

The 2006 New Zealand Petroleum Conference

‘Putting Energy into Exploration’

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**‘Overview of the Gas Industry Company-
Achievements and Challenges Going Forward’**



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Chairman
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Introduction

Good afternoon and I thank the organisers for the invitation to address this year's NZ Petroleum Conference.

I welcome this opportunity to talk to you about some of the issues facing the gas industry and the role of the Gas Industry Co in addressing these challenges.

I know that at last week's National Power Conference there was a lot of discussion about the need to ensure a good balance of fuel sources and in this context the gas industry has a vital role to play in New Zealand's energy sector. Amongst the non-renewable options, gas is a preferred fuel.

Overview

Many were taken aback when President George W Bush in his recent State of the Union speech issued a remarkable call to arms when he called for America to reduce its dependence on imported oil. That simple statement by the leader of the country that comprises 5% of the world's population and yet consumes 25% of the world's oil production is an extraordinary call for change and in that, signals the scale of the oil/energy challenge facing every country.

The term 'peak oil' is now entering the language of those focused on energy issues and soon everyone will be using it. In the 1970's when New Zealand was still debating to what end use Maui gas should be put, the lower 48 states of the US—that is the US except for Alaska and Hawaii—were already at peak production and since then production has been in a steady but remorseless decline back to the production levels of 1945, despite all the new oil exploration and production techniques.

Today the US is 60% dependent on imported oil with that figure predicted to reach 70% by 2025. President Bush's call for change is to be warmly welcomed because it would take some pressure off world oil demand but it won't happen quickly.

For example about two thirds of US oil is used in the transportation sector. The depreciated value of US transportation capital stock is nearly \$US2 trillion and would normally take 25-30 years to replace, so President Bush and his successors have a very big challenge in front of them and so does the world.

The challenge in front of me is to set out what we in the Gas Industry Company are doing or planning to do.

Structure of the Speech

A focus of my speech today is on the changes being made to the policy settings that apply to the gas sector.

- I will start by talking to you about some of the drivers that led to the recent regulatory changes.
- I will then take you through some of the high level challenges facing the gas sector and the role the Gas Industry Co has in addressing these challenges.
- And I will conclude by looking at the implications of the Gas Industry Co's work for the exploration and production sector.

A key theme for you to take away from my speech today is that we are now entering a period of significant regulatory change. However, given the changed circumstances in the gas sector we should not be surprised by this development, and the end goal is targeted regulation aimed at promoting the development of the gas sector.

What are the drivers for regulatory change?

To a large extent, New Zealand's gas sector has been shaped by the concentrated nature of the gas industry. This included the flexibility of Maui gas production, the volume of that field and the stable basis provided by the original contracts.

Market circumstances are now changing. With the progressive depletion of the Maui field, the gas industry is moving from a market dominated by one central field to a market characterized by many smaller fields.

This means that current market arrangements, which are largely contract-based or voluntary industry codes, need to be developed to meet the changing needs of the sector. In many instances it has proved difficult to develop or enforce these arrangements.

As a result, existing policy settings need to be reviewed to encourage market development and new sources of supply. This is particularly relevant for the Exploration and Production sectors, as the lack of governance arrangements and the complexity of the existing structure creates risks, uncertainties and costs for new entrants and existing players.

In 2003, the Government issued a Government Policy Statement which set out the objectives for the gas sector and invited the gas industry to establish a self-governing body. In response, the industry advised Government that it would require some form of regulatory backstop to achieve the Government's objectives.

What changes have been made?

The Government responded and in 2004 passed an amendment to the Gas Act.

The amended Gas Act:

- Gives the Minister wide regulatory powers to make rules and regulations on every facet of the gas supply chain; and

- Established the co-regulatory model which was brought into existence by Order in Council in December 2004.

The Government also issued a revised Government Policy Statement on Gas Governance. This sets out the overall policy objective for the industry, which is:

“To ensure that gas is delivered to existing and new customers in a safe, efficient, fair, reliable, and environmentally sustainable manner”.

The Government has framed this objective as a direction to the industry that it needs to provide a framework for delivering gas which will protect people, the environment and promote the industry and the economy. Not an easy task and achieving this objective will be challenging given the issues currently facing the gas sector.

The GPS also sets out the Government’s desired policy outcomes and in effect these create the work programme for the new co-regulator, the Gas Industry Company.

