

Office of the Convenor,
Ministerial Group on Climate Change

The Chair
CABINET POLICY COMMITTEE

CLIMATE CHANGE: NEGOTIATED GREENHOUSE AGREEMENTS (NGAs)

Purpose

1 This paper is the first in a series of four papers on further detail for the implementation of climate change policies. It proposes, for consultation with stakeholders:

- Criteria for determining whether a firm is competitiveness-at-risk and therefore eligible for a Negotiated Greenhouse Agreement;
- Key components of a Negotiated Greenhouse Agreement; and
- Institutional arrangements and process for assessing eligibility and negotiating the agreements.

2 *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

Executive Summary

3 A key component of the climate change policy package is Negotiated Greenhouse Agreements (NGAs) for firms or industries that are competitiveness-at-risk and for which an exemption would be of net national benefit. Under these agreements a firm or industry would receive a full or partial exemption from the emissions charge in exchange for reducing emissions intensity to world's best practice levels within a defined time period.

4 This paper proposes a five-step approach to assessing the at-risk status of a firm or industry (see figure 1):

Step one – involves filtering out applications from firms who are not exposed to international competition or who compete with foreign producers whose countries have the same or similar climate change policies. For these firms there is no risk of leakage and they are ineligible for at-risk status.

Step two – identifies whether any intra-industry competition issues could be raised through applying the criteria at the firm level e.g. less efficient producers achieving at-risk status while their more efficient domestic competitors do not.

Step three – involves assessing the impact of a \$25 per tonne of CO₂ equivalent charge on firm/industry profitability and comparing this impact to both normal profit variability over a usual business cycle and the return on capital employed. This step gives a feel for the manageability of the charge for the firm.

Step four – involves sensitivity analysis of key parameters in step three (such as consumer price responsiveness) to obtain greater certainty of a firm/industry's status.

Step five – involves an initial consideration of the net national benefit of the firm/industry receiving relief from an emissions charge. A final decision on eligibility would then be taken.

5 Following this decision the government would offer to negotiate an agreement with eligible applicants. Key issues in negotiating an agreement include the level of exemption from the charge, the applicable world's best practice emissions target, penalties for non-compliance, flexibility provisions for meeting targets, and monitoring and enforcement.

6 The government-appointed negotiation team would be tasked with negotiating draft agreements, assessing the benefits and costs of the agreements for New Zealand, and making a recommendation to Ministers (the Convenor, Ministerial Group on Climate Change and the Minister of Finance) on whether the government should enter into the agreement. These Ministers would have authority to sign the agreements.

7 It is proposed that the Chief Executive of the agency responsible for the Climate Change Office¹ (CCO) be responsible for taking the decision on whether an applicant is competitiveness-at-risk.

8 *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

9 *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

¹ Throughout this paper we have used the term "Climate Change Office" to reflect the renaming of the Climate Change Project that is recommended in the Cabinet Paper "Institutional Arrangements for Climate Change Project".

Background

10 The application of climate change measures in New Zealand will result in an increase in the competitiveness of some firms and industries and a decline in the competitiveness of others. Where this decline is offset by increased production from firms in countries with no or less stringent climate change policies there may be a reduction in domestic production and an increase in emissions from the industry at a global level. This leakage can involve production and emissions shifting to non-Kyoto countries and also shifts to other Kyoto countries where there is a significant difference in the climate change policies applied. Firms and industries where there is significant risk of this “leakage” are categorised as competitiveness-at-risk.

11 In October 2002, Cabinet confirmed the climate change policy package. A key component of this package is Negotiated Greenhouse Agreements (NGAs) for firms or industries that are competitiveness-at-risk and for which an exemption would be of net national benefit. Under these agreements a firm or industry would receive a full or partial exemption from the emissions charge in exchange for reducing emissions intensity to world’s best practice levels within a defined time period.

12 Cabinet directed officials to report back by 30 November 2002 on criteria for determining competitiveness-at-risk status and institutional arrangements for Negotiated Greenhouse Agreements (CAB Min(02) 26/18 refers).

Competitiveness-at-risk

13 In May 2002 high level criteria were proposed for determining eligibility for categorisation as competitiveness-at-risk:

- there is a significant risk of industry output and emissions shifting to another country that does not impose emissions costs (i.e. leakage); and
- there is significant risk to the firm’s competitiveness in export markets; and/or
- there is significant risk of imports displacing domestic production.

14 Under these criteria, changes in competitiveness that are just of a domestic nature (e.g. where declines in one firm’s production are offset by increased production elsewhere in the economy) would not result in achieving competitiveness-at-risk status.

Factors in operationalising the criteria

15 The probability of a domestic firm’s output moving offshore as a result of climate change policies will depend on several factors:

- The impact of the emissions charge on production costs of the firm and industry;

