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Petroleum & Minerals, Energy and Resource Markets Branch

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Feedback on decommissioning financial securities and financial capability assessment guidelines

Introduction

1. Energy Resources Aotearoa is New Zealand's peak energy advocacy organisation. Our purpose is to enable constructive collaboration across the energy sector through and beyond New Zealand's transition to net zero carbon emissions in 2050.

2. Legislation designed to explicitly manage the risk of decommissioning costs having to be met by the Crown was introduced in 2021 as a reaction to the commercial failure of the Tui offshore oil field. The failure had resulted in the Crown having to fund and manage the decommissioning of the field to the tune of hundreds of millions of dollars.

3. The legislation introduced attempts to eliminate or minimise this risk. This includes requiring permit and license holders to hold financial securities to ensure decommissioning costs do not again fall to the Crown.

4. This document constitutes our feedback on the proposed guidelines for *Financial Securities – Decommissioning* and the *Financial Capability Guidelines – Decommissioning,* which are intended to provide insight into how the provisions relating to managing the exposure of the Crown or third parties to meeting decommissioning costs in the Crown Minerals Act 1991 (the "**Act**").

Summary of key concerns

5. Notwithstanding our previous conversations, we continue to have serious concerns with these guidelines as they stand. We summarise these concerns below for your convenience:

   a the legal standing of these guidelines is unclear;

b. the “highly likely” test for financial capability assessments is set too high and relies on a framework that has no legal standing in New Zealand;

c. financial security requirements should not rely on the estimated future cost for decommissioning;

d. financial securities held to cover decommissioning costs should be made available to permit holders to fund and undertake decommissioning, not released after the completion of activities;

e. any limit to a parent company guarantee should be removed as the current 20% is arbitrary and does not reflect the high bar of achieving a “highly likely” assessment for financial capability; and

f. the use of a 2P developed reserves over production test for having the maximum amount of net security in place by the time 75% of remaining 2P developed reserves have been produced creates a moving target for permit holders and the Regulator; and

g. the allowance to apply royalty and tax deductions to net security amounts should not be contingent on the permit holder meeting the “highly likely” test.

Overarching view

6. The commercial failure of the Tui field operator highlighted several deficiencies in the legislative management of the life cycle of a petroleum development. While we agree improvements were needed, the subsequent legislative changes are a dramatic over reaction in the absence of any evidence the failure of the Tui operator was a systemic, sector wide issue.

7. This attempt to eliminate or minimise the risk that the Crown (or a third party) may be required to meet the cost of decommissioning has resulted in the layering of protections that will impose significant additional costs on permit holders. It is increasingly clear, as changes to legislation are implemented, that the result of the Crown’s risk shedding will result in private costs that *far exceed* the net public benefits associated with addressing this issue.

8. Amendments to the Act covering decommissioning obligations appear to provide for a reasonable amount of discretion and flexibility for the Minister (and delegates) in their application. The explanatory note in the amendment Bill described the changes as being designed to “minimise” the risk. However, these guidelines appear to go well beyond this intent in an attempt to eliminate risk.

9. The implementation of these guidelines would be unprecedented in terms of government intervention in a functioning sector. The Government risks undermining New Zealand’s attractiveness as an investment destination, beyond the damage already caused, while at the same time undermining a key

component of the energy sector that is critical to supporting the economy as it transitions to low carbon future.

10. If implemented in their current form, it is highly likely we will see a dramatic curtailment of the necessary ongoing investment in current undeveloped 2P reserves and 2C resources and is likely to hasten the early abandonment of fields and exit of firms from New Zealand's petroleum sector. This will have serious security of supply consequences for New Zealand's energy sector and industrial base, at a time where we are facing a cost-of-living crisis, while attempting to transition to a lower carbon economy.

High level comments

11. The following comments apply to both the financial capability assessment and the financial security guidelines and expand on concerns we have with the approach to risk and the standing of these guidelines in the legislative context.

Risk elimination versus risk management

12. The Crown appears to have adopted a risk minimisation approach to avoid having to fund rather another decommissioning project. This has a cascading effect across both guidelines, resulting in a series of rigid and prescriptive measures.

13. We define risk minimisation as the process of risk reduction, ideally to the point of risk elimination. This approach can be expensive and counterproductive due to any opportunity costs (for the permit holders) being discounted or ignored.

14. Risk management, on the other hand, takes a pragmatic and cost-effective approach, balancing the need for risk mitigation against these opportunity costs. This approach seeks a more efficient outcome to lowering the likelihood of an adverse outcome should the identified risk crystalise.

