

Office of the Minister of Transport

Chair, Cabinet Economic Growth and Infrastructure Committee

AMENDMENTS TO THE FINANCIAL SECURITY REGIME FOR OFFSHORE INSTALLATIONS

Proposal

1. This paper reports back to Cabinet on the outcome of public consultation on options to improve the financial assurance regime for offshore oil and gas installations.
2. This paper seeks Cabinet agreement on the approach to amend the level of financial assurance required under Marine Protection Rule Part 102, and seeks Cabinet agreement to consult on a draft rule that gives effect to the agreed approach.

Executive summary

3. New Zealand's regulatory framework for offshore petroleum exploration and production includes a requirement to demonstrate external financial assurance to cover pollution damage¹ that could result from an oil spill from a well or facilities associated with an installation. This requirement sits under the Maritime Transport Act 1994 (MTA) and is outlined in Marine Protection Rule Part 102 (Part 102).
4. A review undertaken by the Ministry of Transport and the Ministry of Business, Innovation and Employment identified three key issues with the current financial assurance requirements for offshore oil and gas installations, namely:
 - 4.1. the lack of a financial assurance requirement for the costs of well containment;
 - 4.2. the low level of assurance currently required for clean-up and compensation; and
 - 4.3. incompatibility between current financial assurance requirements and conventional insurance policies.
5. In December 2016, Cabinet agreed to the release of a discussion document on options to improve the financial assurance regime, with particular regard to the above issues [EGI-16-MIN-0343 refers]. Cabinet also noted that the Minister of Transport would report back on final recommendations following consultation.
6. Consultation on the discussion document was completed on 20 February 2017. Options to improve the regime were further assessed in light of submissions received. As a result, I propose the following measures:
 - 6.1. a financial assurance requirement sufficient to cover the costs of well containment;

¹ Under Part 26A of the MTA, pollution damage means damage or loss of any kind, including the cost of measures to prevent, reduce and clean-up pollution.

- 6.2. refining the scope of financial assurance requirements, to address current compatibility issues with available insurance policies;
- 6.3. introducing a risk-based framework for determining the level of assurance for individual offshore installations, up to a maximum requirement of NZ\$600 million.
7. I propose that a draft Part 102 rule amendment be developed to give effect to the measures proposed in paragraph 6. I seek Cabinet's agreement to consult on the draft rule amendment.
8. Following consultation on the draft rule amendment, a final rule amendment will be developed for my signature as Minister of Transport, subject to Cabinet approval. To provide time for industry and Maritime New Zealand (Maritime NZ) to adapt procedures and policies as required, I envisage that the rule comes into force 12 months after signing. During the first six months of this transition period, a guideline for the financial assurance requirements will be developed.
9. I propose to report back to Cabinet on the proposed draft rule, following consultation and subject to feedback received.

Background

Current financial security regime for offshore installations

10. Permit holders of oil installations are liable for the full costs of any oil spill. Unlike for ships and oil tankers, there is no limitation of liability in international law.
11. As part of the regulatory framework for offshore production and exploration, New Zealand operates a financial security regime to ensure that permit holders are financially able to meet the costs of their proposed activities, meet their legal obligations and cover their potential liabilities.
12. One aspect of the regime is financial assurance. Under Part 26A of the MTA, in the event of an oil spill from their operations, offshore permit holders are liable for all response costs incurred by public agencies and other pollution damage and losses incurred by third parties as a result of the spill.
13. The MTA and Part 102 require offshore permit holders to hold a certificate of insurance from Maritime NZ as evidence of external financial assurance to meet the costs associated with an oil spill incident. The changes proposed in this paper relate entirely to Part 102, although they link with oil spill contingency plans under Marine Protection Rule Part 131.
14. Financial assurance ensures permit holders are able to cover costs arising from their liabilities following a spill event to the limit assured. If a permit holder does not, or cannot, fulfil their legal obligations to respond to an incident, the Crown would need to resolve the situation. This may include paying for the cost of well containment, in addition to other response and environmental clean-up costs.
15. These costs could be significant. Modelling indicates that the possible cost of a worst case spill occurring in New Zealand could be over NZ\$1 billion. The cost would depend on a number of factors, including location and the type of hydrocarbon involved. A robust financial assurance regime would help protect the Crown from this potentially significant cost exposure.

