# Cover Note – "Climate Change: The Projects Mechanism – Details of the model Project Agreements" [Ref: POL (03) 240]

On Wednesday 27 August 2003, Cabinet Policy Committee considered the paper "Climate Change: The Projects Mechanism – Details of the Model Project Agreements" (Ref: POL (03) 240). This paper and the associated POL Minute (Ref: POL Min (03) 21/7) are included.

1. Where information from the paper and minute has been withheld under the Official Information Act (1982) it is clearly labeled. That information has been withheld on the following grounds:

Under ss. 6(a) because "the making available of that information would be likely: To prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand";

Under ss. 9(2)(f)(iv) because "the withholding of the information is necessary to: Maintain the constitutional conventions that for the time being protect: the confidentiality of advice tendered by Ministers of the Crown and officials";

Under ss. 9(2)(g)(i) because "the withholding of the information is necessary to: Maintain the constitutional conventions for the time being which protect: the free and frank expression of opinions by or between or to Ministers of the Crown or member of an organisation or officers and employees of any Department or organisation in the course of their duty";

Under ss. 9(2)(h) because "the withholding of the information is necessary to: Maintain legal professional privilege";

Under ss. 9(2)(i) because "the withholding of the information is necessary to: Enable a Minister of the Crown or any Department or organization holding the information to carry out, without prejudice or disadvantage, commercial activities"; and

Under ss. 9(2)(j) because "the withholding of the information is necessary to: Enable a Minister of the Crown or any Department or organisation holding the information to carry on, without prejudice or disadvantage, negotiations (including commercial and industrial negotiations)".

Office of the Minister of Finance
Office of the Convenor, Ministerial Group on Climate Change

Chair
CABINET POLICY COMMITTEE

# CLIMATE CHANGE: THE PROJECTS MECHANISM - DETAILS OF MODEL PROJECT AGREEMENTS

## Executive Summary

1. The Projects Mechanism is one element of the Government's climate change policy package. Entities that participate in the mechanism will deliver emission abatement from specified projects in exchange for a Crown promise of Kyoto emission units on delivery of that abatement. These entities are referred to as "Project Cos" throughout the paper.

2. Cabinet has previously agreed to key elements of the Projects Mechanism [CAB Min (03) 11/3].

3. This paper seeks agreement to the standard commercial terms of contracts between the Crown and Project Cos (known as Project Agreements).

4. In developing these commercial terms, officials have been guided by the following principles:

i. Uncertainty over the market for units means that there is a "price risk" for those trading the units, and the Crown is not willing to bear that risk; and

ii. The Crown will accept liability for only those actions that are directly within the control of the Government – mainly the management of New Zealand's Kyoto obligations.

5. The Government will only transfer units to a Project Co, or a third party nominated by a Project Co, *if* verifiable emission abatement is achieved. Any third party that deals with a Project Co in a forward trade for units will take on the risk that the project will not deliver contracted emission abatement, and that the Crown will not provide units to the third party nominated by the Project Co.

6. There are four key circumstances in which a Project Co would not be able to execute a successful trade in units because of non-performance by the Crown. These are:

7. *The Kyoto Protocol does not come into force:* The paper recommends that Project Cos should explicitly bear this risk, and that this should be specified in the Project Agreement.

8. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

9. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

10. *The Crown is unable to trade from its registry due to the Government not meeting its inventory or registry requirements under the Protocol rule:* The paper proposes that the Crown should bear this risk.

11. Normal taxation treatment will apply to transactions under the project agreements. Tax is likely to be payable by a Project Co on delivery of the emission units and on sale of the emission units. Project Cos will be able to claim any tax deductions they are eligible for under tax legislation.

12. Four million emission units were allocated to the first Projects round in the 2003 Budget. Funding to administer the round is in Vote Climate Change and Energy Efficiency baselines.

13. The policy presents some risks to the Government:

i. There may be a lack of interest in the Projects Mechanism because of uncertainty over the value of the emission units and the value of emission units is likely to be a relatively small proportion of the total cost of the Project; and

ii. Domestic rules in overseas markets may mean that New Zealand emission units are not accepted.

14. The paper directs officials to report back to Cabinet in February 2004 on the outcome of the first tendering round. [Withheld under the OIA s. 9(2)(f)(iv)]

15. The paper recommends that the Minister of Finance and the Convenor, Ministerial Group on Climate Change be authorised to finalise any further details of the first Projects round, provided that those details are not inconsistent with the recommendations of this paper.