15. In forming this view, it is important to recognise the various ways the Crown is involved in the petroleum sector. This includes various roles such as the:

    a **legislator** – making the rules and regulations that govern the sector;

    b **regulator** – responsible for the enforcement and monitoring of those rules;

    c **resource owner** – seeking private capital to explore, develop, and produce New Zealand's natural resources; and

    d **beneficiary** – receiving a fair return on its petroleum estate in the form of a royalty.

16. While the Crown has multiple roles in the sector, these are not differentiated in the public's mind. Worryingly, in seeking to engineer a risk-free scenario for itself,

the Crown is largely insensitive to the costs imposed on permit holders. This also has potentially significant impacts on the Crown's revenue from the sector (lower resource recovery and royalties) but also increasing administrative costs.

17. We recommend the Crown rethink its approach to managing this risk. A more appropriate stance would be to adopt a risk management approach, which more fairly and proportionately balances the responsibilities of the permit holder with the exposure of the Crown to having to fund and undertake decommissioning.

18. We believe that while ideally this would be done in the context of an amending Bill, the current Act allows sufficient flexibility to implement such an approach.

The legal standing of these guidelines is unclear

19. It is unclear how these guidelines fit into the current legislative environment. With the proliferation of changes to the Act it is surprising there has been no update of the Petroleum Programme 2013 (the "**programme**").

20. Clauses 14(2) and 14(3) outline the purpose and specificity of the minerals programme in that; the minerals programme may describe how the Minster (or delegate) will exercise any powers conferred on them, and that there can only be one minerals programme per mineral. These guidelines appear to, at least partially, fulfil the role of the programme in that they describe:

> *"…how the Minister and the Chief Executive will interpret and apply specific provisions in the Act or regulations made under the Act"*[1]

21. It is possible these guidelines could be seen to be a second minerals programme, albeit one that deals with a narrow set of provisions specified in the Act. We also note there has been no indication from the Ministry of any intention to update the programme despite a raft of significant amendments since 2018.

22. We would expect any substantive updates to the programme would follow normal consultation and review processes, consistent with good public policy practice. Changes to the programme should not be pushed through as a consequential amendment to the minerals programme pursuant to Schedule 1, Part 4, clause 32.

23. The guidelines explicitly state that they are not legally binding, but 'general guidance' reflecting the 'firm' policy to be applied by the Minister. This is concerning because in our view the guidelines are;

    a overly prescriptive; and

    b by being overly prescriptive risk fettering a decision-maker's discretion and prevent decisions from being exercised in a real and genuine sense.

1 See section 1.1(1)(c) of the Petroleum Programme (Minerals Programme for Petroleum 2013) available at https://www.nzpam.govt.nz/assets/Uploads/our-industry/rules-regulations/petroleum-programme-2013.pdf

24. Further, the guidelines themselves offer an ambiguous view on their standing in respect to legislation. Clause 1.7 of the Financial Securities Guidelines states;

> *"This guidance is not a substitute for any regulation or law and is not legal advice. It may and does paraphrase the sections of the Act or Regulations referenced to provide context and improve readability. While it does not have binding legal effect it does reflect the firm policy being applied by the Minister."*

25. Given the inevitable reliance on these guidelines by both the regulator and the permit holder, it is unclear given this disclaimer how these guidelines are to be interpreted, from a legal perspective. We consider this will open the decision-maker up to increased risk of judicial review and administrative law proceedings.

26. The informal standing of these guidelines raises questions in regard to compliance. This informal standing means they may be varied and departed from without due process. We submit that Parliament intended for regulations to be developed via a prescribed regulatory process for such serious matters as setting financial security.[2]

27. Given the dubious standing of these guidelines, and the increased risk of judicial review, we recommend reconsidering the utility of such guidance.

Environmental standards are not set by the Act

28. Simply put; the purpose of the Act is to manage the rights and royalties in relation to the exploration, production, and sale of Crown-owned minerals. The Act is not intended to prescribe an environmental standard for decommissioning activities. That is the purview of resource management legislation.

29. Our reading of s89E(2) suggests a default environmental standard of complete removal of any and all petroleum infrastructure is presumed. The relevant section reads (emphasis added);

> *"However, if in relation to petroleum infrastructure, **no other enactment, relevant standard, or requirement by a regulatory agency** contains any requirements or standards relating to the method of decommissioning a particular item of petroleum infrastructure, **that infrastructure <u>must</u> be decommissioned by totally removing it**."*

30. This legislation is ambiguously written and may be interpreted in several ways. One reading would be that, without appropriate consents or an accepted

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2 We refer the reader to clauses 105(qh) and 105(qi) of the of the Crown Minerals Act (1991) as the enabling powers to prescribe the requirements for monitoring of financial position and assessing financial capability; and for the regulating the setting, obtaining, and maintaining of financial securities.

decommissioning plan for infrastructure in the EEZ, complete removal is the default.[3]

31. The effect of this would be to anchor decommissioning costs at the upper end of estimates, in what is essentially a worst-case scenario assumption. This may have significant financial consequences for permit holders and participants, by unnecessarily tying up capital (so called "dead money") that could otherwise be deployed by the firm to fund other activities.