Oil spill contingency plans

16. The MTA and Marine Protection Rule Part 131: Oil Spill Contingency Plans and Oil Spill Prevention (Part 131) require offshore installations to have marine oil spill contingency plans to support an efficient and effective response to an oil spill. This is an important part of the regulatory framework.
17. The plans must be approved by the Director of Maritime NZ (the Director). A condition of approval is that the permit holder must have appropriate arrangements in place for well control, and be able to demonstrate financial capability to meet the cost of implementing well control measures. There is currently no explicit requirement for permit holders to have external financial assurance to meet these costs or the Crown's costs if the Crown is obliged to step in.

Previous decision

18. In December 2016, following completion of the review of the financial security regime, Cabinet agreed to release a consultation document on options to improve the regulatory regime by addressing key issues identified [EGI-16-MIN-0343 refers]. Cabinet also noted that the Minister of Transport would report back on final recommendations following consultation.
19. The Ministry of Transport released the discussion document on its website on 19 December 2016, for consultation until 20 February 2017. A document describing the results of modelling of spill scenarios in New Zealand was also released.

Issues presented in discussion document

20. The discussion document sought submitters' views on options to respond to the three key issues identified by the review of the financial assurance regime:
 - 20.1. the lack of a requirement for a permit holder to demonstrate financial assurance for the costs associated with well containment;
 - 20.2. the required level of financial assurance being insufficient to ensure permit holders have the financial means to meet their potential liability for spill response, clean-up costs and pollution damage resulting from a spill from their installation; and
 - 20.3. incompatibility of financial assurance requirements with conventional insurance policies.
21. Six submissions were received; five were from the oil and gas industry, and one from an oil and gas insurance broker.

Issue One: there is no explicit requirement for a permit holder to demonstrate financial assurance for the costs associated with containing a well following a loss of control

22. If a permit holder does not, or cannot, fulfil their legal obligations to respond to an incident involving a loss of well control, the Crown may need to respond to control the well. Initial estimates of the cost of well containment are up to NZ\$360 million, depending on the type of well, hydrocarbon, and the nature of the release.
23. The discussion document proposed either retaining the status quo (no explicit requirement), or introducing a requirement sufficient to cover the costs of well containment.

24. A financial assurance requirement sufficient to cover well containment would require permit holders to have demonstrated assurance for costs that would occur in the process of containing a well following a loss of control. This would be in line with standard industry practice and international regimes.
25. Submitters supported introducing an assurance requirement regarding well containment. In line with this feedback, I have directed officials to progress a financial assurance requirement sufficient to cover the costs of well containment through a draft rule amendment. The level of assurance required will be based on formulas in the discussion document, and on the oil spill contingency plan which permit holders are required to provide under Part 131.

Issue Two: the required level of financial assurance is insufficient to ensure that permit holders have the financial means to meet their potential liability for spill response and the clean-up costs and pollution damage resulting from a spill from their installation