## Proposal

16. This paper seeks Cabinet agreement to the details of model Project agreements between the Crown and companies, individuals, or other bodies ("Project Cos") that will be selected to undertake emission reduction projects in exchange for a Crown promise of Assigned Amount units or Emission Reduction units on delivery of abatement.

17. The details of these model Project Agreements will establish standard commercial terms of contracts between the Crown and Project Cos. These commercial terms will determine the value of the Crown's incentive to Project Cos. They will also determine the risk position of the Crown in the agreements.

## Background Information

18. The Projects Mechanism is one element of the Government's climate change policy package. The Mechanism will provide incentives for projects that will deliver emission reductions that would not otherwise have occurred in the timeframe identified – i.e the projects are required to meet "additionality" tests.

19. Cabinet has previously approved two early agreements with Meridian and TrustPower for the delivery of two windfarm projects. Some of the terms of these agreements differ from those being proposed in this paper, as was anticipated at the time they were approved. However, the concept of providing emission units to fund an investment gap remains unchanged. Cabinet was aware that emerging differences were inevitable because agreements on the early projects were finalised in parallel with the policy development on the final design of the Projects Mechanism.

20. Cabinet has previously agreed to important elements of the Projects Mechanism around *eligibility*, the *nature of the incentive*, and the *process of selection* [CAB Min (03) 11/3 of 31 March 2003]. The elements of the Mechanism that are already agreed are summarised below.

### *Eligibility*

21. Key determinants of eligibility are:

i. satisfying "additionality" tests – without the incentive, the project would not proceed in the timeframe proposed on a "business-as-usual" basis;

ii. passing a size threshold of 10,000 tonnes of $CO_2$ equivalent ($CO_2$ (e)) over the five years of the first Kyoto Commitment Period ("CP1"(2008-2012));

iii. the numbers of emission units requested must be no greater than the tonnes of $CO_2$ (e) reductions expected to be generated by the project in CP1.

### *Nature of the Incentive*

22. Cabinet agreed that the incentive will be in the form of promissory notes for emission units. *(This paper proposes a variation from the concept of promissory notes. This is explained below in Annex 1.)*

### *Selection Process*

23. The New Zealand Climate Change Office (NZCCO) will administer the Projects tender and assessment process (the Projects round). Project Cos will bid in with details of the proposed project, the amount of abatement that can be achieved, and the number of units required for the project to proceed.

24. Proposals will be screened to determine whether they pass investment and environmental "additionality" tests[1]. They will then be ranked in priority order, with those projects offering the *most reductions* from the start of the project to the end of 2012 in exchange for the *least number of units* being ranked highest. Thus projects that deliver abatement prior to CP1 will also be given explicit weighting in the ranking order. The risks associated with each proposal are also considered as part of the assessment process.

25. The ranking system will only ration projects that have passed the "additionality" hurdle if the total number of units requested by all Project Cos exceeds 4 million units (the cap for the first Projects round). If rationing is required, projects that contribute to near-term electricity security will be given priority over other projects

## Remaining Issues Requiring Decision

### *Introduction*

26. While Cabinet addressed a number of the threshold design decisions on the Projects Mechanism in March, there are important aspects of the policy that need to be settled. Most of these outstanding issues relate to the commercial terms of the Project Agreement between the Crown and a Project Co – i.e. the details of the Crown's "promise" of emission units, and the details of a Project Co's obligations to deliver verifiable emission reductions. These commercial terms are important in determining the value of the Crown's promise, and therefore the extent that it will leverage projects and so achieve the policy's objectives.

27. In developing these commercial terms, officials have been guided by the following principles:

i. Uncertainty over the market for units means that there is a "price risk" for those trading the units, and the Crown is not willing to bear that risk; and

ii. The Crown will accept liability for only those actions that are directly within the control of the Government – mainly the management of New Zealand's Kyoto obligations.

28. [Withheld under the OIA ss. 9(2)(i) and 9(2)(j)]

29. Some of the proposed commercial terms are likely to be contentious from a prospective Project Co's perspective.

30. Project Cos will wish to see the value of the Crown's promise maximised. The Government should share this objective, but only if it is achieved without the Crown taking on unacceptable risks. All of the commercial terms recommended in this paper would require Project Cos to assume the commercial risks of their projects and some key external risks – e.g. the Kyoto Protocol not coming into effect. The details of the proposed commercial terms are outlined below.