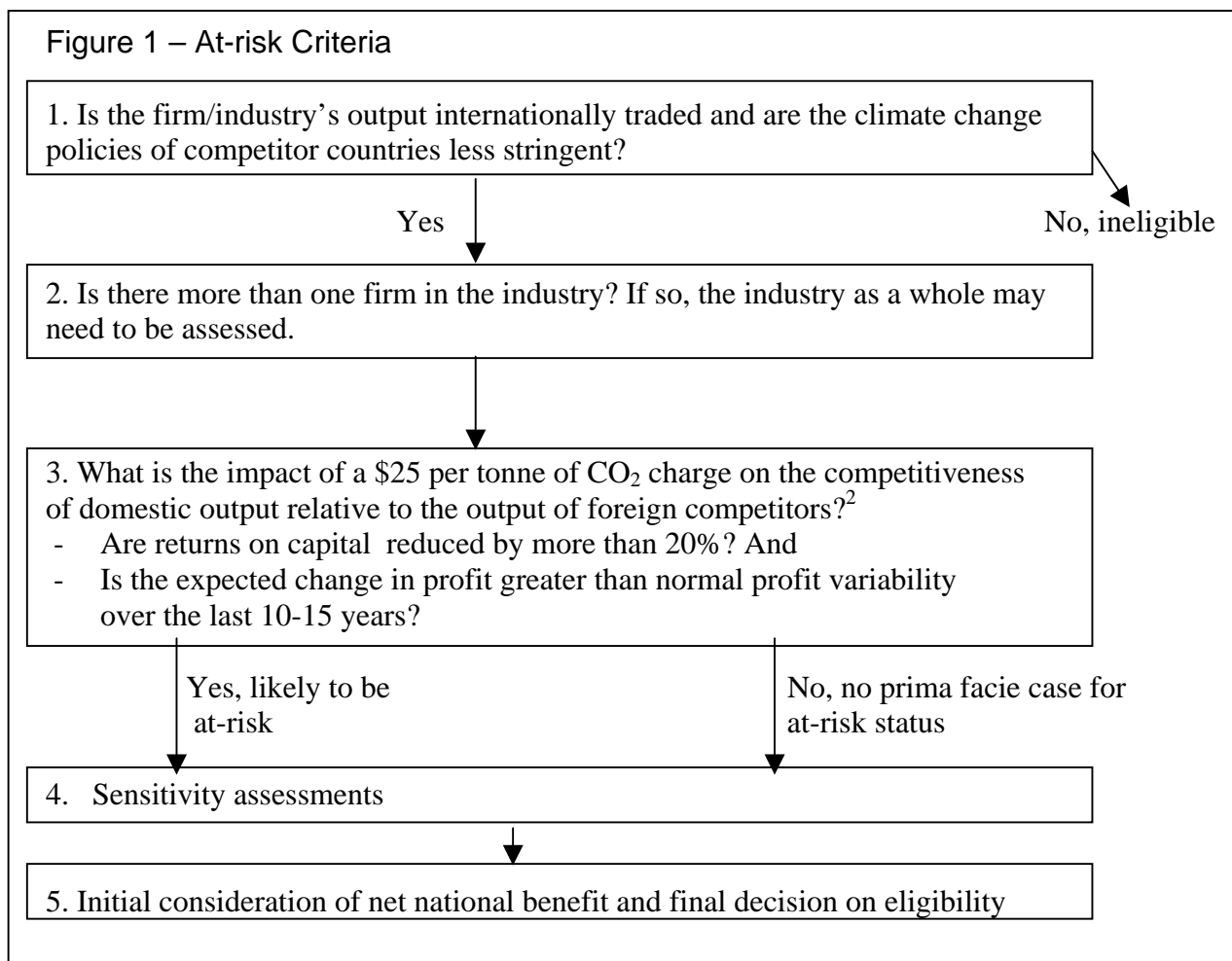
- The capacity and preparedness of the domestic firm and industry to cost effectively reduce emissions and therefore exposure to the charge;
- The capacity and preparedness of the firm or industry to absorb the charge and costs associated with abatement;
- The extent to which other climate change policies, including revenue recycling, mitigates the costs for the firm and industry;
- The degree of international trade in the good or service;
- The climate change policies in the countries of foreign competitors from 2008 (predicted in 2003/4); and
- The degree to which competition is based on price.

16 These factors form the basis for operationalising the high level criteria. There is a degree of uncertainty associated with many of the factors and there are a number of key issues that need to be considered in developing these factors into operational criteria. These include:

- The availability, robustness and cost of obtaining data;
- The administrative costs for firms or industries and Government in verifying and processing the data;
- Ensuring that the assessment is consistent across firms or industries and over time (while recognising and allowing for learning);
- Minimising perverse impacts on intra-industry competition as a result of the criteria;
- The assessment of firms that have business activities in multiple industries; and
- The credibility of the criteria (including what is considered to be a significant risk of leakage).

Five-step assessment approach

17 Based on the above factors Climate Change officials propose the following five step approach to assessing at-risk status (see Figure 1):



18 The first step is to filter out applications from firms who are not exposed to international competition or who compete with foreign producers whose countries have the same or similar climate change policies. For these firms there is no risk of leakage and they are ineligible for at-risk status. This step filters out firms that will experience changes in competitiveness that are only domestic in nature. This filtering will help reduce administrative costs for both government and firms. No threshold is proposed for the degree of international exposure at this step as the information required to assess whether a level of exposure is significant would involve information and assessment included in later steps.

19 The second step identifies whether any intra-industry competition issues could be raised through applying the criteria at the firm level e.g. less efficient producers achieving at risk status while their more efficient domestic competitors do not. An initial industry-wide assessment would mean that at-risk status would apply to all firms in an industry even though some may not individually be at risk. This approach would require a degree of industry

² There are several methods for assessing the impact of an emissions charge on a firm or industry. One approach is to assume that the firm or industry absorbs all of the cost increase. The other extreme is to assume that all of the cost increase is passed on to consumers in the form of higher prices. For many firms some of the cost may be absorbed while the remainder is passed on to consumers. Therefore, in assessing at risk status it may be useful to consider both extremes.

organisation but would be expected to lower the administrative costs involved in the assessment.