26. The current assurance cover requirement is approximately NZ\$27 million². Modelling has been undertaken to estimate the likely cost of oil spills from different offshore locations in New Zealand. The range of estimated costs for exploration wells is highly variable. Estimated values range from NZ\$12 million for a well off the coast of Canterbury to NZ\$926 million for a deep-water Taranaki well. The cost of a response to most significant incidents is likely to exceed the current level of assurance required.
27. The discussion document proposed three options to address this:
 - maintaining the status quo;
 - increasing the current fixed level for all offshore installations to NZ\$300 million; or
 - adopting a scaled framework to reflect that potential pollution damage costs are highly variable for different installations.
28. There is general agreement from the oil and gas sector that the level of assurance should be increased. Of the four submitters who discussed the options to address the level of assurance required, two submitters indicated support for either option. One of these submitters is the association representing members of the oil and gas industry, while the other is a large exploration and production company active in New Zealand. They noted that increasing the set level would be a simpler approach, and that there would be some uncertainty with a scaled approach. A key concern expressed by the submitters was that the assurance requirements need to be insurable.
29. One submitter expressed a clear preference for retaining, though increasing, the current set level approach, as it would be simpler and have lower administrative and insurance costs. This submitter is a smaller exploration and production company based in New Zealand. Another submitter, an exploration and production company active in New Zealand, also expressed concerns with the scaled approach.
30. The scaled framework would reflect the different risks associated with different installations. Under a set level approach, the minimum requirement may be too high for some operators, while being too low for others. The scaled framework is more complex and would result in

² As at 8 June 2017, 1 International Monetary Fund Unit of Account is equal to NZ\$1.93. Based on this rate, 14 million units of account equates to NZ\$26.99 million.

higher implementation costs than simply increasing the set level. However, these costs are expected to be minimised by the fact that modelling will have already been required earlier in the consenting process, and guidance produced by Maritime NZ will assist in determining which band a particular installation should fall in. Any additional costs to Maritime NZ in assessing which band an installation falls in will be passed on to the applicant as part of the normal fee process.

31. I propose adopting the scaled framework, with a maximum requirement of NZ\$600 million, which is closely aligned with requirements in Australia.
32. The maximum level of NZD\$600 million is lower than the level that was initially proposed for the scaled framework (NZD\$800 million). The NZD\$600 million cap means that there is a greater difference between the available assurance and the estimated worst case spill scenario described in paragraph 26, but brings our requirements closer to the Australian financial assurance regime.

Issue Three: financial assurance requirements are incompatible with conventional insurance policies

33. Permit holders are required to provide external assurance to meet requirements under Part 102. This can include insurance policies, parent company guarantees and financial bonds. However, I understand that most permit holders prefer to use insurance to other forms of assurance permitted by the rule.
34. The international insurance market faces difficulties in providing policies that meet the requirements under Part 102, specifically, third party loss of profit from impairment of the environment and costs associated with spills that are a result of slow seepage events. These are both currently included in the assurance requirements. There is an indication that some policies currently meet these requirements, but only through indemnification clauses³, or with very low levels of coverage. This might not continue in the future, particularly with the proposed increases to the level of assurance required, and it may be difficult for small or domestic companies to obtain cover.
35. In the absence of acceptable insurance policies, permit holders currently use other forms of financial assurance to meet the requirements of Part 102, such as parent company guarantees. This would not be possible if required levels of assurance were to increase.
36. The discussion document proposed three options:
 - maintaining the status quo;
 - amending the scope of assurance required, to exclude third party loss of profit from impairment of the environment; or
 - introducing separate requirements for different aspects of liability, with NZ\$27 million proposed for third party loss of profit from impairment of the environment.
37. Submitters strongly supported amending the scope of assurance required, and considered separate requirements would not resolve the issue of insurability of assurance requirements.

³ Where the insurer transfers the risk to the permit holder, by requiring reimbursement in the event of third party claims for this liability.

Insurance policies (with indemnification clauses), bonds and parent company guarantees would only be possible for relatively large companies, because of the capital required to support them. The risk of a small company being unable to cover costs would not be effectively addressed, and small or domestic companies would be disadvantaged. In addition, insurance policies would only be able to cover assurance requirements to a low level, which would represent a small percentage of the likely actual costs. The potential risk to the Crown of having to meet the costs of third party loss of profit from impairment of the environment would therefore not be effectively addressed.