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1 **Investment additionality** tests whether the project would have proceeded under usual investment assumptions ("business-as-usual") in the absence of any financial incentive.

**Environmental additionality** assesses whether the project achieves real net emission abatement beyond "business-as-usual" which would reduce emissions that are counted in New Zealand's greenhouse gas emission inventory.

31. The Project Agreement will contain standard terms and conditions that are consistent across all projects. There are three key reasons for this approach:

i. Ostensibly small changes in the terms of the Agreement can have quite large impacts on the nature of the incentive and the allocation of risk between the Crown and Project Cos;

ii. A variety of important contractual terms would also increase the transaction costs for both the Project Co and the Crown, and make management of the portfolio more difficult; and

iii. Negotiating fundamentally different terms with individual Project Cos could run the risk that the tender process is judged to be inequitable.

32. In addition, each Project agreement will contain information specific to the project, such as implementation milestones and verification processes.

33. The following issues are addressed sequentially in this paper;

A. The Crown's promise to Project Co;

B. Project Co's promise to the Crown;

C. Characteristics of Project Cos;

D. Risk allocation in the Agreement;

E. Types of units to be issued;

F. Taxation treatment; and

G. Dispute settlement.

## *A The Crown's Promise to Project Cos*

34. Further analysis has resulted in a variation from the original concept of a "promissory note" discussed in the March 2003 Projects Cabinet paper. Rather, the only legal documentation the Crown will provide is the project agreement for the delivery of emission abatement in exchange for the delivery of emission units by the Crown. Effectively the Crown is "purchasing" emission abatement in exchange for the promise to transfer a Crown asset (units) at regular intervals during CP1 following delivery of abatement. A Project Co will be able to sell the rights to the expected emission units prior to the commitment period through a forward contract with a third party.

35. The reasons for this proposed variation are set out in Annex 1.

36. The units transferred will correspond to the abatement achieved during CP1 at the agreed ratio of units to emission reductions, up to the specified maximum number of units.

37. The Government will contract with Project Cos to provide emission units. The Government provided for the establishment of a Registry in the *Climate Change Response Act 200*2, which also creates the ability to establish Crown accounts in the Registry and for the Crown to trade units. The legislation does not presently provide for individual accounts in the Registry or for the allocation of units to private persons. The Government intends to provide for individual accounts through amendments to the Act in 2004. Accordingly, project agreements entered into prior to the passing of the legislation will state that the Crown will provide units, but will not specify the exact method of doing so.

### *B Project Co's Promise to the Crown*

38. A Project Co will contract to establish the project in accordance with the specified timetable, and to deliver the agreed emission abatement from the project during CP1.

39. A "grey market" for emission reductions exists in advance of formal trading either under national schemes or the Kyoto Protocol. Such a market is likely to continue in parallel with the formal market. Buyers are attracted by the opportunity to gain experience and acquire credits at substantial discounts prior to formal trading, or to advance their image as a "carbon neutral" producer. Project Cos will be able to sell additional abatement into this market, but only after they have fulfilled their obligations to deliver abatement to the Crown – i.e. the Crown has "first call" on emission reductions from nominated projects and such reductions cannot be sold twice.

40. Project Cos will agree to comply with reporting and other obligations under the Agreement, and to open and maintain an account in the Registry prior to receiving units.

### *C Characteristics of Project Cos*

41. Project Cos may take different forms. Interest in the Projects Mechanism is likely from State Owned and private sector energy and forestry processing companies. Participation by foreign owned companies is also possible, and will be encouraged by selective international promotion of the Projects Mechanism. This will provide opportunities to maximise the climate change outcomes from the Mechanism, and ensure high quality projects occur. The Mechanism may also attract interest from other entities and companies.

42. The Government should be largely indifferent to the *form, governance,* and *ownership* of Project Cos, so long as the abatement occurs in New Zealand. This is because Project Cos, rather than the Crown, bear all the material risks for non-compliance with project agreements. The Government should only be interested in the form and governance of Project Cos to the extent that this *significantly bears* on the *observed capacity* of a project applicant to comply with an agreement or manage a project. Also, the form of Project Cos will need to be compliant with New Zealand law.