20 The third step involves assessing the impact of a \$25 per tonne CO₂ equivalent charge on firm or industry profitability. This involves estimating the change in production costs of domestic producers relative to foreign competitors, the impacts of these costs on the price of output and the resulting impact on consumer demand (see Appendix). The impact on profitability is then compared to both normal profit variability over a usual business cycle and the return on capital employed (ROCE) to give a feel for the manageability of the charge for the firm. For example, if the impact of the charge is within normal profit variability and has only a minor impact on the returns in that business, it is unlikely that the charge would result in reduced production or shut down. The Treasury favours the use of a price lower than \$25 per tonne. This would make it harder for a firm or industry to achieve at-risk status.

21 The third step of the assessment process is likely to attract significant attention from stakeholders, particularly on the threshold. Because of the different profit circumstances of different firms and industries, Climate Change officials consider the threshold should only be considered as a guide and that flexibility and judgement will be required. Consultation will assist in further consideration of the level of the threshold. In confirming the threshold it will be important to consider wider implications of a reduction in profitability on, for example, private sector research and development.

22 Sensitivity analysis of key parameters (such as price responsiveness, level of emissions charge, and thresholds) in the assessment is then used to obtain greater certainty of a firm or industry's status. For example this could include testing of what value the key parameters would need to be in order to change the result of the assessment from at-risk to not and vice versa. The reasonableness of these values could then be judged.

23 The final step involves considering the net national benefit of the firm or industry receiving an emissions charge exemption and deciding the eligibility status of the applicant. A key consideration is what the net impact on the national economy would be if the firm/industry was exposed. There would be a methodology for weighing up the benefits to the economy from avoiding economic disruption against the cost of paying for NGA firms' emissions until those firms become internationally competitive. This acts as a filter to ensure that negotiations only proceed with firms or industries for which there is likely to be net national benefit in sheltering.

24 This general approach is consistent with that adopted by other government agencies such as the Commerce Commission. Officials will discuss this approach further with relevant agencies as a part of broader consultation on NGAs.

25 Climate Change officials have done some testing of this approach and it appears that the criteria are likely to be effective. It was not possible to undertake further testing due to the reluctance of many firms to supply commercially sensitive information. As a consequence, Climate Change officials recommend consultation with key stakeholders on both protocols for assessing such information and the assessment approach and thresholds, prior to finalisation in February 2003.

26 While an analytical approach has been taken to developing the criteria, the analysis will need to be augmented with careful judgement.

Proposed process for applying criteria

27 Depending on the nature of the industry and activity, there can be substantial uncertainties associated with assessing the at-risk status of a firm or industry. As a consequence, a degree of discretion will be required in applying the proposed criteria. The credibility and effectiveness of the policy will rely on developing a process for assessing at-risk status that is:

- Transparent but ensures confidentiality of commercially sensitive information
- Consistent over time
- Cost effective for both firms and government
- Objective
- Demonstrates due consideration
- Ensures accountability of the decision maker
- Minimises opportunities for political intervention

28 Essentially, developing a process for applying the criteria requires balancing the objectivity of a methodological approach against the need for discretion. However, in the interests of transparency, justification will be provided for diverging from the methodological approach.

Process components

29 There are three broad components to applying the at-risk criteria: collection of information, application of criteria and recommendation on status, and decision on status (see figure 2).

30 The information collected will have two purposes for government – assessing at-risk status and to inform later negotiations. Because of the dual requirements it would be more efficient and effective for the same organisation to carry out this function. Climate Change officials recommend that the Climate Change Office collect the information.

31 The application of the criteria and formulation of a recommendation will require a range of skills and expertise. Some of this capability exists within departments, but external expertise may also be required. While ultimate responsibility for obtaining appropriate advice would rest with the decision-maker, normal practice would suggest that multi-departmental and external advice would be employed. This could occur through a working group arrangement where a core team (led by the Climate Change Office and comprising representatives from the Ministry of Economic Development and the Treasury) would consider the applications. This group would be supplemented with representatives from other departments as required. External advice could be used as required such as through a panel of experts. This approach would ensure consistency over time and between firms. It will also minimise the administrative costs.

