

Cover Note – “Climate Change: Final Policy for Negotiated Greenhouse Agreements (NGAs)” [Ref: POL (03) 79]

On Wednesday 09 April 2003, Cabinet Policy Committee considered the paper “Climate Change: Final Policy for Negotiated Greenhouse Agreements (NGAs)” (Ref: POL (03) 79). This paper and the associated POL Minute (Ref: POL Min (03) 8/8) are included.

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

Firstly under ss. 6(a) because the withholding of information is necessary because the “making available of the information would be likely: To prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand”; and

Secondly under ss. 9(2)(h) because “the withholding of information is necessary to maintain legal professional privilege”.

Office of the Convenor, Ministerial Group on Climate Change

The Chair
CABINET POLICY COMMITTEE

CLIMATE CHANGE: FINAL POLICY FOR NEGOTIATED GREENHOUSE AGREEMENTS (NGAs)

Purpose

- 1 This paper seeks confirmation, following public consultation, of NGA policy including:
 - Eligibility Criteria for NGA applicants;
 - Key components of an NGA; and
 - Institutional arrangements for assessing eligibility and negotiating agreements.

Executive Summary

2 A key component of the Government's climate change policy package are NGAs for firms or industries that, as a result of an emissions charge, face significant risk to their competitiveness relative to producers in countries with less stringent climate change policies. Under an NGA firms would receive a full or partial exemption¹ from the emissions charge in exchange for moving towards world's best practice in emissions management.

- 3 Granting of an NGA will require two distinct processes, namely:
 - Identification of eligible "at risk" firms; and
 - Negotiation of exemption from the charge and appropriate world's best practice targets.

4 A five-step approach is proposed to identify eligible at risk firms (see figure 1):

Step one – Verification that the applicant is exposed to international competition from countries with less rigorous climate change policies. This step must be passed to proceed further.

¹ In this paper, "exemption" means exemption, refund, rebate or credit, as appropriate, as the detailed design of the emissions charge is still at a relatively early stage.

Step two – Identification of the appropriate scope for any NGA that might apply to this firm (for example, by firm, industry, or a section of the industry). This is necessary to avoid intra-industry competition issues.

Step three – Assessment of the significance of the risk of leakage. This is achieved by assessing whether:

- a. The firm will face a significant increase in costs (defined as firms for whom energy would represent more than 20% of their total expenses). OR
- b. The \$25 per tonne of CO₂ equivalent charge decreases a firm's:
 - I. profitability (earnings before interest and tax) by more than 10%; OR
 - II. return below the appropriate industry investment hurdle (this will require the existence of an internationally accepted weighted average cost of capital²).

These assessments will require consideration of several (at least three) years' results to remove the effects of short-term variability (e.g. exchange rate or price variability or due to firm internal restructuring).

Step four – Sensitivity analysis of the key parameters used in step three.

Step five – Initial consideration of the net national benefit of the firm/industry receiving relief from an emissions charge.

5 Questions exist on how stringent the eligibility criteria to apply for NGAs should be and, if eligibility is unclear, whether applicants should proceed to negotiations.

- More stringent criteria will reduce the number of applications and consequential negotiation costs. Fewer applications will presumably also reduce the final number of NGAs granted which, in turn, will improve the effectiveness of the emissions charge. However, this may also result in some at risk firms or industries not receiving NGAs and exiting New Zealand;
- Less stringent criteria will result in more firms being eligible to begin negotiations. This will increase at risk firms' ability to receive NGAs and so reduce the risk of leakage of economic production. A lower entry threshold is also likely to increase negotiation costs, result in more applicants being rejected in the negotiation process and may result in lower overall emissions reductions as some NGA firms are likely to face weaker incentives to reduce emissions. The extent to which firms with NGAs will be less effective in achieving emissions reductions cannot be estimated as World's Best Practice targets are the subject of future negotiations.

6 To guide decision making I propose that the following principles underlie the implementation of NGA policy:

² A non-technical description of WACC and its implications is attached as annex 2.

- NGAs should contribute to the Government's overall climate change objective that New Zealand make significant greenhouse gas reductions on business as usual and be set towards a permanent downward path for total gross emissions by 2012; and
- Eligibility assessment processes should be simple and low cost to reduce barriers to at risk firms accessing NGAs.

7 In practice, the second principle will reduce the cost and the rigor of the assessment criteria. This will result in more eligible at risk firms being able to apply for, and receive NGAs, but is also likely to result in some not at risk firms receiving NGAs.

8 Decisions on eligibility do not commit the Government to granting any exemption from the emissions charge (although refusing an NGA to eligible firms may be contentious). It is therefore proposed, in line with feedback from consultation, that the Chief Executive of the Ministry for the Environment (as responsible CE for the Climate Change Office) be responsible for deciding whether applicants are competitiveness-at-risk. This would reverse Cabinet's initial decision that joint Ministers (the Convenor, Ministerial Group on Climate Change and the Minister of Finance) should make this decision.

9 The government would offer to negotiate an agreement with eligible applicants, but would not be required to reach an agreement. Key negotiation parameters will include the coverage and 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.

10 The government-appointed negotiation team would negotiate draft agreements, assess the benefits and costs of the agreements for New Zealand, and make a recommendation to Joint Ministers (the Convenor, Ministerial Group on Climate Change and the Minister of Finance) on whether the government should enter into an NGA. These Ministers would have authority to sign the agreements.

Background

11 A key component of the Government's climate change policy package is NGAs for firms or industries that as a result of an emissions charge face significant risk to their competitiveness relative to producers in countries with less stringent climate change policies. Under an NGA firms would receive a full or partial exemption from the emissions charge in exchange for moving towards world's best practice in emissions management.

12 Cabinet has previously agreed that the new climate change policies for the first commitment period will not be implemented until the Kyoto Protocol comes into force [CAB Min (02) 13/10 refers.

13 In December 2002 Cabinet approved the release for consultation of draft eligibility criteria and institutional arrangements for Negotiated Greenhouse Agreements (POL Min (02) 21/12 refers). Officials have consulted with stakeholders in public meetings in Christchurch, Wellington and Auckland. These meetings were attended by over 130

representatives of firms and industry groups. In addition, twelve written submissions were received.

Feedback from Consultation

14 The main issues raised in consultation concerned:

- the proposed eligibility criteria,
- the appropriate decision maker for determining at risk status, and
- appropriate industry/government cost sharing arrangements.

15 A large number of queries also asked how the proposed policy would relate to specific circumstances or companies. Specific issues raised, officials' comment and proposed final policy recommendations are outlined below.

Proposed Final Policy – Eligibility for Negotiated Greenhouse Agreements

Principles Guiding Competitiveness At Risk Decision Making

16 NGA policy is a subset of the Government's overall climate change policy which has as its objective "that NZ make significant greenhouse gas reductions on business as usual and be set toward a permanent downward path for total gross emissions by 2012". The most effective tool to achieving this will be a broad based tax emissions charge. The broader the application of the emissions charge the stronger the emissions reduction incentive, the lower the relative administration costs and the greater the revenue available for recycling. Balanced against this is the objective to minimise economic leakage.