## *D Risk Allocation in the Agreement*

i. Conditionality and Damages

### *(a) Non-performance by Project Co*

43. A key feature of the contract between the Crown and Project Co is that the Government will only transfer units to a Project Co, or to a third party nominated by the Project Co, if verifiable emission abatement is achieved. Any third party that deals with a Project Co in a forward trade for units will take on the risk that the project will not deliver contracted emission abatement, and that the Crown will not provide units to the third party nominated by the Project Co.

44. The Crown will have no separate obligations to any third party through the standard Project Agreement. However, the Government may in some cases wish to enter into agreements that are outside of the main Project agreement with third parties to assist in maximising the value of units allocated (for instance through providing a "letter of approval" to allow a project to enter into the Netherlands Emissions Reduction Unit Procurement Tender).

45. The corollary of the Crown not being required to provide units in the case of non-performance by a Project Co is that the Projects Mechanism will not incorporate any provisions for damages. The only recourse the Crown will require in the event of non-performance by a Project Co is the withholding of units, or under some circumstances, cancellation of the agreement, without compensation.

### *(b) Non-performance by the Crown*

46. There are four key circumstances in which a Project Co would not be able to execute a successful trade because of non-performance by the Crown:

47. *The Kyoto Protocol does not come into force:* We propose that Project Cos should explicitly bear this risk, and that this should be specified in the Agreement. It is outside of the Government's control.

48. *A change of policy by a future Government (e.g. a withdrawal from the Protocol):* A future Government that withdrew from the Kyoto Protocol would be bound by the agreements. Project Cos could seek compensation from the Government, although the Government could legislate to remove any liability.

49. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

50. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

51. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

52. *The Crown is unable to trade from its registry due to the Government not meeting its inventory or registry requirements under the Protocol rule:;* We propose that the Crown should bear this risk. The rationale is that this is largely in the Crown's control.

Project Cos could exaggerate the risk and lower the value of units – i.e. the Crown is much better placed to assess and manage this risk than Project Cos.

ii. Baselines and Clawback of units

53. There are two options for calculating the "baseline" against which emission abatement is measured.

54. During consultations on the Project Mechanism in early 2003, officials expressed a preference for a **dynamic baseline**. A dynamic baseline is one which is calculated ex-post periodically throughout the project life. The objective is to pick up any changes in the "business-as-usual" scenario – for example due to electricity price path changes - so that the incentive is more accurately allocated to actual additional abatement.

55. Recent analysis has pointed to four significant disadvantages in the dynamic baseline approach:

i. It is likely to be costly and complex to administer.

ii. The baseline could shift over the life of the project to the detriment of the investor. Investors are likely to compensate for this risk by discounting the value of the Crown's promise.

iii. As the baseline is not known at the outset of the project, neither the Crown nor the Project Co can determine what additional abatement will be delivered. Unless the allocation is capped, the Crown could be exposed to the allocation of additional emission units to a project above what was originally intended.

iv. As the number of emission units available is capped, rationing of projects may be required. This will be difficult when using a dynamic baseline, as the forecast emission abatement will be unknown.

56. It is proposed that projects generally be assessed on the basis of a **static baseline** – i.e. the baseline against which additionality is determined will not change through the life of the project. There may be some projects where a departure from this approach is warranted, if this is agreed by both the Crown and the Project Co.

iii. Project Reporting and Verification of Emission Abatement

57. In order to monitor project implementation and performance, including the emission abatement delivered by a project, a Project agreement will specify implementation milestones, reporting obligations of the Project Co, and verification processes. These performance expectations will be project-specific but have standard minimum information requirements.

58. Reporting and monitoring information will be used to assist in managing the portfolio of projects and to reduce the opportunity cost of units being tied up by projects that are not delivering expected levels of emission abatement. Implementation milestones will ensure that satisfactory progress is made, prior to the delivery of abatement.