Characteristics of a decision-maker

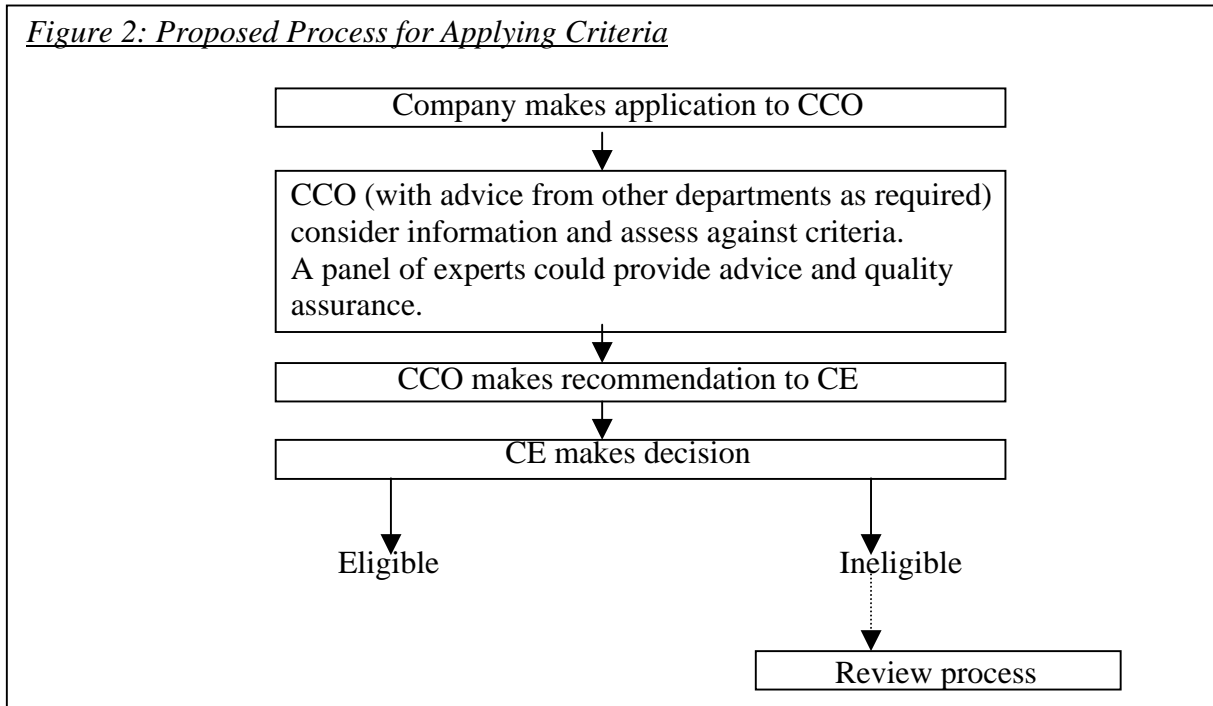
32 Important characteristics for the decision-maker include credibility, relevant expertise, clear lines of accountability, and independence from subsequent negotiations to avoid the creep of negotiations into at-risk assessments. Options for the decision-maker include:

- A statutory officer (like the Commissioner for Inland Revenue)
- Chief Executive of a government department

33 The statutory officer option would require legislation. While provision could be made in an amendment to the Climate Change Response Act, an amendment is unlikely to be enacted until 2004 and could result in a delay in commencing agreements.

34 A departmental Chief Executive (such as the CE of the Ministry for the Environment) would provide sufficient status, expertise and independence from negotiations. It would also ensure accountability of decisions. Opportunities for judicial review can be minimised by ensuring the assessment is focussed as much as possible on objective criteria. A similar approach is taken with the Ministry of Agriculture and Forestry in respect to bio-security, the Ministry of Health, Customs and the Inland Revenue Department.

Figure 2: Proposed Process for Applying Criteria



Review of at-risk status

35 [Information withheld under s9(2)(h) of the Official Information Act 1982]. Officials will work further with Crown Law in developing the process to minimise any legal risks as details of the process are developed.

Period of application

36 A fixed cut-off date for applying for at-risk status (e.g. 2005) would encourage earlier engagement by business and demonstrate government commitment to the implementation and enforcement of NGAs. It would also simplify the administration of the emissions charge by clarifying which firms and industries will get relief. An issue to be considered is whether a cut-off date would mitigate the risk of encouraging new entrants that would not be competitive without relief from the charge.. However, a fixed cut off date would create difficulties for new entrants and also for existing sites facing changing economic conditions. It could also result in some NGAs requiring renegotiation because all necessary information was not available when first negotiated.

37 On balance Climate Change officials consider that there should be not be a cut-off date for NGA applications at this time. However, this issue amongst others will be considered and reported-back on in the development of approaches for new entrants.

Cost sharing

38 Officials consider that some cost sharing between government and applicants is appropriate in assessing at-risk status. There are a range of options including:

- Applicants paying all the associated costs (including the administration costs of government); or
- Applicants and government paying their own costs; or
- Government paying all the costs of applicants.

39 For the purposes of consultation, officials propose that applicants contribute to all or a substantial part of the Government's assessment costs (excluding the salaries of officials) and pay their own costs associated with the assessment of at-risk status. This approach ensures that applicants pay the full cost of an administrative process that they could benefit from and is consistent with the approach of the Commerce Commission. It would also provide discipline on the applicants to only come forward with genuine cases.

40 Note that while the sharing of costs will put discipline on applicants, the potential benefits from achieving relief from the charge may be significant. As a consequence it may be necessary to develop processes (such as a time limit on negotiations) to prevent an escalation of costs.

Assessment of new entrants

41 An underlying principle of the climate change policy package is the need to ensure consistency with a growing and sustainable economy. The assessment of new entrants can raise different issues to those for existing firms and industries. New entrants are also able to address emissions in the design stages of their investment.

42 There are both advantages and disadvantages from offering NGAs to new entrants. Further work is required to develop where appropriate, policies and procedures for assessing new entrants. Officials will report back to Cabinet by 28 February 2003 with a proposed approach for new entrants.

Negotiating Greenhouse Agreements

43 An NGA is a contract between the Government and a firm or industry that contains binding targets and is enforceable. There are many models of such agreements in Europe the most applicable to the New Zealand situation being the Dutch Benchmarking Covenants.

44 NGAs could be negotiated between the government and either individual firms or groups of firms. To reduce administration costs and to maintain competitiveness between companies within the same industry it may be appropriate for some firms to enter into a joint agreement. Consultation will inform whether and how an approach to industry agreements should be developed. The components of the agreements will be common.