17 These two objectives are best balanced by ensuring that NGAs are limited to applicants who are genuinely competitiveness-at-risk. Finding this limit, however, will be difficult, as there will be considerable uncertainty for some firms as to whether they are competitiveness at risk due to the uncertainties of:

- how individual firms and markets will respond to changing relative prices;
- the impacts of how individual firms and markets will respond to the emissions charge itself; and
- the impacts of other climate change policies such as revenue recycling.

18 This uncertainty could be reduced by more detailed analysis and modelling, however, this would increase costs and reduce the ability of genuinely at risk firms to apply for an NGA. Questions therefore exist over how stringent the eligibility criteria for NGAs should be, and in cases of uncertainty whether doubt should favour the applicant.

- More stringent criteria will reduce the number of applications and consequential negotiation costs. Fewer applications will presumably also reduce the number of NGAs granted which, in turn, will improve the effectiveness of the emissions charge. The disadvantage is that more stringent criteria will result in some at risk firms or industries not receiving NGAs and reducing production or exiting New Zealand;

- Less stringent criteria will result in more firms being deemed eligible to begin negotiations. This will increase the ability of at risk firms to receive NGAs and so reduce the leakage of economic production. A lower entry threshold is also likely to increase negotiation costs, result in more applicants being rejected in the negotiation process and may result in lower overall emissions reductions as firms with NGAs may face weaker incentives to reduce emissions³. The extent to which NGAs firms will be less effective in achieving emissions reductions cannot be estimated as world's best practice targets are the subject of future negotiations.

19 Given the potential uncertainty over some firms' status it is proposed that for determining at risk status the following principles should apply:

- NGAs should contribute to the Government's overall climate change objective that New Zealand make significant greenhouse gas reductions on business as usual and be set towards a permanent downward path for total gross emissions by 2012;
- Assessment processes should be simple and low cost to reduce barriers to at risk firms accessing NGAs;

20 In practice the second principle will reduce the cost and rigor of the tests. This will result in more at risk firms being able to apply for and receive NGAs, but is also likely to result in some not at risk firms unintentionally receiving NGAs. Climate change officials consider it desirable to keep the application process low cost at the loss of some precision in the tests. Climate change officials also consider that some discretion be available in assessing the at risk status of borderline firms. This discretion is considered appropriate as if an at risk firm is incorrectly deemed ineligible for an NGA and subsequently closes or moves offshore, then this leakage may be irreversible.

Recommendation

Agree that the following principles should guide decision making on eligibility assessments:

- NGAs should contribute to the Government's overall climate change objective that New Zealand make significant greenhouse gas reductions on business as usual and be set towards a permanent downward path for total gross emissions by 2012; and
- Eligibility assessment processes should be simple and low cost to reduce barriers to at risk firms accessing NGAs.

Proposed Competitiveness at Risk Criteria

Issues considered

21 Feedback on the proposed eligibility criteria fell into four main groups. These were:

³ While NGAs firms are likely to be less effective in reducing emissions they are also likely to start work on reducing emissions from the date an NGA is agreed whereas other firms are likely to wait until closer to when the emissions charge will commence.

Group 1 – No eligibility criteria should exist – NGAs should be available on demand.

Comment

22 Stakeholders noted that the Voluntary Agreements regime resulted in some significant emissions reductions and these could be repeated. Firms should therefore be allowed open access to NGAs to achieve the Government’s emissions reductions targets. Officials disagree with this and recommend that NGAs be restricted to firms who can demonstrate a legitimate case of probable economic leakage as:

- the success of voluntary agreements was uneven and the Government would ultimately be liable if firms failed to deliver their side of the agreement;
- broad application of the charge will produce the greatest emissions reductions;
- open access would not target need and would favour larger firms with the greatest ability to afford negotiations;
- the potentially large number of NGA negotiations would be costly and may crowd out genuinely at risk applicants; and
- NGAs on demand may require industry wide agreements that would result in inappropriate or unobtainable targets for many participants.

Recommendation

- No change to policy that NGAs be limited to firms or industries that, as a result of an emissions charge, face significant risk to their competitiveness relative to producers in countries with less stringent climate change policies.

Group 2 – The proposed criteria (a 20% change in profitability) was too high and would not adequately identify at risk firms

Comment

23 The 20% change in profitability figure is a proxy for the magnitude of change that is likely to lead to leakage. Climate change officials agree with stakeholders that for some firms where demand is extremely price sensitive considerably smaller changes will result in leakage. Officials consider that this concern has some merit and propose lowering the threshold to 10% (but retaining the requirement that the firm faces international competition).

Recommendation

Agree that firms be deemed eligible to apply for an NGA where the impact of a \$25 per tonne of CO₂ charge will decrease profitability by more than 10%.

Agree that for the purposes of this test the measure of profitability used be Earnings before Interest and Tax.

Agree that for assessing applications from cooperatives where profitability is not normally defined, climate change officials be responsible for defining an appropriate measure of at risk status based on the change between income and expenses.

Group 3 - The proposed change in profitability criteria is inappropriate as it would be difficult, expensive or impossible to gather the required information, or because more appropriate tests exist. A proposed alternative is that firms are deemed at risk if the rate of profit after the addition of the emissions charge is below the appropriate industry weighted average cost of capital (WACC).

- For new investment the determining factor would be whether the imposition of the emissions charge pushes a project below the appropriate WACC hurdle rate.

Comment

24 Officials agree that if firms' projected profits fall below their WACC due to the imposition of the emissions charge then a prima facie case of competitiveness at risk exists. When the CAR test was initially designed, the use of industry specific WACC criterion was considered but rejected on the basis that there would be endless debate on what constituted a reasonable WACC for any given industry. It seems, however, that amongst major energy users (such as forestry and base metals) there is reasonably wide acceptance of benchmark WACCs. The change in profitability criteria is a good proxy for the risk of leakage, since it is likely to reflect the inability of firms to pass on the cost of the emissions charge to customers. The WACC is more of an absolute benchmark of a firm's viability.

25 However, officials also consider that, because many viable businesses may have a level of annual profit below industry WACC in a given year, and because a level only slightly below WACC would satisfy this criterion, it could be vulnerable to short-term variability and deliberate (but non-fraudulent) manipulation of the relevant variables. Furthermore, some firms and industries have traditionally remained viable despite operating below WACC. Therefore the expected long term average profit should be considered against WACC, not current profit. This is consistent with the normal use of WACC in investment decisions.

26 It is proposed that the Climate Change Office determine which criteria should be applied to a given firm or industry, in consultation with applicants. Factors considered would include the existence of an internationally accepted WACC, the feasibility and cost of obtaining the relevant data, and the historical sensitivity of the firm or industry to performance below WACC. It seems likely that the WACC test would only be viable for firms which produce fairly standard internationally traded commodities such as steel, petrol, cement, paper and so on. For these highly exposed firms, a 10% change in profitability may be an inappropriate test of the risk of leakage. Firms that produce more specialised products would be unlikely to have an accepted benchmark WACC, and are more likely to be in a position to compete internationally despite the impact of the emissions charge on variable costs. Thus we would expect to see larger firms with high energy use applying under a WACC test and smaller firms applying under the change in profitability criteria.