59. The Project Agreement will provide the Crown with the right to renegotiate or terminate the Agreement for non-performance by the Project Co against these milestones. Reporting and verification will provide the information necessary to ensure that the emission units transferred to the Project Co correspond to actual emission

abatement. If the nature of the project significantly alters after from the original Project agreement, for example following a resource consent decision, the Crown would need to agree to such changes, and would be able to adjust the emission units committed to the project to reflect relevant changes.

iv. Agreement Termination

60. The Crown will retain the right to terminate agreements with Project Cos in the following circumstances:

i. A Project Co's tender is discovered to have been materially incomplete, inaccurate, or misleading;

ii. There is significant delay in constructing or commissioning the project;

iii. There are material breaches by a Project Co of its reporting obligations (including any such reports being materially incomplete, inaccurate, or misleading);

iv. There is a failure to deliver a specified minimum level of emission reductions in any year; or

v. A Project Co becomes insolvent.

61. A Project Co will be entitled to terminate an agreement for material breach by the Crown.

62. Agreements will provide for limited 'force majeure' circumstances outside of the control of the parties in which both parties will be relieved of their obligations under the agreement.

## *E Types of Units to be Issued*

63. Under the Kyoto Protocol, there are four different types of emission units each equivalent to a tonne of $CO_2$ equivalent. Each of the unit types has slightly different rules and restrictions around their use.

64. The two units most likely to be relevant for the Projects Mechanism are the Assigned Amount Units (AAUs) and the Emission Reduction Units (ERUs).

65. AAUs are New Zealand's original allocation based on 1990 emissions levels. ERUs are project-backed units that satisfy the international requirements for Joint Implementation projects (projects located in a country with an emissions target under the Protocol and "funded" by another country with an emissions target).

66. It is likely that, as the market matures, price differentiation between the different types of units may emerge. Before the Protocol comes into force, and possibly for a number of years thereafter, the domestic policies of participating countries, and therefore possible markets for New Zealand units, will still be developing. Given this uncertainty, officials recommend that the Project Agreement should provide that AAUs will be supplied, but Project Cos would be able to elect to receive ERUs where they meet the criteria for allocation of ERUs and agree to pay any extra compliance costs associated with the allocation of ERUs. This formulation will allow Project Cos to leverage maximum value from changes in overseas market demands.

### *F Taxation Treatment*

67. The Project agreement has been structured as a contract for services. This means that during CP1 the Crown will pay units to the Project Co in return for the delivery of abatement. Normal taxation treatment will apply. The Project Co will be able to claim any tax benefits it is eligible for under tax legislation.

68. It is expected that the Project Co will have to pay income tax on the delivery of the units. Tax would be payable at that time because it would only be then that the Project Co has delivered the service and earned the income. The units, because they are convertible to cash, are likely to meet the test of being income for the Project Co. The income tax would then be calculated on the value of the units at the time of their delivery to the Project Co.

69. For GST purposes, there are likely to be two equal and offsetting taxable supplies under agreement between the Crown and the Project Co – one being the supply of units by the Crown to the Project Co and another being the supply of abatement by the Project Co to the Crown. Therefore the net GST impact on Project Cos is zero.

70. If a Project Co chooses to enter into a forward contract with a third party for the sale or assignment of an interest in the units, prior to CP1, the usual taxation rules applicable to a financial arrangement will apply. The likely outcome of these, if the Project Co uses a forward contract to fund the investment, is that the Project Co would be entitled to a deduction for the costs of the funding. The GST implications arising in respect of the forward contract are still being considered.

71. [Withheld under the OIA s. 9(2)(g)(i)]

### *G Dispute Settlement*

72. The Agreement will specify a process for dispute resolution by mutually agreed independent experts.

## Risks

Interest

73. There is a risk of a lack of interest in the Projects Mechanism because of uncertainty over the value of units being provided - e.g. the units will not exist if the Kyoto Protocol does not come into effect. Also, the value of units is likely to be a relatively small proportion of most projects. Analysis by officials in recent months has explored a range of options to increase the value of units. However, the only practicable ways of increasing value involve the Crown assuming higher levels of risk. Given the current uncertainties surrounding the Kyoto Protocol coming into force and the nature of the emissions market that will emerge, transferring higher levels of risk to the Crown at this time would not be appropriate. Officials have discussed this analysis with the relevant Ministers.

Markets

74. There is also a risk of New Zealand based units becoming unacceptable (or discounted) by overseas purchasers as foreign governments establish their own rules and protocols on trading into their emerging emissions markets. This risk can be

mitigated by New Zealand establishing consultation and collaboration processes with key governments (e.g. in the EU), inter-governmental organisations and NGOs to ensure that New Zealand units awarded to projects can meet the qualifying conditions that may be laid down and therefore ensure that maximum value can be achieved for those units.