NGA Design

45 Key elements in the design of NGAs include:

- World's best practice
- Timing and form of targets
- Flexibility provisions
- Monitoring and enforcement
- Level of emissions charge exemption

Establishing World's Best Practice

46 There are elements of the Netherland's benchmarking model that are useful in establishing world's best practice. Under this model the Government and the firm/industry would jointly employ an agreed independent expert who has a duty of care to both parties to identify world's best practice and if required, its modification to the New Zealand context. In particular where world's best practice is assessed in energy terms an additional step would be needed to determine viable fuel switching opportunities (ie to renewable or less carbon-intensive fuels). Where possible, existing benchmarks will be used and if necessary unique emissions standards for New Zealand will be established by consultation with reference to similar manufacturing processes.

Timing and Form of Targets

47 An NGA will set out the pathway for moving the firm or industry towards world's best practice. The end point of the pathway is the requirement to achieve emissions intensity within a given range³ of best practice (as modified for the New Zealand context) within a

³ The Netherlands programme uses 10 percent.

defined timeframe. The starting point of the pathway will be current emissions performance. This will ensure that actions that have already been taken to improve performance (e.g. under the voluntary agreements programme that operated in the 1990s) will be recognised as they will reduce the distance to world's best practice. Targets along the pathway will be negotiated with the firm/industry.

Flexibility Provisions

48 Flexibility provisions could include:

- Trading of over and under achievement between NGA signatories
- Paying an emissions charge on emissions in excess of target
- The ability to invest in offsite projects to offset emissions covered by the NGA⁴; and
- The ability to bank over achievement to future assessment periods.

49 There are several issues around allowing flexibility provisions and consultation with stakeholders is required prior to confirmation. These issues include the depth of an NGA trading market (and the price in this market relative to the emissions charge and international emissions price), the evolution of NGAs into an allowance-based emissions trading scheme in the future (and its relationship to the planned European Union emissions trading scheme), and the relationship between penalties for non-achievement of a target and the flexibility provisions. These issues will be further considered during consultation and reported back to Cabinet by 28 February 2003.

Monitoring and Enforcement

50 Fundamental to the success of any industry agreements programme is that emissions are monitored and where milestones are not met there are consequences that provide an incentive to comply. These consequences must be greater than the benefit to a firm not to comply. Officials will report back to Cabinet by 28 February 2002 with a penalty regime for non-attainment of targets.

51 The firm/industry will be required to report on progress annually. Elements of these reports will be publicly available. Progress towards targets will be assessed at a minimum in 2005, 2007, 2010 and 2012. This will include independent verification. The practicality and potential benefits of annual assessments will be explored during consultation with stakeholders and reported back to Cabinet by 28 February 2003.

Level of Emissions Charge Exemption

52 The level of exemption a firm or industry receives will in general be linked to the degree to which the firm/industry is competitiveness at risk and the national benefit of the exemption. A guide to the level of exemption will be provided through the process of establishing eligibility. However, this will need to be informed by the nature of the investments required by the firm/industry to achieve best practice. As a result, the level of

⁴ Funding from the Project Mechanism would not be available for such projects.

exemption will need to be considered on a case by case basis during negotiations. This would ensure that the cost of meeting a target set is not disproportionate to the level of relief from the charge. In the event that no agreement can be reached between the parties on an agreed exemption level then no NGA will be entered into. Further work will be undertaken with regards to the WTO to ensure that the granting of exemptions does not raise any problematic subsidy issues.

Enactment of Charge and Exemption Legislation

53 There is likely to be pressure from NGA participants for the Government to provide certainty that the emission charge and exemption for NGAs will be implemented in future. It is not possible for the Crown to provide a legally binding commitment in advance that the charge and exemption will be implemented in 2007. Early enactment of the charge and exemption would provide a degree of assurance for NGA participants, as a later Act of Parliament would be required to override it. However, it is not expected that legislation for the charge will be ready for enactment prior to 2005.

54 To the extent NGA participants perceive that non-delivery of a promised exemption by a future Government is a risk, this will be reflected in their willingness to negotiate NGAs and assume obligations. Nevertheless, the fact that the NGA agreement is contractual in nature, and will give rise to obligations on the part of the Government as well as NGA participants, it will give an indication of the Government's commitment to the process and provide some assurance to participants. Clear communication of the ongoing process of development of the emission charge and exemption by Government may also provide assurance to participants.

