, separate selling from a single gas field, but increased field on field competition. If we're going to have more competitive gas markets we have to have more producing gas fields and the associated infrastructure that goes with that. The only way to achieve this is through more exploration.

The Commission in the Draft Determination acknowledges that entry into the gas market requires discovery of a viable gas field, and that it's also acknowledged that the gas market will depend in part on new gas fields being discovered and brought into production. But the Commission, or the Draft Determination only briefly considers the conditions for exploration. This is somewhat cursory and confined to the permitting of a regime around exploration; it doesn't really consider and go into detail on what are the key drivers for exploration.

PEANZ is concerned that, if we end up with a final decision that reflects the reasoning in the Draft Determination, that capital investment for exploration will become difficult to access or simply will not be available. This, in turn, will stifle the very market development that we're all looking to achieve.

We've gone into some detail in the submissions as to why this might be, but in summary some of the key issues that we'd like to point out is that, we do compete in a global market for exploration capital. Exploration companies are driven by reserves and reserves replacement. Exploration is a high risk activity and Joint Ventures are the mechanism that are internationally adopted to manage those high risks.

The goal of exploration and the objectives for which parties go into exploration Joint Ventures is production. Many Joint Venture Partners in New Zealand are what we might regard as primarily financial Joint Venture Partners. Frequently it's the operator who is the only Joint Venture Party who is established in New Zealand, or has an established presence in New Zealand. So, the practical considerations involved in separate marketing, once you've got a gas find, make it at odds with the nature of that financial investment, that financial Joint Venture Party, and the role that those parties have in the New Zealand exploration environment.

The Draft Determination briefly looks at the view that had been expressed that separate marketing would disincentivise exploration and dismisses it. The reasons which it gives seem to be somewhat circular. The Commission expresses as the reasons for dismissing the disincentive on exploration that it has concerns about the high level of market concentration, concerns that the existing market power of the Pohokura Joint Venture Parties and at the limited supply alternatives.

It also acknowledges that the New Zealand market is immature with few participants but anticipates these circumstances will change in the coming years. It doesn't go on to say why; we don't seem to be able to extract any credible reasons as to why that should be.

I suppose the key point that we want to make is that it is the view of the exploration members of PEANZ that, until we get more gas fields into production and the associated infrastructure, that potential investors are likely to perceive the requirement for separate marketing as a disincentive. That makes the change in circumstance that the Commission suggests will occur in fact unlikely to occur. So, we seem to end up going around in a circle.

I'd also note that in the first round of submissions, although PEANZ hadn't put in a submission at that stage, Indo-Pacific, who is not a PEANZ member, had put in a submission and made a similar comment, expressed similar views. So we've got PEANZ and also a non-PEANZ member who's probably one of the other major exploration companies in New Zealand all taking the view that separate marketing will disincentivise exploration.

None of these parties really have any incentive to support a position of market power by the Pohokura Joint Venture Parties; in fact, it's probably to the contrary, yet they all have this common view and concern that to suggest joint marketing by a gas field joint venture would lessen competition and could only proceed if we can establish substantial public benefits; in this case the most significant public benefit that's been identified is the earlier field development, that if that's the regime that we're going to be looking at going forward, then we will have an impact on the scale of exploration in New Zealand and the number of likely participants.

CHAIR: Can I just ask you a question there; the need to seek an authorisation for something like this is not unusual in the world, so I just -- I understand the point about conditions on which an authorisation might be granted, but the fact that an authorisation may be required does not seem to be atypical at all, so why is the effect here so much more perverse than it is elsewhere?

DR PATRICK: I can't comment on that. In terms of international -- the difference between an international regime or an overseas regime and New Zealand, other than the following we're a very very small, out of the way, expensive to do business country in terms of exploration; attracting the exploration capital over here is difficult, the players that do invest in New Zealand are obviously doing so for good reason, reserve replacement, building up reserves and so on.

A number of other factors which make New Zealand, okay, we're the -- apparently we're the 14th most attractive regime in the world, or whatever the Crown minerals group will tell you. We need to be better than that in order to get the exploration activity up to a level where we can start finding the number of producing gas fields that we need, both to meet the demand and also go beyond that and create the market that the Commission is looking for or hoping will develop at some stage.

And I think the combination of all of those means that anything that is seen as an impediment added into the other ones that I mentioned, the cost of doing business, the distance away from, you know, etc, etc, makes us a bit more sensitive to something like this perhaps rather than a bigger market area overseas somewhere.

CHAIR: I guess you will understand that, if there is a substantial lessening of the process, if there is jurisdiction for us to consider it because there is a substantial lessening, then there's a process that must be gone through and there's no -- the Commission has no power, one way or the other, to decide that it's better for parties not to have to seek authorisation because of this, so it still remains a question.

Then, if you get to that point, if authorisation is granted, granted on what terms? I wonder if you have any comment to make on the conditions that have been suggested, not just by the Commission but by some of the other parties? I note that some parties have agreed with the applicant that, for instance, a time limit on an authorisation would cause difficulties, but they have suggested other means to ensure that the benefits do arrive from early development of Pohokura; for instance, through an authorisation that protects any contracts that are signed by a particular date.

So, I wonder if the association has any comment on those matters?

MS WELSON: Before answering that, can I just go back to your earlier question?

I think there are a number of points probably which we'd want to emphasise in terms of your question, would authorisation per se create a disincentive. I think there's a couple of points to be made there.