38. Requiring financial assurance in excess of the international standard would be a major deterrent for exploration and production companies contemplating investment in New Zealand. Sensible regulation in line with best practice global standards is often singled out by potential investors as a key reason for investing in this country. This helps to overcome challenges and costs associated with our remoteness, and perceived geological uncertainty.
39. In line with this feedback, I have directed officials to progress the option of amending the scope of assurance required through the draft rule amendment. Implicit in this approach is a trade-off between the potential risk exposure to the Crown and preventing an increase in compliance costs associated with separate requirements for different aspects of liability.

General feedback from submitters on the financial assurance requirements

40. While submitters supported amendments to the current assurance requirements, they also raised several key issues:
 - 40.1. Industry would like the changes to the regime to be progressed quickly, because uncertainty around the financial assurance requirements is affecting their ability to plan work programmes in the medium-term. I agree that the work should be progressed quickly, both for this reason and to reduce risk to the Crown.
 - 40.2. Submitters highlighted aspects of the discussion document that would need more clarity or definition before the change is brought into effect. I intend to include this detail in the consultation paper to support the proposed rule change.
 - 40.3. Submitters expressed concern with the structure of the current MTA financial assurance regime, and thought that amendments to the MTA were necessary. I do not believe changes to the MTA are necessary. I consider that my rule-making powers under the MTA provide the authority to make a marine protection rule to give effect to the proposed changes. Furthermore, amending the primary legislation could add considerably to the time required to make the proposed changes. This would not address the concerns outlined in paragraph 40.1.

A draft rule will be developed for public consultation

41. Subject to your agreement, I propose to develop a draft rule to give effect to the proposed changes. In accordance with statutory requirements, I will publicly consult on the draft rule.
42. As part of the consultation, supporting documentation will provide greater detail as to the new requirements for industry. Should you agree to a scaled framework, further detail on the scaled system will be provided during consultation. Further detail on well containment requirements will also be provided.

Consultation

43. In the development of this paper, the Ministry of Transport and the Ministry of Business, Innovation and Employment have consulted with the following agencies: the Ministry for the Environment, the Department of Conservation, Maritime New Zealand, the Environmental Protection Authority and the Treasury. The Department of the Prime Minister and Cabinet has been informed.
44. Engagement with key stakeholders has been undertaken at key parts of the policy development process. Industry members and representatives have been consulted throughout the process of reviewing the regime including, as discussed above, consultation on the options discussed in this paper.
45. Toward the end of the consultation process, officials contacted potentially interested parties to ensure they were aware of the discussion document and invite submissions. No submissions on the discussion document were received from Māori, environmental groups or other interested parties.
46. Further consultation will occur on the draft rule amendment and will be available on the Ministry's website. Consultation will last for four weeks.

Financial implications

47. There are no direct fiscal implications resulting from the proposed amendment rule.
48. Permit holders are currently not required to provide financial assurance commensurate with the potential cost of spill response measures or pollution damage as the result of a significant spill. This exposes the Crown and other third parties to the risk of being unable to recover these costs from a permit holder. The proposed amendments are intended to reduce this risk exposure.
49. The proposed amendments to the regime will result in implementation and regulatory costs for both industry and the regulator, more so with a scaled approach than increasing the current set level of assurance. Increases in required cover with either option will result in increased insurance premiums compared to the current level of assurance required, although this would not be the case for the lowest risk installations under the scaled framework. Insurance is a cost-effective way to provide financial security, and is strongly supported by the industry.
50. As discussed at paragraph 30, a scaled framework will result in higher costs associated with regulation, compared to either maintaining the status quo or introducing a higher set level. The costs are still being quantified, although at this stage it appears most of these costs would occur in the set-up phase. Any ongoing costs to Maritime NZ, such as assessment of which band an installation falls in, will be passed on to the applicant as part of the normal fee process. This means there will be increased costs for industry.
51. The proposed amendments would bring the New Zealand regime into line with equivalent regimes in other countries, regardless of the option progressed in relation to the level of assurance. It is therefore not expected that the amended regime would deter investment in New Zealand from exploration and production companies.