Although there are a number of challenges facing the industry, I am confident that these can all be addressed through a combination of cool heads when it comes to making the hard decisions and a commitment from all industry participants to meeting the Government’s overall policy objective.

This afternoon I will first look at matters relating to consumer protection and the retail and distribution sector. Then I will examine challenges facing the transmission pipeline sector, and the gas contingency arrangements. Finally, I will discuss the changes occurring in the supply sector, and the implications of these changes for wholesale gas trading arrangements and access arrangements to processing facilities.

Challenges relating to consumer protection

In relation to consumer protection, there are a number of important matters to address.

- We have already put in place a consumer complaints scheme - there have been very few complaints - and the Gas Industry Co has also done some work on benchmark contracts for consumers.
- We are also looking at industry practices in relation to:
- The purpose of this work is to make a recommendation to the Minister about any changes required.

Challenges facing the retail and distribution sector

In the retail and distribution sector, there are a number of opportunities to improve the overall performance.

- Essential to the development of a competitive retail market is an efficient process to allow customers to switch from one retailer to another. Currently, we have a partially manual, partially automated switching process, which means it can take up to 3 months to switch a customer. This creates frustrations and costs on all sides. Fortunately, with industry cooperation, the Gas Industry Co is well advanced on the design of improved switching arrangements.
- There is a need to develop gas reconciliation arrangements, which produce accurate and timely information to enable all industry participants to track the quantities of gas they trade and transport. The goal here is simply to ensure that participants pay for the gas they take and don't pay for the gas they don't take. The Gas Industry Co has recently formed a project team to examine this issue.
- This year we will also review distribution and metering arrangements to ensure that the market is operating efficiently.

Challenges facing the transmission pipeline sector

The challenges facing the transmission pipeline sector have had some profile over the last year, particularly during the development of the Maui Pipeline Operating Code. While it is excellent news that this very key piece of infrastructure - the Maui pipeline - is now open for the transport of non-Maui gas, the legacy Maui contracts still cast their shadow over the new access arrangements.

Also, it is unfortunate that New Zealand does not have a consistent access regime across its two major transmission systems – the Maui pipeline and the Vector/NGC pipelines. This issue deserves examination because the presence of two different access regimes potentially creates two sets of costs and risks for participants. The requirements of the two regimes may also impact on the flexibility able to be offered in supply contracts.

Because these are issues which could significantly influence the efficiency of the industry, the Minister will expect the Gas Industry Co to provide advice on what the issues are and how they might be addressed.

In its review, the Gas Industry Co will be considering to what extent the outcomes required by the GPS are likely to be achieved by current arrangements.

However, any change to a single access regime would require significant changes to existing commercial arrangements. Therefore this issue will require careful consideration.

For clarity I might add that pricing methodologies and prices are outside the scope of this review.

Challenges facing contingency arrangements

Regarding security and safety, we currently have a situation in New Zealand where:

- The outage and contingency plan, the NGOCP, is a voluntary arrangement
- That plan is no longer supported by all industry members; and

- As a result the position is somewhat problematic.

The Gas Industry Co has been asked by industry participants to review the existing arrangements. There is a lot of work ahead to achieve this. We are looking at retaining much of the existing code, but transitioning to a more commercial footing.

Changes in the gas supply sector

As noted earlier, the dynamics in the gas supply sector are undergoing significant change. Historically, gas market arrangements have been dominated by the Maui gas field. In particular:

- The flexibility of gas supply from the field matched with the capacity of processing facilities and pipeline, has enabled the Maui joint venture partners to readily satisfy fluctuating demands for gas supply.
- This has been a particular advantage for electricity generation where demand is seasonal and fluctuates across the day.
- The dominance of the field in production and supply removed any need for sophisticated gas trading or pipeline balancing arrangements.

As Maui declines, gas supplies are becoming more restricted and the production sector is less able to accommodate buyers with fluctuating demand requirements. In addition, new gas supplies may provide limited flexibility, with economics and field characteristics forcing the production and processing facilities to provide relatively constant supply. Take-or-pay contracts at constant delivery rates may become the norm. These factors are likely to have implications for the design of pipeline access regimes and wholesale market arrangements.

Although the medium-term focus is on existing fields and the Taranaki Basin, the preferred market design will need to adapt and accommodate a more diverse range of producers and supply locations in the longer term.