There is a delay factor as we've heard, there are significant capital investment and parties are incentivised to try and get on and get their returns going as quickly as possible, but possibly more importantly is the uncertainty, and it relates to the question that you've just asked, which is around what those conditions might be in the sense that, having invested in your exploration to get to the point where you find that the conditions are unexpected or unknown, uncertain, might be unpalatable, does create a disincentive and, as Dr Patrick has said, when you're coming in at the front end you're weighing up, where will I invest my capital given a choice. Obviously, there's no one factor that's going to tip it, but it's a balancing, and the more things that balance against, the less likely we are to get that capital.

MR MORGAN: If I may, let me comment a moment about what makes the majority of the exploration permits and that's, simply put, it's made up of joint ventures; there are very few permits held 100% by a single explorer. The whole purpose of the joint venture is to share the risk and to be able to go forward with any development of a field if you're lucky to discover one.

Having any type of negative restrictions on the ability to market your hydrocarbons at would be certainly a negative towards attracting other Joint Venture Partners. The whole subject of being able to really do what we want to do as explorers is centred around, not only the risk of drilling the wells, but the ability to be able to market what you hope to find.

MS WELSON: In relation to your question about the conditions, we have made a number of comments in the submissions around the conditions and we certainly didn't have any additional comments to make beyond the Conference memorandum, but happy to answer any specific questions.

CHAIR: I just wondered whether you had any further comments to make about the submissions from other parties here on the conditions?

MS WELSON: No.

CHAIR: Okay, thank you.

MR STEVENS: Just a couple of questions, if I may.

One of them was a comment in your submission that forcing separate marketing would stifle competition. I guess you weren't here when Shell were talking that their preference would be for separate marketing in any event, but then they look at the particulars of the market that they find themselves in.

What do you see as different about the market here that would support a better outcome, being joint marketing vis-a-vis separate marketing, or more simply put, why is competition being stifled by separate marketing?

MR MORGAN: I think my first thought about that would be that your Joint Venture Partners, if required to separately market a petroleum product that's discovered, would have certainly less ability to be able to do it. There's members of Joint Ventures that are not even present in New Zealand, if that answers --

MR STEVENSON: I'm still a little bit confused, sorry. Are you saying that separate marketing per se would stifle competition in New Zealand?

MS WELSON: No, what we're saying is, what we need is to drive exploration to get more gas fields, and to the extent that separate marketing in the current market circumstances would create a disincentive for exploration, you get back to the point where we're not going to get the more gas fields coming on-stream which will then allow the development of the competitive marketing.

MR STEVENS: My question was, why does separate marketing create a disincentive for exploration? You make the statement, it creates a disincentive for exploration; my question is, why?

DR PATRICK: In general, if I can answer that, again it's -- I'll put a scenario to you. One of our members wants to farm in -- in other words, pull in Joint Venture Parties to share the risk of an exploration programme off-shore on the East Coast, this is a real example, it's not a fictitious one. It is almost certain that a good proportion of that investment capital, should he attract it, will be from overseas companies not present in New Zealand looking simply to put money up to get involved in the management of the joint venture by way of the Joint Venture Committee -- the Joint Venture Operating Agreement, that's it.

If my member went around the world seeking investment capital from such companies from such people and just said, 'Oh, and by the way, should we find something, your 15% share of the joint venture is going to mean that you own 15% of the gas which you are going to then have to sell separately'; I'm sorry, but you ain't gonna get a lot of people coming in putting money into that regime. They don't want to do that, they don't just share the risk and the exploration development capital; they like to share the selling of the product and the revenue that it generates.

MR STEVENS: How does it line up with Europe and America where separate marketing is the norm, as opposed to joint marketing?

MR MORGAN: I think I could maybe comment on that a little stronger than my two colleagues here.

The gas market in New Zealand absolutely cannot be compared with the gas market in the US. The simple explanation of that is that there's a distinct difference in infrastructure and a very distinct difference in the numbers of operators and/or wells; there's just no way that I see that New Zealand could be compared -- or the gas market here be compared with any gas market in the US.

MR STEVENS: My last question really was in terms of PEANZ's submission on the potential conditions that may well attach to an authorisation, and one of the submissions that you have is on the focus on the time limit aspect of it.

You mention that it just needs to be consistent with the economies of the field. Is that similar to what we were hearing from Westpac before in terms of, in other words, it has to be able to finance itself; if there is a time limit, it has to be able to make sure that the cashflows from that is able to finance it. Is that what you were meaning by consistency with the economies of the field development?

MR MORGAN: Yes, I think it is.

MR STEVENS: Thank you.

CHAIR: I believe we interrupted your presentation, so if you want to pick up...

MS WELSON: We've pretty much come to the end, and I think we've covered the remaining points in the questions.

CHAIR: Thank you very much, and I'm pleased to say that we got you through to schedule, which was the only case today where we managed that.

Okay, it's -- I think we need to -- we'll need to talk with the applicant at the end of today's session about the process for tomorrow. We are approaching the ending time for today and I think it's best that we finish at this point.

So, I will adjourn the meeting for today and we are due to start in the morning at 9 am, and we will resume with the applicant. If the other parties who were present in the morning want to stick around, we'll agree an alternative timeframe for tomorrow. So, thank you very much.

Conference adjourned at 5.00 pm
Resuming Wednesday, 2 July 2003 at 9.00 am

***