32. This confusion may relate to a blurring of the legislative responsibilities of various regulators across the petroleum sector. Our view is that much of the financial security obligations in relation to decommissioning petroleum infrastructure are in fact land use issues, and would be better placed in more appropriate, effects-based legislation.

33. The Act has a clear role to play in setting out clear obligations and expectations for permit holders in respect to decommissioning of petroleum infrastructure, but not in the setting of environmental and restoration standards. We reiterate our position, as per our 2021 submission on the Crown Minerals (Decommissioning and Other Matter) Amendment Bill, the requirement to remove infrastructure potentially creates regulatory inconsistency with other specific laws.[4]

34. We recommend guidance should make explicit the link between the decommissioning plan submitted to and accepted by the petroleum regulator and the decommissioning cost estimate,

Guidance for timelines should be established

35. Many of the matters covered in these guidelines have the potential to be drawn-out, contentious, and administratively costly processes. We recommend officials contemplate providing guidance on reasonable review and decision-making timeframes.

36. The following sections outline our feedback on each of the guidelines provided for review and comment. For convenience, references to "permit holder" are also applicable to "license holders" authorised under the Petroleum Act 1937.

Financial capability guidelines

37. The following provides our feedback on the financial capability guidelines. We largely agree with an approach based on cash flow and 2P reserves. However, we caution that the reliance on a highly likely test for permit holders to meet their decommissioning obligations is likely to be problematic.

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3 In this case the decommissioning plan we refer to is prescribed in subpart 4 of Part 3 of the Exclusive Economic Zone and Continental Shelf (Environmental Effects) Act 2012.

4 Our submission is available at: https://www.energyresources.org.nz/dmsdocument/187

Insufficient weight is given to financial securities when considering financial capability

38. It is curious the financial capability assessment does not consider the effect of having sufficient financial security in place in determining the likelihood of being able to fund decommissioning. Given the highly liquid nature of the acceptable securities, it is difficult to understand why these are not considered in the financial capability assessment.

39. As a result, it seems the permit holder is required to demonstrate they have the capacity to cover the cost of decommissioning twice over. Once as financial security, and a second time to actually fund and undertake decommissioning itself. This is not a proportionate response to managing the risk of default by the permit holder.

40. We recommend including financial securities in a permit holder assessment.

The "highly likely" test is problematic

41. The essential function of the financial capability assessment is to determine the likelihood of a permit holder to be able to meet their decommissioning costs. The outcome of this test is in effect binary – the permit holder is either highly likely to be able to meet the cost of decommissioning, or not.

42. This is problematic for two reasons:

    a the probability yardstick relied upon, where a "highly likely" permit holder achieves a score of >80%, has no relevance to New Zealand law and its use and target for highly likely appears arbitrary; and

    b the consequences of not achieving a highly likely score will unduly penalise those permit holders who might otherwise rely on tax and royalty refunds to help meet their decommissioning costs.

43. Care needs to be exercised in setting the targets for achieving a highly likely outcome for a permit holder's financial capability assessment. If this quantitative assessment approach is retained a probability of around 70% would be more in line with the concept in the legislation.

44. Sections 6.5 and 6.6 outline the treatment of royalty and tax rebates for permit holders. We consider it prudent for the Minister to apply the consideration of royalty and tax refunds in setting the financial security amount uniformly, across all permit holders, regardless of their financial capability assessment outcome.

Financial capability assessments become unnecessary when such large amounts of financial security are required

45. Setting aside the need to establish a baseline for the financial capabilities of the permit holder (and permit participants) to meet decommissioning costs, the

decision to undertake a review of financial capability is subjective. Section 5.0 outlines a range of criteria to be considered when deciding to undertake a financial capability assessment.

46. These criteria are, by and large, a shopping list of information supplied by permit holders to the regulator. What is concerning is future cash flow are Indeed, section 8 of the financial capability assessment guidelines state;

> *"A cashflow forecast based on reasonable assumptions and robust methodologies that demonstrates the Permit participant will generate sufficient free cashflow to meet its decommissioning obligations, in addition to its other commitments and obligations including debt and a fair return to shareholder, with a reasonable amount of headroom is a strong indication that the Permit participant has adequate financial capacity."*

47. Much of this assessment becomes redundant once the maximum amount of financial security is in place. Although we again note our surprise that financial security is not given due prominence in the decision to undertake a financial capability assessment. Particularly when it is a requirement the maximum amount be in place well in advance of cessation of production.