Human rights implications

52. There are no human rights implications.

Legislative implications

53. This paper proposes amendments to Part 102. It does not propose any changes to the MTA, as amendments are within the existing scope of the MTA.

Regulatory Impact Analysis

54. A regulatory impact statement (RIS) is attached. The transport sector Regulatory Impact Assessment Quality Assurance Panel has reviewed this RIS and considers that the information and analysis summarised in the RIS partially meet the quality assurance criteria. The nature of the problem is comprehensively described. However, the issues are complex and intertwined. Information is lacking on the actual extent and magnitude of gaps in financial assurance. The likely extra costs to industry are therefore not set out. Implementation costs are not fully known at this time.

Publicity

55. A draft rule will be developed that gives effect to Cabinet's agreed approach on the level of assurance required, as well as the approach outlined regarding well containment and the scope of assurance required.
56. Should Cabinet agree, the draft rule and this Cabinet paper will be released on the Ministry's website, with an accompanying Invitation to Comment that will provide further detail on the requirements that would sit under the rule.
57. There could be heightened public and media interest in the potential impact and cost of an oil spill as a result of the proposed consultation. To address these comments, I plan to highlight that these scenarios represent a worst case with an extremely low probability of occurrence⁴.
58. I will also reiterate that New Zealand's regulatory framework for offshore exploration and production is robust, and focuses on preventing spills by ensuring permit holders have plans and resources in place to minimise the likelihood, and reduce the effect, of any adverse event.
59. Stakeholders may also perceive the consultation on the incompatibility of conventional insurance policies as an attempt to loosen regulation. I plan to highlight that higher financial assurance may not be possible without narrowing its scope and that permit holders are still liable for all costs and damages. I will also highlight the fact that the required level of assurance has been greatly increased.

⁴ The estimated probability of a blow-out occurring in New Zealand is less than 1% per year.

Recommendations

The Minister of Transport recommends that the Committee:

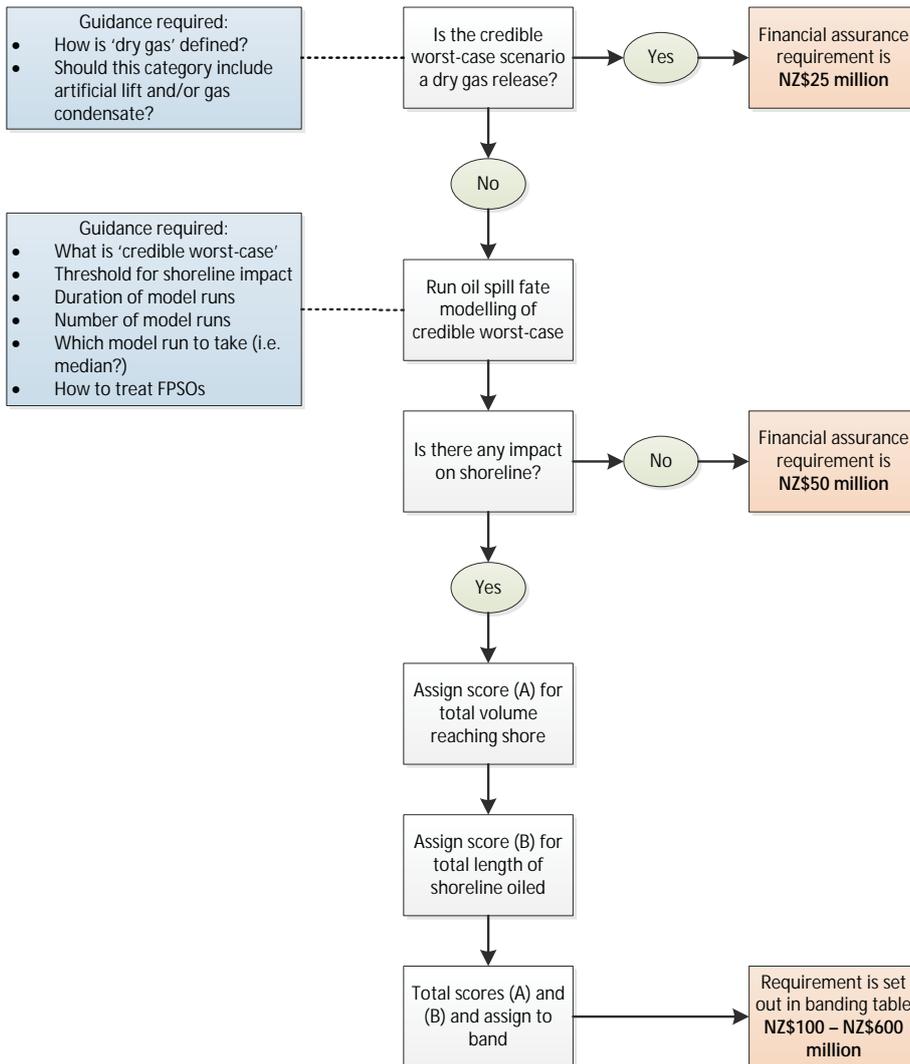
1. **note** that consultation on proposed changes to the offshore financial assurance regime occurred from December 2016 to February 2017
2. **note** that the consultation document invited comment on options to address three issues:
 - 2.1. the lack of a financial assurance requirement regarding well containment;
 - 2.2. the insufficient level of financial assurance required for clean-up and compensation; and
 - 2.3. compatibility issues between financial assurance requirements and conventional insurance policies
3. **note** that in relation to the first issue, I have directed officials to progress amendments to financial assurance requirements to include a requirement sufficient to cover the costs of well containment
4. **note** that in relation to the third issue, I have directed officials to progress amendments to the financial assurance regime to amend the scope of financial assurance requirements
5. **agree** to amend the level of financial assurance for clean-up and compensation by introducing a scaled framework, up to a maximum requirement of NZ\$600 million
6. **agree** that a draft rule be developed that reflects recommendation five, and that the draft rule is released for consultation
7. **invite** the Minister of Transport, following consultation and subject to the feedback received, to report back to EGI with a proposed draft rule
8. **agree** to release this Cabinet paper on the Ministry of Transport's website.

Authorised for lodgement

Hon Simon Bridges

Minister of Transport

Appendix 1: Proposed scaled framework for assurance for pollution damage



| Score A: Hydrocarbon type | | | | | | | |
|--|-------------------------|----------------------|-----------------------|---------------------------------|-------------------------|-------------------------|-------------------|
| Dry gas | | | | Other | | | |
| 0 points | | | | 1 point | | | |
| Score B: Total length of shoreline oiled | | | | | | | |
| 0km | 1 to 200 km | 200 to 400km | 400 to 600 km | 600 to 800 km | Over 800 km | | |
| 0 points | 1 point | 2 points | 3 points | 4 points | 5 points | | |
| Score C: Total volume reaching shore | | | | | | | |
| 0 bbls | 1 to 5,000 bbls | 5,000 to 40,000 bbls | 40,000 to 80,000 bbls | 80,000 to 120,000 bbls | 120,000 to 160,000 bbls | 160,000 to 200,000 bbls | Over 200,000 bbls |
| 0 points | 1 point | 2 points | 3 points | 4 points | 5 points | 6 points | 7 points |
| Total Score | | | | | | | |
| Score (total A + B + C) | Band | | | Financial Assurance Requirement | | | |
| 0 | 0 (Dry gas) | | | NZ\$25 million | | | |
| 1 | 1 (No shoreline impact) | | | NZ\$50 million | | | |
| 2-3 | 2 | | | NZ\$100 million | | | |
| 4-5 | 3 | | | NZ\$200 million | | | |
| 6-7 | 4 | | | NZ\$300 million | | | |
| 8-9 | 5 | | | NZ\$450 million | | | |
| 10-13 | 6 | | | NZ\$600 million | | | |