27 Testing of the weighted average cost of capital approach is, in theory, unnecessary as, by definition, firms that are operating below their WACC are in danger of closing. This is likely as returns to investors do not justify the risk associated with investing in that firm. Firms whose returns fall significantly below WACC solely because of the emissions charge will be legitimately at risk and eligible for an NGA. Firms operating below WACC irrespective of

the emissions charge are already of tenuous viability and are unlikely to be saved by exemption from the emissions charge. However, such firms would be at risk and eligible to apply for an NGA as it is not the purpose of the NGA process to close marginal firms.

28 As it may be false to assume that firms operating below WACC are normally in danger of closing, officials consider that further analysis, for example of the historical viability of firms performing below WACC, will be needed to estimate what level of difference between a firm's expected average profit and WACC is "significant" in the sense of placing the firm at risk. Officials will report back on this issue by 30 June 2004 as part of the general report back on the operation and applicability of NGA policy.

Recommendations

Agree that firms be eligible to apply for an NGA where appropriate and verifiable industry weighted average cost of capital exist, and the impact of a \$25 per tonne of CO₂ charge will result in the firm's returns being significantly below the appropriate industry WACC.

Agree that Climate Change Officials, in consultation with applicants, will determine the appropriate criterion to apply for a given firm or industry.

- *Group 4* – There is a need for a simple low cost test for firms that are highly likely to be at risk due to their international exposure and high energy use. Automatic qualifying criteria would reduce administration costs where the result is virtually a forgone conclusion. A similar energy use threshold is used in the Netherlands to identify eligibility for their version of NGAs.

Comment

29 Officials agree that a small number of high energy users or process CO₂ emitters trading internationally are likely to be at risk from the emissions charge and hence eligible for an NGA. A low cost eligibility process is therefore appropriate for such firms.

30 Even with the simplified process and automatic presumption of at risk status for high energy use firms facing international competition, it is still likely that many at risk small and medium sized firms will not be able to access NGAs due to the transaction costs of establishing an agreement. A separate Cabinet paper is being prepared to address the issue of how to encourage small and medium sized firms to reduce their greenhouse gas emissions.

Recommendation

Agree that firms facing significantly increased costs from the charge (due to more than 20% of the firm's expenses arising from direct energy use & emissions) be eligible to apply for an NGA.

Assessment of new entrants or new investment by existing firms

Issue

31 Stakeholders agreed that NGAs should be available to both new entrants and new investment on the same terms and conditions as existing firms as there is no difference in avoiding leakage between existing or new investment/entrants. In both cases the risk is that production investment will be located outside of New Zealand solely to exploit less stringent climate change policies.

32 The proposed use of the WACC and change in profitability criteria allows consistent treatment between new and existing investment, although reasonably anticipated rather than actual figures would be used. Each project would be assessed for its rate of return with and without an emissions charge. Where the emissions charge pushed the investment below its WACC hurdle rate, or reduced profitability by more than 10%, the new entrant/investment would be deemed at risk and eligible for an NGA. Note that the appropriate WACC for a new investment or performance improvement capital expenditure is likely to be higher than normal industry WACCs reflecting the greater risk of these types of investment.

33 Given the difficulties of using projected figures, industry WACCs may be unavailable or inappropriate in some cases. It may therefore be necessary to establish special criteria for assessing specific new entrants or investment.

34 All of the proposed criteria will require projections of future profit under scenarios with and without the emissions charge, as projected, not current, profits are the basis of investment decisions. This will need to take account of other aspects of climate change policy that may mitigate the effect of the charge on profits. The complication with new investment will be the lack of historical data on which to base these projections.

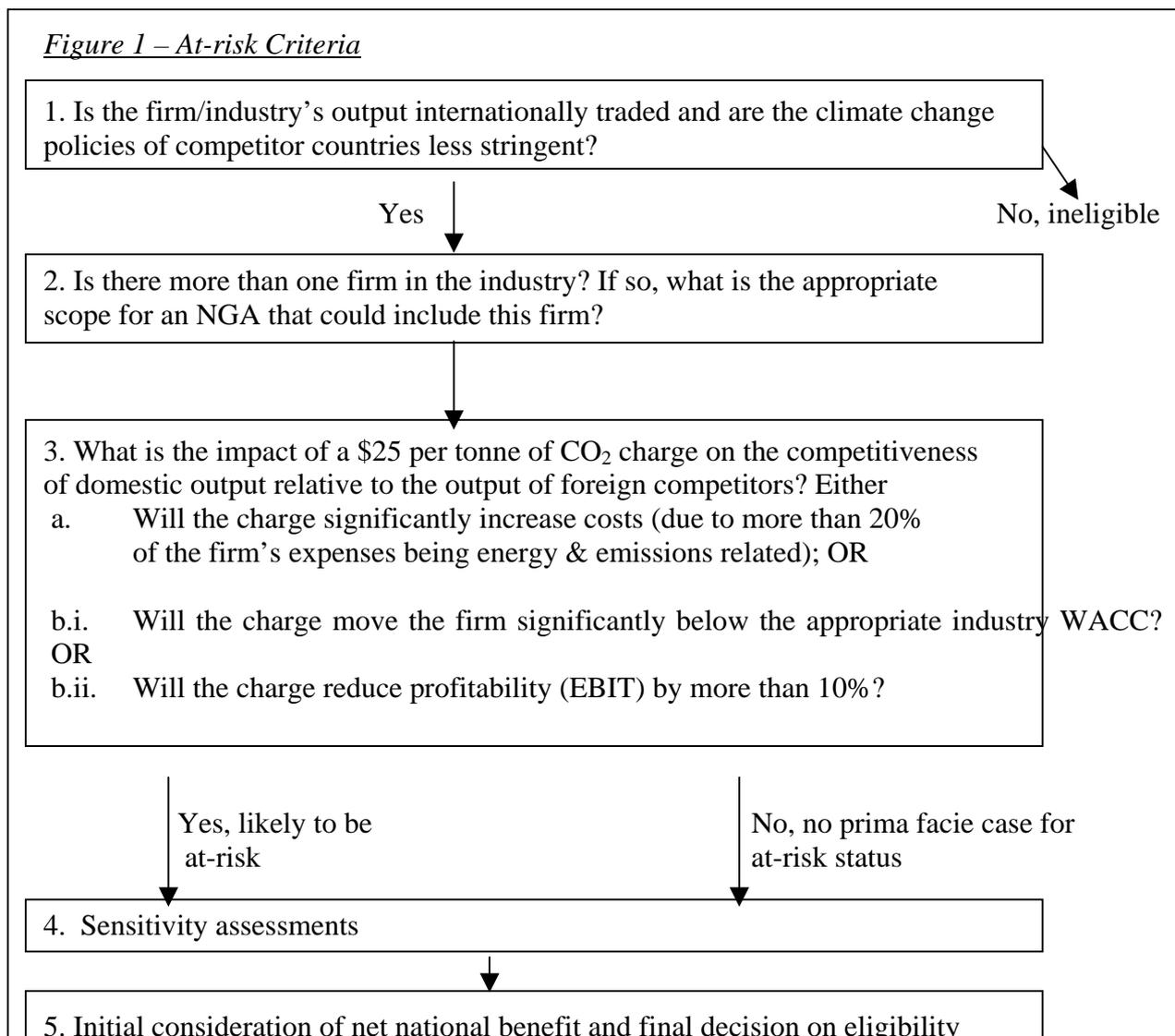
Recommendation

Note that use of the WACC and change in profitability criteria is expected to allow new entrants and new investment to be assessed on a basis consistent with that for existing firms.