48. These assessments surely provide only marginal comfort to the Minister that decommissioning costs can be met by the permit holder. They are simply not worth the additional cost and time to both the regulator and the permit holder.

49. This begs the question: with such strict financial security requirements, what is the need and purpose for such invasive financial capability assessments?

50. We recommend this requirement be relaxed once sufficient financial securities are in place.

Financial securities guidelines

51. The following provides specific feedback on the guidelines the financial securities guidelines.

Section 6.0 – relying on the future value of decommissioning is problematic

52. It is highly concerning that MBIE has opted to rely on the future cost estimate for setting the type and amount of financial security required. This is a clear departure from previous guidance where the intent of providing future value was to link the cost estimate to projected cashflows, so as to inform the financial capability assessment.

53. Given the future cost could be well into the future, the requirement to have financial security in place now, for a future cost is extremely unreasonable and not consistent with typical finance/investment logic.

54. For example, if the decommissioning cost is $100m (in today's dollars) but it is not expected to occur for 10 years, the guidelines would require >$130m of

security now (assuming 3% inflation). Not only does the security not allow the funds to be used to invest, but they are also assumed to be locked up for a long period of time generating a 0% return, from an opportunity cost perspective. This is akin to a tax.

55. We strongly recommend reverting back to the use of current value for calculating contributions, as per the initial draft of the guidelines.

Section 5.7 - Parent company guarantees

56. Section 5.7 outlines the key considerations for a parent company guarantee (a “PCG”) to be acceptable as part of a financial security package against future decommissioning costs. Key to this is all permit participants need to be covered by the PCG.

57. This means where the permit holder is a joint venture between unrelated firms a PCG will not be considered. While this is consistent with the financial security being required from the permit holder, rather than from individual permit participants, this disadvantages prudent, well manged firms.

58. Accepting that this distinction and preference for when a PCG will be considered by the Crown, it is difficult to understand then why a PCG would be arbitrarily limited to no more than 20% of a financial security package. The cascading effect of higher levels other financial securities may have the effect of unnecessarily interfering with the capital allocation and risk management at the group level.

59. Further, any consideration to accept a PCG the Crown relies on the firm’s financial capability assessment. Given a firm will have to achieve a “highly likely” outcome as the starting point, the Crown should have satisfied itself the underlying business is sound. We submit therefore limiting a PCG to 20% is unnecessarily restrictive.

60. We strongly recommend removing the 20% limit on a PCG and guidance expands on the circumstances where greater amounts might be considered.

The application of secondary principles is not embodied in the guidelines

61. The secondary principles for establishing financial securities, outlined in section 2.0, include:

    a *“…the balance between compliance and opportunity costs on industry, and administrative costs to the Crown, are ‘fair’ to industry participants and taxpayers. The process can be applied on a consistent basis between Permit Holders.”*

    b *“…certainty and transparency around industry requirements (and provides market confidence to transact upstream assets and undertake investment).”*

c “…ensure the process does not cause market distortions or unintended consequences. It is recognised most NZ permits are a significant way through their production lifecycle and this will be considered during the introduction of the financial securities process.”

62. In our view these principles are not embodied in the subsequent guidelines. In particular requiring permit holders to meet the cost of decommissioning firstly as a financial security, and secondly in funding decommissioning, is highly likely to reduce investments and lead to the early abandonment of the field.

63. In light of this we believe the guidelines need to be reworked to ensure these principles are more clearly incorporated in the implementation of financial security requirements.

The use of investment funds should not be unnecessarily limited

64. We disagree that, due to their inherent volatility, investment funds are limited to a maximum of 50% of the total financial security. Investment funds can and do have different risk profiles. Permit holders who can demonstrate sufficient prudence in their investment funds should have to the opportunity to seek an increased amount of coverage.

65. We believe over the longer-term the concerns relating to volatility, in combination with the make-good provisions, should be sufficient to offset any concerns the Regulator might have.

66. Where the Regulator may have concerns about the liquidity, and therefore the availability of certain types of investment, the option to retain any restrictions on the amount of coverage remains.

Inconsistency between sections 5.0 and 6.2

67. Guidelines should clarify the potential grey area between the net security and reserves coverage outlined in Section 6.2.

68. Section 6.2 includes only 2P developed reserves, whereas guidance in section 5.2 on developing decommissioning cost estimates and cash flow modelling require the inclusion of 2P undeveloped reserves and the associated development, operating, and decommissioning expenditure to be included in the cashflow model.