Cost Sharing

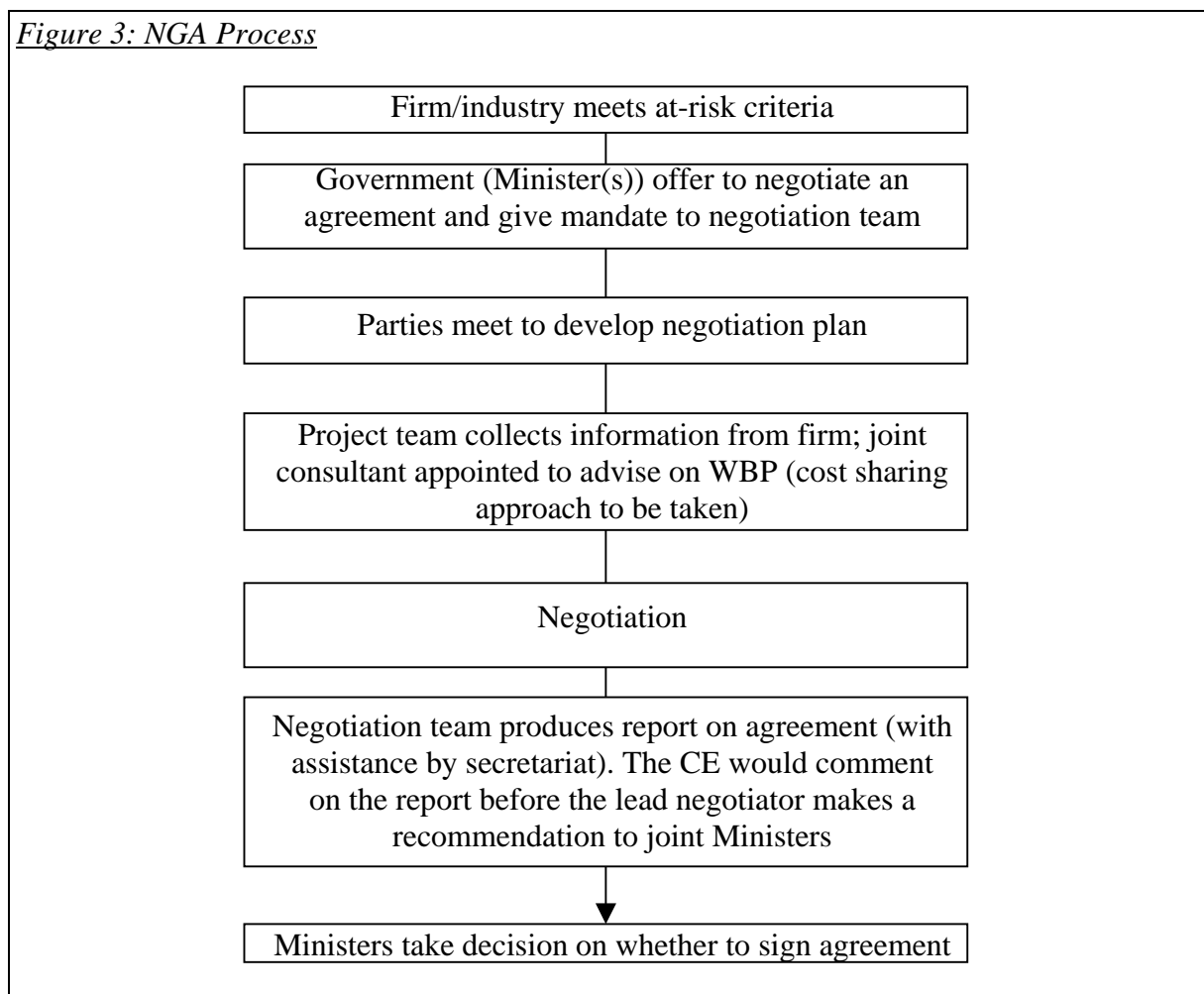
55 For the purposes of consultation, officials propose that:

- applicants be responsible for all additional (ie non-departmental personnel and administration) costs to the Crown of negotiating NGAs; and
- applicants meet their own costs of negotiating an agreement and the costs of establishing emissions baselines and world's best practice (although consideration will need to be given to the issue of duty of care).

Proposed process for negotiating agreements

56 Ministers will recall that there are a range of factors to consider in developing a process for negotiating agreements such as transparency, consistency over time, cost effectiveness, accountability and objectiveness. Climate Change officials propose the following process for negotiating the agreements (see Figure 3).

Figure 3: NGA Process



57 If a firm or industry has met the eligibility requirements, the Government would offer to negotiate an agreement. The Government appointed negotiation team would begin discussions with the firm on a negotiation plan (to scope out the process for the negotiations). This plan could also identify certain generic requirements that are prescribed to help achieve consistency and reduce negotiation time and costs.

58 The negotiation team would be supported by a group of officials as required from the Climate Change Office, EECA, MED, Treasury, MFE, MAF, and TPK. This “secretariat” would collect required information and provide analytical support prior to and during formal negotiations. Processes for ensuring the confidentiality of commercially sensitive information will be required.

59 At the completion of the negotiations, the negotiation team would produce a report on the agreement reached including an assessment of the benefits and costs for New Zealand. The Chief Executive responsible for making at-risk assessments would provide comment on the report before the negotiation team would make a recommendation to Ministers (the Convenor, Ministerial Group on Climate Change and the Minister of Finance).

60 Responsibility for assessing progress against the target (including the assessment of the use of flexibility provisions by firms) will rest with the Climate Change Office (supported by officials from other departments including EECA, as required).

61 *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

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68 *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

Financial Implications

69 The financial implications of NGAs include (compared to where NGAs are not available and firms would be subject to the full charge on all emissions):

- cost of emissions (or foregone sink credit revenues) over 2008-2012;
- changes in tax revenues and costs of economic dislocation from economic leakage;
- emissions charge revenue – however an aspect of the climate change policy is that through revenue recycling “revenue from the charge will not be used to improve the Crown’s fiscal position”;
- the cost to the Crown of future monitoring and enforcement of NGAs, including the assessment of the use of flexibility provisions by firms; and
- the cost to the Crown of the negotiations.

70 Estimates of the first three impacts can only be derived from actual negotiated outcomes. These impacts form part of the assessment of net national interest that will be determined as part of the at-risk assessment and during negotiations of NGAs.

71 Costs to the Crown of monitoring and enforcement of NGAs, will depend on the nature and scale of the overall NGA programme. These costs will be able to be better determined following stakeholder consultation and will be identified in the report back from officials in February 2003.