Final Five-step assessment approach

35 Based on the above changes Climate Change officials propose the following five step approach to assessing at-risk status:

Figure 1 – At-risk Criteria



36 While an analytical approach has been taken to developing the above criteria, the analysis will need to be augmented with careful judgement. At least at this early stage of implementation of NGA policy, the criteria should be seen as administrative guidelines rather than mechanical rules.

NGA Eligibility Process – Competitiveness At Risk Decision Maker

Issues considered

37 Stakeholders were comfortable with all aspects of the proposed process (see figure 2 below) with the exception of the proposal that the final decision on competitiveness at risk be made by Joint Ministers. The majority of verbal and written submissions questioned the appropriateness of politicians making what they considered should be technical decisions. There were also concerns over:

- the potential for politicising the process;
- a perceived loss of transparency;
- Minister's experience at assessing firm's commercial position;
- what criteria Ministerial decision making will be based on.

Comment

38 In view of feedback proposed shortlist options for the final eligibility decision are:

- Chief Executive of the Ministry for the Environment, as the chief executive responsible for the Climate Change Office; or
- Joint Ministerial decision.

39 The Chief Executive option would provide sufficient status, expertise and independence from negotiations. Having a Chief Executive make a decision on eligibility to negotiate also ensures that Ministers are not compromised on their later decision on the content and scope of any NGA. 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 in the assessment of taxation, approval of sustainable forest management plans and allocation of East Coast Forestry grants, with the respective Chief Executives of the Inland Revenue Department and Ministry of Agriculture and Forestry responsible for final decision making.

40 The main advantage of Ministerial decision making is that Ministers have greater ability to evaluate and make decisions on subjective information. This will be important as for a number of firms there will be considerable uncertainty over whether they are eligible for an NGA. The greater ability of Ministers to make judgement calls is also likely to result in considerable lobbying of Ministers in borderline cases.

41 In most cases where eligibility for a government grant, subsidy or exemption is determined on technical grounds, the level to which decision making is delegated depends upon the frequency and complexity of the decision. Where the decision is frequent and can be readily codified, such as eligibility for social welfare benefits or learner driver licences, eligibility decisions are low level administrative decisions. For frequent, but complex gatekeeping decisions such as eligibility for proposals to be considered for roading or science funding initial eligibility decisions are the responsibility of technical experts guided by broad Government policy guidance. Ministerial decision making is usually only reserved where unique or infrequent decisions are required.

42 Determining firms' eligibility to apply for NGAs will require an ongoing series of technical decisions similar to decisions on eligibility for science or roading funding. Given the repetitive and technical nature of the decision officials consider the advantages of having a chief executive responsible for eligibility decisions outweighs the advantage of greater ministerial discretion on borderline cases. [Withheld under sections 6 (a) and 9 (2)(h) of the Official Information Act].

43 Climate change officials therefore recommended that eligibility decisions be delegated to the Chief Executive of the Ministry for the Environment with Ministers responsible for

setting broad policy guidelines, such as for the treatment of uncertain cases. Delegating responsibility for determining eligibility to negotiate an NGA will not impinge on the Convenor of the Ministerial Group on Climate Change and the Minister of Finance final decisions on whether to grant an NGA to a specific firm.

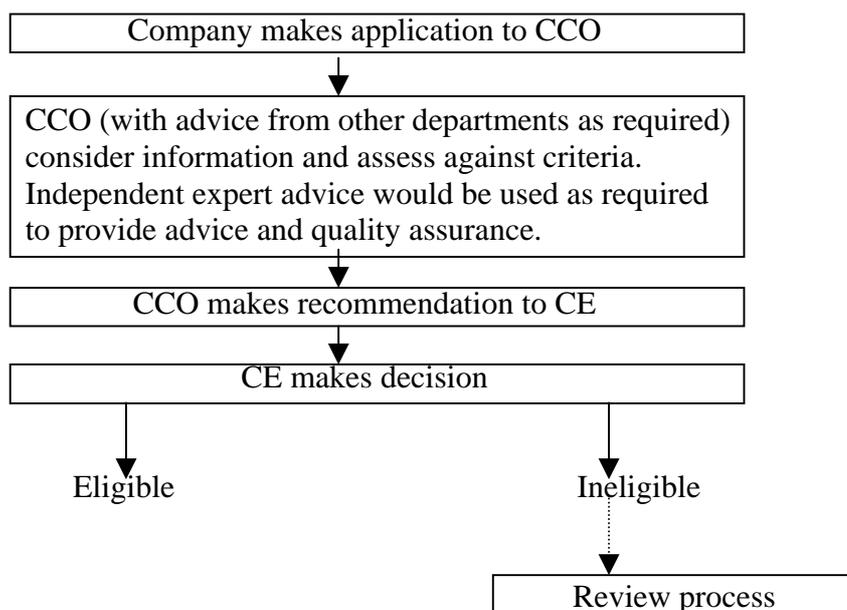
Recommendation

Confirm the proposed process laid out in table 2 below; and either

Agree that the Chief Executive of the Ministry for the Environment be responsible for final decision on firm's eligible to apply for an NGA (Officials' preferred option); OR

Agree that the Convenor of the Ministerial Group on Climate Change and the Minister of Finance be responsible for final decision on eligible of firms to apply for an NGA.

Figure 2: Proposed Process for Applying Criteria



Period of application

44 Stakeholders agreed with the proposal that there be no fixed cut-off date for applying for at-risk status.

Recommendation

Agree that there be no fixed cut-off date for applying for at-risk status.

Applications for NGAs for Parts of Firms Only

Issue

45 For some firms only parts of their operations or particular plants may be competitiveness at risk. In such cases, provided that the process or plant is sufficiently identifiable and can be ring-fenced for the purpose of an agreement, firms should be allowed to seek an NGA for only the at risk part of the firm. Similarly if it becomes apparent to officials during the review of an NGA application that only part of the firm or industry is at risk, then officials should be able to recommend an NGA for only part of a firm or industry.

46 In some cases firms may apply for an NGA, be declined or only be granted a partial exemption and subsequently become at risk. In such cases it is proposed that firms be allowed to reapply for consideration for an NGA or for renegotiation of the extent of the exemption they receive. Further work will be needed on the broader question of how frequently a firm or industry should be able to seek eligibility, as repeated applications from the same firms would be administratively costly.

Recommendation

Agree that:

- applications for NGAs for only part of a firm or industry be acceptable.
- officials be able to recommend that an NGA be granted for only part of a firm or industry.
- firms be able to reapply for an NGA or to have its eligibility reviewed should subsequent events make the industry competitiveness at risk.

Direct officials to report back on how frequently a firm or industry should be allowed to seek reapply for consideration for an NGA.