There are several possibilities on the horizon. These include:

- The development of new gas supplies;
- The establishment of an LNG processing facility; and
- The creation of a “virtual pipeline of CNG tankers”.

Each or all of these options could eventuate, and they all have implications for gas market design.

Challenges for the development of wholesale trading arrangements

The GPS tasks the Gas Industry Co with developing wholesale gas trading arrangements. There are a number of issues which the Gas Industry Co is looking at, and which need to be addressed, as part of the design of a wholesale gas market. These include:

- Achieving a practical market design that reflects the small number of participants and low liquidity in the market.
- Designing market arrangements that recognise the physical characteristics of the pipeline network and the current concentration of production in the Taranaki region.
- Providing an alternative means of supplying balancing gas.
- Developing a consistent set of integrated arrangements for reconciliation of trades.
- Ensuring pipeline capacity trading arrangements do not impede gas trading.
- And finally, ensuring that the design has the flexibility to accommodate different sources of gas.

The Gas Industry Co is considering all of these issues and we expect to release a consultation paper on the high-level market design in April.

Challenges facing the gas processing sector

Given the looming supply shortfall, it is not surprising that the Government is committed to making New Zealand an attractive destination for Exploration and Production activity. A potential component of attracting this activity is assuring parties that if they find gas they will be able to access existing gas processing facilities. The GPS asks the Gas Industry Co to look at this issue.

Clearly, regulating access may infringe on the property rights of existing infrastructure owners. There is a trade-off between allowing access for the benefit of wider gas stakeholders, and regulating access, which potentially could reduce incentives to invest in infrastructure. Differing approaches to this difficult issue are used around the world. They range from regulated access schemes to voluntary industry codes. All possible approaches will be considered.

What tools do we have to meet these challenges?

The Gas Industry Co as the approved co-regulatory body under the Gas Act, has the responsibility of recommending to the Minister suitable new policy arrangements across the different sectors I have talked about. There is a choice about the form of these arrangements, which in theory could include voluntary codes, industry agreements, or formal rules and regulation.

In practice, given the difficulty of getting common agreement amongst industry stakeholders on commercial issues, and the likely need for approval from the Commerce Commission for arrangements between competitors, new regulatory based arrangements are most likely.

How does the Gas Industry Co operate?

To those who are still uncertain about where the Gas Industry Co fits in, I refer them to the Minister's comment last week, that the Gas Industry Co is "first and foremost a regulator". Therefore, it should come as no surprise to you that we will follow the usual regulatory processes. Typically this will involve six steps.

- The first step for any policy matter is detailed problem definition and identification of the best fit solutions.
- We like to go to consultation at this stage, so that the people who will be affected by the new policy have an early opportunity to input into its development. That is stages one and two.

- The next two stages involve detailed development of the preferred option, cost benefit analysis and further consultation to ensure we have the details right, “the devil is in the detail”. That’s stages three and four.
- The fifth stage is to make our recommendation to the Minister and for him to pass the new rules or regulation if required.
- The final step is implementation. This could include the development of software, the appointment of a service provider, and allowing time for the persons affected by the regulation to amend their business systems.

It is our expectation that on a complex matter, such as the development of new arrangements for wholesale gas trading, it will take up to two years to go through all of these important stages.

This may seem like a long process, but the alternative is hasty regulation. In my experience hasty regulation is normally poor regulation.

How does this affect the Exploration and Production sector?

In summary, the industry is entering a period of regulatory change. The purpose of this change is to keep the gas regulatory environment in step with the changing market circumstances. This should be welcomed.

The changes that will result from the work we are doing will have important implications for the Exploration and Production sector.

- New wholesale market arrangements will give more options to new and existing participants to sell their gas in the market place.
- Changes to access arrangements for gas processing facilities and transmission pipelines will make it easier for parties to get their gas to market.
- New contingency arrangements will provide greater clarity and confidence in how emergency events will be managed.
- Improvements to the operation of the retail market will have flow-on benefits for the upstream sector.

In developing these arrangements, the Gas Industry Co is committed to following rigorous processes, and to developing recommendations that are targeted to specific challenges facing the industry and are focused on promoting the gas industry as a whole.

In doing this we have the benefit of experienced directors on our board, including the three industry directors.

I conclude by saying that I am confident that we will be able to support the industry as it continues to fulfill its important role in New Zealand's energy sector, as New Zealand like all other countries, comes to terms with a very changed world energy market and the implications of energy policies on climate change.

Thank you

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