[Withheld under the OIA s. 6(a) and s.9(2)(h)]

75. [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

## Report backs

76. We propose that officials be asked to report back to Cabinet in February 2004 on the outcome of the first tendering round. [Withheld under the OIA s. 9(2)(f)(iv)]

## Refinement of Projects Mechanism

77. We propose that, as Minister of Finance and Convenor, Ministerial Panel on Climate Change, we be authorised to finalise any further details of the first Projects round, provided that those details are not inconsistent with the recommendations of this paper.

## Financial Implications

78. The Government will allocate a maximum of 4 million emission units for the first Projects round. This was approved in the 2003 Budget.

79. There is not currently a clear market price for units. The Netherlands government recently concluded a project tender round, where the average price was 5 Euro (approximately $10 New Zealand dollars) per tonne of $CO_2$ (e), or emission unit.

80. Funding to administer the round was appropriated to Vote Climate Change and Energy Efficiency in the 2003 Budget.

## Consultation

81. The Treasury and the New Zealand Climate Change Office were involved in the preparation of this paper. Te Puni Kokiri, the Ministry of Economic Development, the Ministry of Agriculture and Forestry, the Ministry of Foreign Affairs and Trade, the Department of Prime Minister and Cabinet, the Ministry of Transport, Inland Revenue Department, and the Energy Efficiency and Conservation Authority were consulted.

## Recommendations

82. It is recommended that the Cabinet Policy Committee recommend that Cabinet:

***Background***

1 **note** that Cabinet has previously agreed to key elements of the Climate Change Projects Mechanism around eligibility, the nature of the incentive, and the process of selection [CAB Min (03) 11/3];

***Obligations of Parties to the Agreement***

2 **note** that key features of the Crown's promise of units are that the promise is specific to a project, and the promise will only be met if abatement is delivered by the project during CP1;

3 **note** that units transferred to companies, individuals, or other bodies that are selected to undertake emission abatement projects (referred to as **"Project Cos"** in the paragraphs that follow) should correspond to the abatement achieved during CP1 at the agreed ratio of units to emission reductions, up to the specified maximum number of units, and that the transfer of units from the Crown is entirely conditional on the achievement of contracted abatement during CP1;

4 **agree** that the Government will not form any contractual relationships through the Project Agreement with, or provide undertakings to, any third parties that Project Cos deal with;

5 **note** that there may be some circumstances where the Government may wish to enter into agreements with third parties that are outside the Project agreement to assist in maximising the value of units allocated;

6 **agree** that the Government will be indifferent to the form, governance, and ownership of Project Cos, provided these are compliant with New Zealand law, and except to the extent that these significantly bear on capacity to comply with an agreement or to manage a project;

7 **agree** that the Projects Agreement will not incorporate any provisions for damages for non performance by a Project Co;

***Assessment***

8 **agree** that all projects be assessed on the basis of an emissions baseline against which additionality is determined, and which will not be changed for the purposes of any additionality assessment through the life of the project, except where both the Crown and the Project Co agree to a departure from this approach.

***Non-Performance by the Crown***

9 **note** that there are four key circumstances in which a Project Co would not be able to execute a successful trade in units because of non-performance by the Crown:

(i) The Kyoto Protocol does not come into force;

(ii) A change of policy by a future Government (e.g. a withdrawal from the Protocol);

(iii) [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

(iv) The Crown is unable to trade from its registry due to the Government not meeting its inventory or registry requirements under the Protocol rules.

10 **agree** that Project Cos should explicitly bear the risk of (i) in recommendation 9 above, and that this should be specified in the Project Agreement;

11 **note** that future Governments will be bound by agreements with Project Cos, but that Project Cos will bear the risk that a future Government legislates to extinguish its liability;

12 [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

13 [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

14 [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

15 **agree** that the Crown should bear the risk of (iv) in recommendation 9, above;

***Termination***

16 **agree** that the Crown retain the right to terminate agreements with a Project Co in the following circumstances:

i A Project Co's tender is discovered to have been materially incomplete, inaccurate, or misleading;

ii There is significant delay in constructing or commissioning the project;

iii There are material breaches by a Project Co of its reporting obligations (including any such reports being materially incomplete, inaccurate, or misleading);

iv There is a failure to deliver a specified minimum level of emission reductions in any year; or

v A Project Co becomes insolvent.