Criteria for Whole of Industry Agreements

Issue

47 In some cases deeming a firm at risk may raise intra-industry competition issues. If so it may be appropriate, on a case by case basis, to deem the industry as a whole or part of an industry (and new entrants to the industry) at risk and eligible to negotiate collective or individual NGAs. The need to consider part of an industry is due to the difficulty of defining an industry's boundaries. It is important to select the most appropriate set of firms with which to negotiate NGAs.

Recommendation

Agree that in certain cases it may be appropriate to deem an entire industry or part of an industry at risk and eligible to apply to negotiate collective or individual NGAs.

Contents of, and Process for Negotiated Greenhouse Agreements

48 Key elements in NGAs design include:

- World's best practice
- Reporting and milestones
- Consequences and flexibilities
- Exemption
- Review

World's Best Practice (WBP)

Issues Considered

49 In consultation, stakeholders accepted the concept of a pathway for emissions performance overtime with a start point of current emissions performance and an end point of world's best practice (as modified to what is technically and economically feasible for New Zealand industry), provided that WBP is based on existing performance rather than WBP in 2012. Stakeholders are concerned that the uncertainty in forecasting 2012 levels may result in the setting of an unachievable target.

Comment

50 Officials consider that it is important that NGA firms are moved towards WBP emissions performance over time to minimise emissions and ensure that firms maintain their international competitiveness and viability in future years. However, officials acknowledge that in some cases it may not be possible to forecast WBP for the duration of the agreement. In this situation, officials consider that firms should be locked to their WBP commitments at least until 2008 and that any changes in targets through to 2012 then be negotiated. This recognises that the Crown has specific commitments for 2008-2012.

51 As with any contract deviation from the terms of the contract can be achieved on a case by case basis by mutual agreement of the parties involved. In practice, review clauses in individual NGAs should determine what changes in circumstances can trigger reviews.

52 In some cases it is possible that WBP targets will not exist or will be prohibitively expensive to ascertain. Climate change officials recommend that in such cases challenging WBP targets be agreed by negotiation between the parties.

Recommendation

Agree that emissions intensity targets will, where possible, be based on WBP (as modified to what is technically and economically feasible in the New Zealand context) as forecast over the duration of the agreement.

Agree that once set NGA targets cannot be varied prior to 2008 and can be varied after 2008 only upon mutual agreement of the parties involved.

Agree that where WBP targets do not exist or cannot be ascertained at reasonable cost appropriate challenging targets be agreed by negotiation.

Milestones and Reporting

Issues considered

53 In consultation, stakeholders accepted the concept of milestones and milestone reports at specified times during the agreement at which time performance against targets would be assessed. Experience from the negotiations with the New Zealand Refining Company (NZRC) suggests that the timing of these milestones should be influenced by the specific investment profile of the firm, rather than be generically determined. While this may reduce flexibility in trading over and under performance amongst NGA participants (if there is no access to the international market), officials consider it more important to match milestones with a firm's investment and subsequent operational profile.

54 In addition to milestone reports, officials consider that NGA participants should be required to submit annual reports on performance. This approach has been taken with NZRC and includes a requirement for NZRC to justify its performance if insufficient progress has been made. This "no-surprises" approach will assist the Government in managing its emission liabilities.

55 Officials consider that while it is desirable for the milestone and annual reports to be audited and verified, this may be administratively difficult and costly. As an alternative, officials recommend that milestones be audited and that the government retain a "right of enquiry" that it may exercise at its discretion.

Recommendations

Agree that:

- There be milestones for assessing performance against targets;
- The timing of milestones be influenced by the investment and subsequent operational profile of the firm and the Government's international reporting requirements;
- Audited milestone reports be submitted for each milestone period; and
- There be annual reports on performance.

Consequences and Flexibility Provisions

Issues considered

56 In consultation, stakeholders generally accepted the need for positive and negative consequences and were very supportive of the flexibility provisions.

Comment

57 Building on experience with NZRC and stakeholder feedback, officials consider the best balance is achieved through the following combination of flexibilities and consequences:

- Milestone report submitted and performance assessed

- Where there are excess emissions the firm would have a specified period of time (ie 60 days) to comply through the flexibility provisions by:
 - investing in offsite projects to offset emissions; and/or
 - purchasing emission units; or
 - paying an equivalent charge if there is no functioning market; or
 - carrying over excess emissions to a future milestone period.

Failure to comply within specified period would result in a 30% penalty. This is the approach taken under the Kyoto Protocol where failure to comply results in a requirement to purchase 1.3 emission units for every tonne of excess emissions.

Failure to rectify and pay penalty within a specified period of time (i.e. 30 days) would result in termination of the agreement.

- Where the firm has over achieved its target, it may achieve value for those reductions through:
 - Selling its overachievement (emission units)
 - Banking the emission units for a future milestone period

Recommendations

Agree that:

- NGA participants will have access to flexibility provisions including offsite projects, trading of under and over achievement, and carry overs
- Failure to rectify emissions in excess of target within 60 working days of written notification will result in a 30% penalty;
- Failure to pay the penalty and rectify within 30 working days of written notification will result in termination of the agreement

Exemption

Issues Considered

58 There are three key issues regarding the emissions charge exemption: coverage, level and giving it effect prior to the enactment of the emissions charge itself.

Comment

59 Officials consider that the coverage of an exemption should be consistent with the coverage of the at-risk assessment. As a consequence, business activities that are not considered at-risk would not receive an exemption. This also means that that both direct and indirect (e.g. electricity) inputs could be covered by the exemption if they are material and reasonably quantifiable. Stakeholders supported this principle.

60 Officials consider that where a clear decision has been made about the CAR status of a firm – i.e. there is a high degree of confidence about at risk status – then a full exemption would be the expected outcome of an NGA provided that WBP targets can be agreed. Partial exemptions might occur where only parts of a business are deemed to be at risk or where there is doubt about a firm's status and the Government might wish to hold back on a full exemption. The Government should, however, reserve the right to modify the level of exemption based on the assessment of net national benefit.

61 Officials also consider that the scope and level of exemption should be tied to specific firms and processes. Consequently, in the case of takeover or change in ownership of the firm or business unit the coverage of the NGA should extend no further than the exemption granted prior to the change in ownership.

62 As indicated in December 2002, there is pressure from stakeholders for the Government to provide certainty that the emissions charge and any negotiated exemption will be given effect in future. One solution is of the Government to commit that its intention would be to hold the firm “harmless” from the material and reasonably quantifiable impacts of an emissions charge on production costs. This approach was accepted by NZRC.

63 The form of exemptions has yet to be determined, since it will depend on the design of the emissions charge – particularly the location of points of obligation relative to the firm. For example, “exemptions” may mean rebates, refunds, or credits. The phrase “holding the firm harmless” does not necessarily mean exempting emissions produced after production: they will not cover, for example, the emissions from fuel supplied to NZRF customers, since imported fuels will be subject to the charge.