72 Costs to the Crown of negotiating NGA agreements will include the costs of consultants to establish world’s best practice and adapt this to New Zealand industry, legal costs, negotiation and monitoring costs. These costs are expected to be overtime in the range of \$50,000 to \$100,000 per agreement. Approximately two to three negotiations are anticipated to commence before 31 June 2003. This relatively low cost to the Crown reflects the proposed cost sharing approach where applicants be responsible for all additional (ie non-departmental personnel and administration) costs to the Crown of negotiating NGAs. Other Crown costs of agreements in the 2002/03 year, such as personnel and administration costs of the Climate Change Office and in other departments can be absorbed within existing baselines. A Budget bid is expected as part of the 2003 Budget process to cover the direct costs of out-year negotiations of the Climate Change Office and departments involved in negotiations.

Consultation

73 The following departments have been consulted in the development of this paper: the State Services Commission, Inland Revenue Department, the Energy Efficiency and Conservation Authority, Te Puni Kokiri, the Ministry of Agriculture and Forestry, the Ministry of Research, Science and Technology, the Ministry of Economic Development, the Ministry for the Environment, the Treasury, and the Ministry of Transport. The Crown Law Office was also consulted.

Treaty of Waitangi Implications

74 There are no Treaty of Waitangi implications arising from this paper.

Legislative Implications

75 Implementation of an emissions charge and exemptions will require legislation. This is discussed in the paper "Climate Change: Work Programme for Emissions Charge and Revenue Recycling".

76 Officials will develop the detail for the NGA process with advice from Crown Law as required. It may be desirable to recognise parts of the NGA process through legislation. However, at this time officials consider that it is unlikely that legislative recognition will be required. As a consequence, officials do not consider it necessary to develop a legislative framework for reporting back to Cabinet in February 2003 as referred to in "Climate Change: Work Programme, Budget and Institution for Climate Change Project" (Cab min(02)26/18 refers).

Recommendations

It is recommended that the Committee:

1. **Note** Negotiated Greenhouse Agreements are a key component of the climate change policy package;
2. **Note** that in October 2002 Cabinet directed officials to report back by 30 November 2002 on the institutional arrangements for the Negotiated Greenhouse Agreements and final competitiveness-at-risk criteria for determining whether a firm is eligible to negotiate an NGA and the process for this.

Regarding At-risk Criteria

3. **Note** the proposed five step approach (see Figure 1) to assessing at-risk status;
4. **Note** the at-risk criteria are likely to attract significant attention from stakeholders, particularly on the thresholds;
5. **Note** flexibility and judgement will be required in applying the at-risk criteria;
6. **Direct** officials to consult with stakeholders on the proposed approach and report back to Cabinet with confirmed at-risk assessment criteria by 28 February 2003;

Regarding Process for Applying the Criteria

7. **Agree** that the Climate Change Office be responsible for collecting the information for at-risk assessments, application of criteria, and recommendation on status;
8. **Agree** that the Chief Executive of the Ministry responsible for the Climate Change Office be given the authority to decide whether a firm or industry qualifies for at-risk status;
9. **Note** officials will work further with Crown Law in developing the process for applying the criteria to minimise any legal risks as details of the process are developed;
10. **Agree** for the purposes of consultation that:
 - there be no explicit cut off date at this time for application for at-risk status;
 - applicants will contribute to all or a substantial part of the Government's assessment costs (excluding the salaries of officials) and pay their own costs associated with the assessment (including the provision of information).;
11. **Direct** officials to report back to Cabinet by 28 February 2003 with a confirmed process for applying the criteria and with an assessment of proposed approaches for new entrants;

Regarding Negotiated Greenhouse Agreements

12. **Agree** for the purposes of consultation:
 - World's best practice emissions intensity would be determined by an independent expert agreed by both parties to the negotiation;
 - The agreement would set out a pathway for moving from current emissions intensity to best practice, adapted to New Zealand conditions, within a defined period of time. Milestones/targets will be established along this pathway;
 - The firm or industry will be required to report on progress towards targets annually with elements of these reports made public. Independent verification of progress would occur at a minimum in 2005, 2007, 2010, and 2012 with penalties for failing to meet targets at each of these reviews;
 - Flexibility provisions such as an emissions charge on excess emissions or trading of over and under achievement will be included in an agreement to contribute towards target achievement;
 - The level of exemption from the emissions charge, emissions targets and where appropriate penalties for not meeting emissions targets will be agreed by negotiation based on the particular circumstances of the individual firms or industries;

- applicants will be responsible for all additional (ie non-departmental personnel and administration) costs to the Crown of negotiation NGAs, their own costs, and the costs of establishing emissions baselines and world's best practice;
- 13. **Direct** officials to report back to Cabinet by 28 February 2003 with a final NGA model including unresolved issues such as flexibility mechanisms;
- 14. **Note** there is likely to be pressure from NGA participants for the Government to provide certainty that the emissions charge will be implemented in future and that there will be legal provisions to provide relief for firms who have negotiated agreements;
- 15. **Note** officials will work further with Crown Law in developing the process for negotiating agreements to minimise any legal risks as details of the process are developed;

Regarding Process for Negotiating Agreements

- 16. **Agree** that negotiations will be led by the Climate Change Office with support as required from EECA, the Treasury and the ministries of Economic Development, Environment and Agriculture and Forestry and Te Puni Kokiri;
- 17. **Agree** that the Minister of Finance and the Convenor, Ministerial Group on Climate Change be delegated authority to finalise and sign Negotiated Greenhouse Agreements on behalf of the Crown;
- 18. **Note** that the Climate Change Office and other departments will submit bids in the 2003 Budget round to cover the costs of undertaking competitiveness at risk assessments and negotiating NGAs;
- 19. *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*
- 20. *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*
- 21. *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*
- 22. *[Information withheld under s9(2)(b)(ii), s9(2)(g)(i) and 9(2)(j) of the Official Information Act 1982]*

Regarding Consultation

23. **Direct** the Convenor, Ministerial Group on Climate Change to prepare and release a discussion document consistent with the content of this paper for the purposes of targeted stakeholder consultation.