69. While this may be of consideration in determining the financial capabilities of the permit holder it is should not be relevant when setting the amount and type of financial security. Particularly in relation to Section 6.2, which specifically excludes 2P undeveloped reserves.

Net security to reserves unreasonably front end loads financial security requirements

70. Further, section 6.2 outlines a relationship between remaining reserves (calculated at the time a financial security is first implemented) and production of

those reserves. This basis may be problematic as reserves and production forecasts are not static and are revised (and submitted) every year. We note that each year it is possible for reserves to be significantly written down or increased.[5] This introduces the risk of having a "moving target" for permit holders of when the maximum amount of net security needs to be in place.

71. Clause 6.2 also states that the intention of requiring the maximum amount of financial security to be in place at this time is to provide a 'buffer' for any uncertainty and negative volatility towards the end of field life. This 'buffer' of 25% 2P developed reserves remaining is well beyond what would be considered a reasonable amount and risks unnecessarily front-loading financial security obligations.

72. In our view this proposal loses sight of the primary purpose of the financial securities – which is to minimise the risk of the permit holder (or participants) defaulting on decommissioning costs. This approach is highly likely to introduce financial stress on existing permit and license holders.

73. We recommend removing this requirement and replacing it with a periodic payment based on a flat rate, using the 2P developed decommissioning cost estimate, out to the end of economic field life.

Requiring financial securities for exploration permits is an unnecessary administrative expense

74. We disagree that, as per section 6.7, exploration permits should be required to have a nominal financial security in place, even when there are no decommissioning obligations. Further, guidance does not elaborate on how this might be calculated or set, or what risk the risks are that this security is required to offset.

75. It is also not clear why financial security would be required for an exploration well. Normal oilfield practice is for exploration wells to be plugged and abandoned as they are not designed for production. On those occasions where a well is suspended for further testing or for recompletion as a production well, it would not be unreasonable for the Regulator to contemplate some form of financial security to ensure wells are not left suspended for overly long periods.

76. Where a financial security is required for an exploration permit, and this should be an exception, we recommend the 20% restriction on the level for a PCG be relaxed for all exploration (and prospecting) permit holders.

5 Under regulations permit and license holders are required to submit reserves estimates and production forecasts as of 1 January each year. These estimates and forecasts are subject have a natural volatility as they are recalculated using the additional information gained from the previous year's production.

Refunds from escrow and s97 securities

77. The wording of section 10, which deals with refunds from escrow and s97 securities seems to suggest funds can only be released once it has been confirmed that decommissioning, whether partial or final, has been completed.

78. Decommissioning projects will likely incur expenditure across a multi-year project. By not making those funds available to permit holders to fund and undertake decommissioning activities permit holders will likely incur unreasonable and unnecessary additional costs. This seems contrary to the intent of the financial security – which is to ensure sufficient funds are available to undertake decommissioning.

79. We recommend the Crown ensures those liquid financial securities held to cover the risk of permit holder default are made available to undertake decommissioning activities as the occur, not after completion.

Suggested minor changes

80. For readability it makes more sense to move Section 5.3 (characteristics of securities) in front of Sections 5.1 (generally accepted financial securities) and 5.2 (unacceptable securities).

81. While appreciating the inclusion of an Appendix (incorrectly labelled Appendix 2 in the guideline) to illustrate how the Minister will consider the various matters in setting the kind and amount of security, Section 3.4 largely repeats what is in the Act (s89ZM). For readability it would be better for the worked examples in the Appendix to be woven into the Section 3.4 to provide better context for the reader.

Concluding remarks

82. Thank you for the opportunity to provide feedback on the proposed guidelines. Energy Resources Aotearoa supports the need for providing permit holders and participants clear guidance on how the legislation is expected to be operationalised.

83. However, as presented these guidelines are a curious mix of prescription, which would normally be expected in yet to be released regulations, and explanation of how the Act will be interpreted and applied , which we suggest is the purpose of the Petroleum Programme.

84. We reiterate our concern that the legal standing of these guidelines is ambiguous and unclear. In our view this increases the likelihood of more judicial reviews as a means of testing and clarifying the guidance.

85. These guidelines, though well intentioned, go far beyond the apparent intent of the Act. By taking an approach that looks to eliminate risk any consideration of the opportunity and increased administrative costs are largely ignored.

86. We strongly recommend the Ministry pause to fully consider the implications of these changes, before finalising these guidelines. The approach by the Minister presented here is likely to imperil the ongoing supply of New Zealand's natural gas and adversely affect the economy and industrial base.