Recommendations

Agree that:

- the coverage of an exemption be consistent with the coverage of the at-risk assessment including direct and indirect (e.g. electricity) inputs if they are material and reasonably quantifiable;
- the form of any exemption will depend on the final design of the emission charge, and could include refunds, rebates or credits rather than “exemptions” per se;
- the level of the exemption be linked to the degree of confidence about the at risk status of the firm and the net national benefit of the exemption;
- exemption commitments given prior to the detail design of the emission charge be based on the principle of a commitment to hold the firm “harmless” (or part there of) from the material and reasonably quantifiable impacts of an emissions charge on production costs; and
- In the case of takeover or other change of ownership of the firm or business unit the coverage of the NGA extends no further than the scope of the exemption granted prior to the change in ownership.

Review

Issues Considered and comment

64 Review is an important component of an NGA and becomes more relevant the longer the term of agreement. Review allows the key components of the agreement to be recalibrated and could include:

- at-risk status and exemption level;
- WBP and targets (where it is not possible to forecast WBP for the entire term of the agreement, or where WBP has been overestimated in the original agreement);
- flexibility provisions (i.e. whether there is a functioning emissions market and if not what emissions price will apply for excess emissions);

Recommendations

Agree that:

- Review is an important component of an NGA; and
- The timing of reviews be determined on a case by case basis as influenced by the investment and operational profile of the firm, information availability duration of the agreement and the Government's international obligations in terms of reporting.

Other Issues

Negotiation of Industry Agreements

Issue

65 It is possible that an entire industry may seek a collective NGA. It is proposed that such industry wide NGAs be allowed contingent upon:

- the industry as a whole being deemed at risk and eligible to negotiate an NGA
- the existence of a suitable industry body or agreed representative;
- industry processes being sufficiently homogenous that an appropriate WBP target(s) can be identified for the industry;
- there is industry agreement on cost sharing between members and certainty of the industry body being able to enforce this agreement; and
- the ability to clearly identify industry participants that would be subject to an industry agreement.

66 It is proposed that apart from the number of companies covered by the agreement, industry NGAs operate under the same conditions and processes as other NGAs. However, in view of the uncertainty over how industry NGAs may operate in practice it may be necessary to trial the existing approach and return to Cabinet if problems are encountered in implementing the existing policy.

Recommendation

67 Agree that, in principle, industry wide NGAs be allowed contingent upon:

- the whole industry being deemed at risk and eligible to negotiate an NGA
- suitable industry body or agreed representative existing;
- industry processes being sufficiently homogenous that appropriate WBP target(s) can be identified for the industry;
- there is industry agreement on cost sharing between members and certainty of the industry body being able to enforce this agreement.

Net National Benefit Criteria

Issue considered

68 Stakeholders sought assurance that the net national benefit test would provide an opportunity for all other relevant factors to their application to be considered.

Comment

69 The proposed methodology for weighing up the net national benefits is outlined below. This assessment balances the benefit to the economy from preventing economic disruption against the cost of paying for NGA firms' emissions until those firms again become internationally competitive. Climate Change Office Officials propose that the objective parts of the net national benefit calculation need to be balanced by subjective information to ensure that firms have a full opportunity to make their case and that the Government can consider all aspects of the national interest.

Proposed Methodology for Net National Benefit Assessment

70 Determining net national benefit requires assessing the costs of granting an exemption versus the benefits of preventing leakage. The cost of granting an exemption include:

- the opportunity cost of emission reductions foregone (as by definition the Crown will be covering emissions that would otherwise not occur in New Zealand due to leakage) less emissions reductions that will be achieved by the firm in meeting WBP targets;
- the cost of distortions imposed on the economy by providing a relative cost competitiveness advantage to one firm or industry over other firms who pay the emissions charge (dynamic and allocative efficiency) less the costs placed on firms in meeting WBP targets (these will be less than the cost advantage otherwise firms would simply pay the emissions charge);
- transaction costs of negotiating, monitoring and enforcing an NGA – this includes direct fiscal costs as well as businesses' costs and compliance cost of monitoring and enforcing the NGA;
- reduced benefits from revenue recycling from the emissions charge; and

- potential slowing of the adoption of less emitting technologies as a result of insulating firms from price signals (moderated by careful management of the WBP target and timetable).

71 Of the above costs it is likely that the last two will be trivial. Of the others the magnitude of efficiency distortions are notoriously difficult to estimate with any degree of precision within reasonable cost.

72 The potential benefits of granting an exemption include:

- maintenance of economic activity;
- encouragement of investment activity (vis-a-via countries with less stringent climate change policies);
- possible regional development benefits;
- the reduction in worldwide emissions by preventing leakage to a country with less stringent climate change policies;

73 There are clear costs and benefits on both sides. A key question is the time and effort that should be expended in precise measurement. Overall, given the difficulty and cost of estimating several of the above factors with any degree of precision it is proposed that the net national benefit comprise an objective and subjective element. The objective test would focus primarily on an assessment of the first cost and benefit bullet points only (net cost versus economic contribution). This calculation could then be rebalanced to include consideration of more subjective factors such as regional and investment benefits against a subjective assessment of the magnitude of distortions created.

Recommendation

Agree to the proposed net national benefit assessment whereby the costs of granting the exemption are balance against the firm or industry's economic contribution. This assessment can be rebalanced by inclusion of other relevant factors including

- the costs of negotiating, monitoring and enforcing an NGA,
- reduced benefits from revenue recycling from the emissions charge;
- slowing of the adoption of less emitting technologies
- encouragement of investment activity
- regional development benefits;
- the possible reduction in worldwide emissions by preventing leakage;

Agree that firms be allowed to submit any additional information they consider relevant as part of the net national benefit test.

Process for Negotiating Agreements

74 Stakeholders were comfortable with the proposed process for negotiating agreements.

75 Officials recommend Cabinet confirm the process for negotiation an NGA be:

Figure 3 Proposed Process for NGA negotiations

1. Government offers to negotiate with the at-risk firm. Officials prepare negotiation brief for approval by Ministers
2. Parties meet to develop a negotiation plan
3. Parties appoint joint advisor on world's best practice
4. Negotiation
5. Officials produce a report on the framework for the agreement ("heads of agreement") for ministerial approval to begin legal drafting of agreement
6. Legal drafting
7. Officials make recommendations to Ministers and parties take decisions on whether to ratify the agreement

Recommendations

Agree

- the NGA negotiation process identified in figure 3
- That responsibility for assessing progress against the target (including 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).

Cost Sharing for Eligibility Assessments and NGAs

76 Stakeholders considered that the proposed approach of applicants and the Government covering their own costs for both eligibility assessments and NGA processes was appropriate. Stakeholders also considered that all external costs (such as independent experts to identify WBP and legal drafting) should be equally shared to:

- ensure that all consultants have a duty of care to both parties;
- recognise that both parties benefit from the NGA (emissions reduction and maintenance of economic activity to the Government, avoidance of the emissions charge to firms);
- encourage both parties to minimise costs;

- in the case of applications, to minimise the barriers to at risk firms seeking exemptions.

77 Climate Change Office officials consider that some cost sharing between government and applicants is appropriate in assessing at-risk status as the benefits of preventing leakage are shared by the firm and the government (through contributing to lower international emissions). In the context of the CAR assessment, such sharing would probably be achieved by having applicants and Government paying their own costs including any external consultants that may be required by either side to make the case or assess the case respectively.