Hon Pete Hodgson
Convenor, Ministerial Group on Climate Change

Appendix – Summarised Explanation of Competitiveness at Risk Test and Thresholds

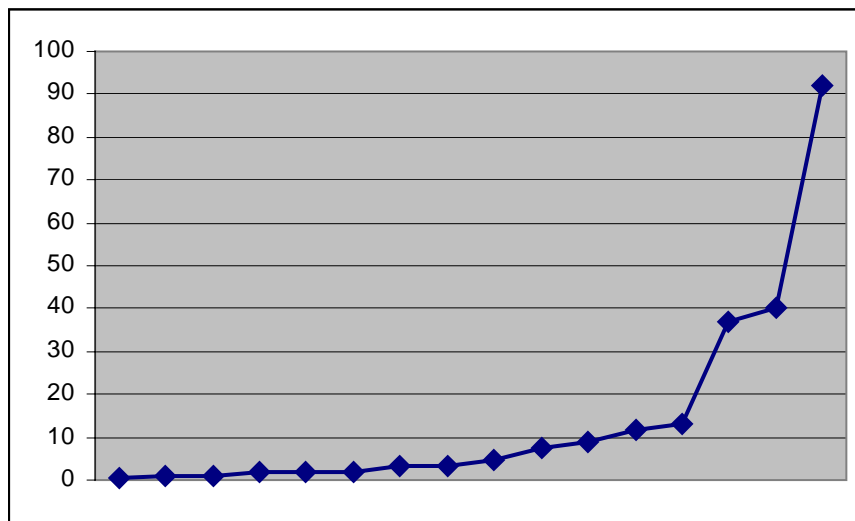
The test determines the effect of an emissions charge on a firm or industry's profitability, putting it in perspective against 'normal' profit variability. The steps outlined below assume the emissions charge is passed on to consumer through higher prices. To estimate the impact on profitability assuming the firm or industry absorbs all of the cost steps 3, 4 and 5 would be excluded. Note, lower thresholds may be appropriate for the latter approach.

Given that a product is, or is potentially internationally traded, eligibility is determined as follows.

1. Calculate the change in costs, i.e. the value of the emissions charge payment.
2. Allow for possible changes in the mix of inputs, which would reduce emissions and thus lower the emissions charge liability. Any costs associated with input substitution should be amortised and brought into the calculation.
3. Given the net change in costs, calculate the implied change in the price of the company's output, assuming no change in other costs.
4. Determine how much the price of overseas competitors' products may change. Each competing country is rated according to the comprehensiveness of its Kyoto policies with regard to the industry concerned⁵. This produces a weighted average measure of change in competitiveness, ranging from 0 (policies about the same as New Zealand's) to 1 (no policies to reduce GHG emissions). Multiplying this proportion by the change in price from step 3 gives an approximation of how competitor's prices may change.
5. Given a price elasticity of demand for the firm or industry's products, not for the global market as a whole, calculate the implied change in demand based on the change in relative price from Steps 3 and 4. As the elasticity is a key parameter, sensitivity testing may be required.
6. Calculate the effect on revenue and hence on profit.
7. Given, the change in profit, is it likely to lead to the company scaling down its operations (perhaps closing) and thereby generating leakage. In other words what is a significant adverse change in profit?
8. A threshold of 20% change in profits is proposed. During consultation, profit data on 18 companies was obtained. As indicated in the graph below, for many companies the impact of a \$25 carbon charge is less than 20% of profit. In fact there seems to be significant jump at around that point. The three companies above the 20% mark are all *prima facie* cases for at-risk status, although they might fail the criteria on other grounds.

⁵ Because of uncertainties associated with predicting the commitment period climate change policies of competitor countries, the potential impact on foreign competitor costs is estimated by rating the comprehensiveness of the competing country climate change policies for the industry.

CO₂ Charge as a Percentage of NOPAT



9. Profit variability also needs consideration. That is, an unusually low profit rate for the year to which the test relates, would make it relatively easy for an emissions charge to lead to a negative profit, thereby easily (and unjustifiably) meeting the 20% change threshold. One way to preclude this possibility is to put the absolute change in the level of profit into some sort of historical perspective. Profit variability is easily measured using the standard deviation of past the 10-15 years of profit. The threshold might be that the variation in profit caused by a carbon charge should exceed X standard deviation of profit.
10. The value for X probably needs to be reasonably generous as we need to acknowledge the issue of path dependency. That is, a low level of profit may be unusual, but it is nonetheless a real situation from which the company may need time to recover. We therefore suggest X=1.
11. If profit variability is approximately normally distributed, then one standard deviation encompasses 68% of observed values. So on average, in about three years out of ten, profit falls outside of the one standard deviation range.
12. In summary then two criteria are suggested, both of which need to be satisfied for a company to achieve CAR status i.e.:
 - The rate of profit (RONA or ROCE) should change by more than 20%.
 - The absolute change in profit (probably EBIT, but perhaps NOPAT or NOPBT) should exceed one standard deviation of the mean, calculated over 5-10 years if possible.
13. Sensitivity testing should be undertaken for any company, which has outcomes close to the thresholds. The thresholds are guides; they are not robust enough to merit strict adherence.