17 **note** that a Project Co will be entitled to terminate an agreement for material breach by the Crown;

***Allocation and Assignment of Units***

18 **note** that the unit types most likely to be relevant for the Projects Mechanism are the Assigned Amount Units (AAUs) and the Emission Reduction Units (ERUs);

19 **agree** that the Project Agreement provide that AAUs will be supplied, but Project Cos would be able to elect to receive ERUs where they meet the criteria for allocation of ERUs and agree to pay any extra compliance costs associated with the allocation of ERUs;

20 **note** that a "grey market" for emission reductions exists in advance of formal trading either under national schemes or the Kyoto Protocol;

21 **agree** that Project Cos be free to sell emission abatements into this market, but only after they have fulfilled their obligations to deliver abatement to the Crown;

***Taxation***

22 **agree** that the Project agreement should be structured as an agreement for services;

23 **note** that it is expected that the delivery and subsequent sale of the emission units will be subject to income tax and a Project Co would be able to claim any tax benefits for which it is eligible;

24 **note** that when the units are transferred to a Project Co, upon delivery of abatement, the Crown will be required to add GST to the transaction;

[Withheld under the OIA s. 6(a) and s. 9(2)(h)]

25 [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

26 [Withheld under the OIA s. 6(a) and s. 9(2)(h)]

***Dispute Resolution***

27 **agree** that the Project Agreement will specify a process for dispute resolution by mutually agreed independent experts;

***Report Backs***

28 **direct** officials to report back to the Cabinet Policy Committee by February 2004 on progress with the first Projects tendering round; and

***Further changes***

29 **authorise** the Minister of Finance and the Convenor, Ministerial Group on Climate Change to finalise any further details of the first Projects round, provided that these are not inconsistent with the above recommendations.

Hon Dr Michael Cullen
Minister of Finance

Hon Pete Hodgson
Convenor, Ministerial Group
On Climate Change

## The "Promissory Note" Concept and Fungibility

1. When Cabinet considered the form of the Projects Mechanism in March 2003, officials envisaged that the Crown would issue "Promissory Notes" for units and that these Notes would be a tradable financial instrument that could be leveraged (on-sold or borrowed against) in a liquid market. Analysis by the Treasury over the last few months has led to a departure from the concept of a Promissory Note in the Projects Mechanism. This is explained below.

2. Defining features of the Crown's promise that are relevant to consideration of the use of a Promissory Note are:

a The promise is specific to a project; and

b The promise will only be met if abatement is delivered.

3. It is now apparent that these features will inhibit a liquid, fungible[2] market in Promissory Notes, because any prospective buyers of such Notes will distinguish between the Notes attached to different projects, and will seek redress from Project Cos in the case of non-delivery of abatement. A Promissory Note tagged to Project A could have a very different value from a Promissory Note attached to Project B. There is a market expectation that Promissory Notes would be fungible.

4. The Government could facilitate a more liquid market in Promissory Notes by guaranteeing to provide units to any holders of Notes, not just to the Project Co, irrespective of whether the promised abatement had been delivered. However, it would then need to be able to recover damages from the Project Co in the case of such non-delivery (or under-delivery) of abatement. This would, in turn, complicate the agreements and increase transaction costs. These extra costs would (at least partially) offset any higher value of the units.

5. A fungible secondary market in Promissory Notes would increase the value of the Crown promise because transaction costs in such a market would probably be significantly lower than those in trading in "project-specific" Crown promises. There are other mechanisms that would allow a secondary market to become more liquid. The most likely is the emergence of brokers who would "package" the agreements of a number of New Zealand based projects and sell these portfolios to third parties. These arrangements are unlikely to emerge on a large scale in the short-term.

6. It is important to note that this change does not represent a fundamental change to the Projects Mechanism as previously envisaged. The incentive remains the promise of emission units, and those units still can be transferred to third parties by the Project Co, or used as security for borrowing. Project Cos are also able to contract freely on terms of their choosing, to maximise the value of the units.

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2 **Fungible** is a term used to apply to financial instruments, which are identical in specifications. For example, options and futures contracts are highly fungible, since they are highly standardised arrangements. By contrast, debt portfolios are not, since they are customised arrangements. Instruments that are highly fungible tend to be very liquid, and so transaction costs tend to be low.