78 Climate Change Office officials also consider that the government should make a contribution, to be negotiated, for any third party costs incurred in negotiations such as establishing emissions baselines and world's best practice. This will ensure that consultant owe a duty of care to the Crown, and will enable the data obtained through this process to be used, with suitable protections to inform wider Climate Change work and possibly for other purposes with the consent of the relevant companies.

Recommendations

Agree that:

- applicants and the Crown meet their own costs of assessing eligibility and negotiating an agreement;
- applicants and the Crown equally share any third party costs incurred in the considerations of competitiveness at risk status;
- the Crown make a contribution to the any joint third party costs incurred as part of the negotiation of an NGA (to recognise the joint benefits fro this work and to establish a duty of care to the Crown). The level of contribution would be negotiated; and
- NGA firms be responsible for annual performance reports and audits.

Review of NGA Policy

79 In view of the considerable uncertainty surrounding key aspects of climate change policy such as structure of the emissions charge, the form of revenue recycling and also due to uncertainty over how workable several aspects of the NGA policy will prove in practice it is proposed that officials be directed to report back to Cabinet by 30 June 2004 on the operation of the NGA policy. This report back will cover experience with NGAs to date, the applicability of the proposed assessment criteria, the NGA process and any recommended improvements to the NGA policy.

Recommendations

Direct officials to report back to Cabinet by 30 June 2004 on:

- Experience with NGAs to date;

- Applicability of the proposed NGA eligibility criteria and processes; and applicants and the Crown equally share any third party costs incurred in the considerations of competitiveness at risk status; and
- Recommended improvements to the NGA policy.

Financial Implications

80 The direct 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 covering emissions (or foregone sink credit revenues) over 2008-2012;
- changes in tax revenues and costs of economic dislocation from economic leakage;
- emissions charge revenue - this will not be used to improve the Crown's fiscal position, but may, through revenue recycling, help to mitigate some of the impact of the charge and hence the number of NGAs required;
- 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.

81 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.

82 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 depend on individual agreements and cannot be reliably estimated at this time.

83 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.

84 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 for \$1.125 million for 2003/04 and 2004/05 and for \$0.562 million for outyears (all GST inclusive) has been submitted in the 2003/04 Budget to cover the direct costs of out-year negotiations of the Climate Change Office and departments involved in negotiations.

Indirect economic implications of NGAs may also include

- The more NGAs there are the less revenue there will be available from the tax for recycling and the greater the administration costs associated with the tax are likely to be. This may reduce the efficiency of the tax and undermine the Government's revenue and tax policies;
- NGAs will be sheltering major emitters from the emissions charge and may result in inefficient firms being supported and distort investment decisions from low emitting

firms to protected firms. These costs will be exasperated if large numbers of ineligible firms receive NGAs due to uncertainties as to their correct status; and

- The risk that NGA firms will not be able to adapt sufficiently to be competitive by the end of the NGA. A decision on what to do in these cases will need to be informed by what is occurring in international climate change policy at the time but as a default NGAs should not be eligible for extension.

[

[Withheld under sections 6(a) and 9(2)(h) of the Official Information Act]

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Consultation

85 The following departments have been consulted in the development of this paper: the State Services Commission, Inland Revenue Department, the Department of Prime Minister and Cabinet, 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. Their feedback has been incorporated in this paper.

Treaty of Waitangi Implications

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

Legislative Implications

87 Implementation of an emissions charge and exemptions will require legislation. This was discussed in the paper “Climate Change: Work Programme for Emissions Charge and Revenue Recycling”.

88 Officials will develop the detail for the NGA process with advice from Crown Law as required. Since NGAs will involve exemptions from revenue provisions in the emissions charge legislation, they may need to be provided for legislatively, whether case-by-case or (more likely) by empowering the Governor-General to make NGA regulations. Enforcement of NGAs may also require legislation.

Recommendations

It is recommended that the Committee:

1. **Note** that in October 2002 Cabinet directed officials to consult with stakeholders on the proposed criteria for determining whether a firm is competitiveness-at-risk and eligible to negotiate an Negotiated Greenhouse Agreements and institutional arrangements for the NGAs and report back to Cabinet;
2. **Note** that Cabinet has previously agreed that new climate change policies (including NGAs) for the first commitment period will not be implemented until the Kyoto Protocol comes into force.
3. **Note** that the main feedback from consultation concerned:
 - a. the level and appropriateness of the proposed criteria;
 - b. the appropriateness of political decision makers in determining eligibility; and
 - c. the equity of the proposed cost sharing regime.

Regarding Proposed Competitiveness at Risk Criteria

4. **Confirm** that NGAs be limited to firms or industries that, as a result of an emissions charge, face significant risk to their competitiveness relative to producers in countries with less stringent climate change policies.
5. **Agree** that the following principles should guide decision making on eligibility assessments:
 - NGAs should contribute to the Government's overall climate change objective that New Zealand will make significant greenhouse gas reductions on business as usual and be set towards a permanent downward path for total gross emissions by 2012.
 - Eligibility assessment processes should be simple and low cost to reduce barriers to at risk firms accessing NGAs;
6. **Note** that the second of the principles above is more likely to result in competitiveness at risk firms being able to apply for and receive NGAs, but is also likely to result in some firms who are not at risk also receiving NGAs;
7. **Note** that the number of NGAs granted has implications for the efficiency of any emissions charge;
8. **Agree** the proposed five step approach (see Figure 1, page 10) to assessing at-risk status;
9. **Note** that under the proposed five step approach firms or industries will be eligible to apply for an NGA if as a result of the charge:

- the firm would face significant cost increases (due to more than 20% of the firm's total expenses arising from direct energy use & emissions); OR
 - an appropriate and verifiable industry weighted average cost of capital exists, and a \$25 per tonne of CO₂ charge would result in the firm's returns being significantly below the appropriate industry WACC; OR
 - a \$25 per tonne of CO₂ charge will decrease profitability (earnings before interest and tax) by more than 10%.
10. **Agree** that Climate Change Officials, in consultation with applicants, will determine the appropriate criterion to apply for a given firm or industry;
 11. **Note** that the use of reasonable projected (WACC and change in profitability) estimates should allow new entrants and new investment to be assessed on a basis that is reasonably consistent with that for existing firms;
 12. **Agree** that for assessing applications from cooperatives where profitability is not normally defined, climate change officials be responsible for defining an appropriate measure of at risk status (based on the change in income and expenses);
 13. **Note** that the proposed criteria provide indicative rather than conclusive proof of at-risk status and the final assessment of at risk status may require some subjective judgement;
 14. **Note** that some at risk small and medium sized enterprises will be unable to access NGAs due to cost. A separate report to Cabinet is being prepared on this issue;

Regarding Process for Applying the Competitiveness At Risk Criteria

15. **Agree** the proposed process for applying competitiveness at risk criteria (see figure 2 page 12);
16. **Agree** that the Climate Change Office be responsible for collecting the information for at-risk assessments, application of criteria, and recommendation on status;

EITHER (Climate Change Office)
17. **Agree** that the Chief Executive of the Ministry for the Environment be responsible for final decisions on firms' eligibility to apply for an NGA;

OR (Previous Cabinet decision)
18. **Agree** that the Minister of Finance and the Convenor of the Ministerial Group on Climate Change be responsible for final decisions on firms' eligibility to apply for an NGA.

Regarding Competitiveness At Risk Applications

19. Agree that:

- a. there be no fixed cut-off date at this time for application for at-risk status;
- b. firms rejected for an NGA or only offered a partial exemption be eligible to reapply if they can demonstrate that due to changing circumstances they should now be eligible, or eligible for a greater exemption;
- c. new entrants and new investment be subject, as far as possible, to the same rules and application process as existing firms;
- d. applicants can apply for at risk status for only part of a firm (e.g. for a specific process, plant or regional activity) provided that the coverage of a partial exemption can be clearly identified for the purposes of an NGA;
- e. where officials consider that only part of a firm or industry is at risk then officials can recommend that only that part of the firm or industry be eligible for an NGA;
- f. in certain cases it may be appropriate to deem an entire industry at risk and eligible to apply to negotiate collective or individual NGAs.

Regarding Negotiated Greenhouse Agreements

20. Agree that; unless specifically modified in individual NGAs:

- a. Industry or part-industry agreements be allowed where the granting of an NGA to an individual firm would otherwise raise intra-industry competitiveness concerns and
 - the industry or part-industry is deemed at risk and eligible to negotiate an NGA;
 - a suitable industry body or agreed representative exists;
 - industry processes and structure are sufficiently homogenous that appropriate WBP target(s) can be identified for the industry;
 - there is industry agreement on cost sharing within the industry and certainty that the industry body will be able to enforce this agreement; and
 - industry participants who would be subject to an industry agreement can be clearly identified.
- b. Emissions intensity targets will, where possible, be based on World's Best Practice (as modified to what is technically and economically feasible in the New Zealand context) as forecast over the duration of the agreement;
- c. Agree that once agreed NGA targets cannot be varied prior to 2008 and can be varied after this date only upon mutual agreement of the parties involved;

- d. Agree that where WBP targets do not exist or cannot be ascertained at reasonable cost, then appropriate challenging targets be agreed by negotiation;
- e. There be milestones for assessing performance against targets;
- f. The timing of milestones be influenced by the investment profile of the firm and the Government's international reporting obligations;
- g. Audited milestone reports be submitted for each milestone period;
- h. There be annual reports on performance;
- i. NGA participants will have access to flexibility provisions including offsite projects, trading of under and over achievement, and banking;
- j. Failure to rectify emissions in excess of target within 60 working days of written notification will result in a 30% penalty;
- k. Failure to pay the penalty and rectify within 30 working days of written notification will result in termination of the agreement;
- l. The form of any exemption will depend on the final design of the emission charge, and could include refunds, rebates or credits rather than "exemptions" per se;
- m. The coverage of an exemption be consistent with the coverage of the at-risk assessment including direct and indirect (e.g. electricity) inputs if they are material and reasonably quantifiable;
- n. The level of the exemption be linked to the degree to which the firm is at-risk and the net national benefit of the exemption;
- o. Exemption commitments given prior to the detailed design of the emission charge be based on the principle of a commitment to hold the firm "harmless" from the material and reasonably quantifiable impacts of an emissions charge (or part thereof);
- p. In the case of takeover or other change of ownership of the firm or business unit the coverage of the NGA extends no further than the scope of the exemption granted prior to the change in ownership;
- q. Review is an important component of an NGA; and
- r. The timing of reviews be determined on a case by case basis as influenced by the investment and operational profile of the firm, information availability, duration of the agreement and the Government's international reporting obligations.

Regarding Net National Benefit Assessment

21. **Agree** that the net national benefit assessment comprise an objective and subjective element and that:
 - a. the objective element would focus primarily on an assessment of the net cost to the Government of granting an exemption versus the total economic contribution of the applicant; and
 - b. the objective element would then be rebalanced by consideration of subjective factors such as, but not limited to, regional and investment benefits versus economic efficiency distortions.
22. **Agree** that firms be allowed to submit any additional information they consider relevant as part of the net national benefit test.

Regarding Process for Negotiating Agreements

23. **Agree** the negotiation process identified in Figure 3 (page 21);
24. **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;
25. **Agree** That responsibility for assessing progress against the target (including 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).
26. **Agree** that the Minister of Finance and the Minister responsible for the Climate Change Office (Convenor, Ministerial Group on Climate Change) be delegated authority to finalise and sign Negotiated Greenhouse Agreements on behalf of the Crown;

Regarding Review of NGA Policy

27. **Direct** officials to report back to Cabinet by 30 June 2004 on:
 - How frequently firms or industries should be allowed to reapply for eligibility, or renegotiation of an NGA;
 - consideration of Experience with NGAs to date;
 - Applicability of the proposed NGA eligibility criteria and processes; and
 - Recommended Improvements to the NGA policy.

[Withheld under sections 6(a) and 9(2)(h) of the Official Information Act]

28. [Withheld under sections 6(a) and 9(2)(h) of the Official Information Act]

29. [Withheld under sections 6(a) and 9(2)(h) of the Official Information Act]

Regarding Financial Implications and Cost Sharing

30. **Note** that the estimated cost to the Crown of negotiating NGAs is anticipated to be \$50,000 to \$100,000 per agreement;
31. **Note** that the costs of NGAs negotiated in the 2002/03 financial year can be covered within existing Vote Environment baselines;
32. **Note** that a bid of \$1.125 million for 2003/04 and 2004/05 and for \$0.562 million for outyears (all GST inclusive) has been made as part of the 2003/04 Budget for funding to cover the costs to the Crown of negotiating NGAs;
33. **Agree** that for competitiveness at risk applications, applicants and the Crown will each pay their own costs associated with the assessment (including the provision of information) while all other costs such as external consultants will be equally shared between the parties;
34. **Agree** that for NGA negotiations, applicants and the Crown will each pay their own costs associated with the assessment (including the provision of information) and the Crown make a contribution to the any joint third party costs incurred as part of the negotiation of an NGA (to recognise the joint benefits fro this work and to establish a duty of care to the Crown); and
35. **Agree** that applicants be responsible for the cost of performance reports and audits.

Hon Pete Hodgson
Convenor, Ministerial Group on Climate Change

Appendix – Description of Weighted Average Cost of Capital

The term weighted average cost of capital refers to the fact that firms use both equity (from shareholders) and debt (from banks and other lenders) to finance their operations. The cost of each of these sources of funding is different because of, among other things, the difference in the tax treatment of debt and equity.

The cost of a businesses capital is therefore a weighted average of the cost of equity and debt with the weights equal to the proportions of equity and debt that the firm has (the “capital structure”).

The level of WACC will vary between industries and firms due to the relative risk of the industries and the specific characteristics of the firms inside the industry. For example technology stocks are usually more risk than manufacturing band small companies more risky than large ones. For more risky ventures a higher rate of return will be demanded.

The importance of WACC is that if a firm is earning below its WACC (i.e. the return the market demands from it) then investors will typically divest from the firm. This divestment can include closing plants in one country and moving to more lucrative locations.

If an industry has an internationally accepted WACC then if the firm is operating below this level it is an indication that the firm is at risk of closing as the owners can get better returns for their money elsewhere.