

Cover Note – “Climate Change: The Projects Mechanism – Details and Process” [Ref: POL (03) 45]

On Wednesday 26 March 2003, Cabinet Policy Committee considered the paper “Climate Change: The Projects Mechanism – Details and Process” (Ref: POL (03) 45). This paper and the associated POL Minute (Ref: POL Min (03) 6/4) are included.

1. 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”.

2. Please note that the information concerning the timetable for the exploratory round in the paper in paragraph 62 especially is no longer applicable. For more information concerning the proposed timing of tender round one, please follow the Projects link on the climate change web site for any updates.

Chair
Cabinet Policy Committee

CLIMATE CHANGE: THE PROJECTS MECHANISM – DETAILS AND PROCESS

Purpose

1. This paper seeks agreement to the detail and process for the Climate Change Projects mechanism so that the mechanism can be operational by June 2003.

Executive Summary

2. The Projects mechanism is a key component of the Government's climate change policy and involves the provision of an incentive to generate greenhouse gas emission reductions that go beyond business-as-usual. These additional emission reductions lower New Zealand's liabilities during the Kyoto Protocol's first commitment period¹ (2008-2012) and offset the incentive provided.

3. This paper reports on the following elements of the Projects mechanism:

- feedback from the workshop held on January the 28th 2003 where a draft model of the mechanism was presented;
- the issue of eligibility, and in particular:
 - to give effect to additionality (to ensure that the project incentive does not go to "business-as-usual" proposals); and
 - to avoid overlaps with complementary climate change policies;
- issues around the nature and timing of the incentive;
- the assessment of proposals, the means of ensuring contestability between proposals, and taking account of climate change and other Government policy objectives;
- a proposed project cycle along with proposals for the composition of the assessment team and the decision-maker;
- legislative and budget consequences; and
- actions required leading up to the exploratory round.

4. The decisions in this paper concerning the Projects model and institutional arrangements will enable work to proceed on the implementation of the exploratory round, including development of the required documentation and publicity to advise applicants and allow preparation of proposals. The subsequent report back on Project Agreements is necessary to complete the exploratory round. This report back deadline is recommended to be brought forward to 31 May 2003, from 30 June 2003, to facilitate prompt implementation of the exploratory round.

¹ Please note that the Kyoto Protocol's First Commitment Period is generally abbreviated to CP1.

Context

5. In the climate change papers considered by Cabinet in October 2002, reporting deadlines were set for various key elements of the climate change package. For the Projects mechanism three separate deadlines were set (Cab Min (02) 28/18 refers). The first report-back, considered by POL on the 4th of December 2002, concerned the agency responsible for the mechanism and the Government's intention to operate an exploratory projects round early in financial year 2003/2004 (POL Min (02) 21/14 refers).

6. This paper concerns the second report-back and seeks agreement to the detail of the Projects policy, including a process for Projects and any necessary legislation requirements. The final report-back, due by 30 June 2003, covers the nature of Projects agreements that will be required between the promoters of successful Projects and the Government.

Feedback from the January 28th workshop

7. A draft outline of the mechanism was presented to a generally well-attended full-day workshop held on January the 28th 2003. Almost 100 non-officials attended, indicating wide interest in the mechanism. A number of Māori businesses were invited to the workshop, but none attended. A good proportion of the day was spent explaining elements of the proposed model and noting the concerns of potential project proponents. Several brief submissions were received soon after the workshop. Views received have been incorporated to the extent possible and are summarised as Annex 1.

Key elements of the mechanism

8. The mechanism aims to contribute to New Zealand meeting its Kyoto Protocol emissions obligations by providing incentives for projects that reduce emissions below business as usual during the Protocol's first commitment period. The key design elements of the mechanism include: eligibility requirements; the timing and nature of the incentive provided; the assessment process; and institutional arrangements necessary for Projects.

Eligibility

9. Cabinet has previously decided that to be eligible for the Projects mechanism a proposal must pass an additionality test to ensure that the support is required and that there are emission benefits for New Zealand (Cab Min (02) 13/10 refers). This additionality assessment has been broken into two main components. Some other eligibility requirements are also proposed, related to size of abatement and managing overlaps with other climate change policies.

Eligibility – investment additionality

10. Investment additionality relates to the need for the incentive to ensure that the proposal proceeds, i.e. it is additional to business as usual. It requires answers to the questions:

- would it have proceeded anyhow?
- when might it have proceeded anyway?
- under what circumstances might it proceed?

11. To address these questions necessarily involves judgements concerning an uncertain future. Workshop participants expressed concerns about its potential complexity and the need to access potentially confidential information concerning investment analysis. These concerns have been noted and the proposed approach balances simplicity with the need to assure the Government that the incentive is not being applied to business as usual proposals.

12. The scheme administrator would provide a set of standard assumptions (such as emission and electricity price profiles) that are to be used in applications. The onus would then be on the applicant to show that the proposal is not business as usual by reporting outcomes from an investment model of the proposal, firstly applying the standard assumptions provided and secondly using their own judgements if they differ significantly. In addition, if there are any non-economic barriers that mean the proposal is unlikely to proceed; then the applicant is invited to outline them and to show how project support addresses the barrier.

Eligibility – environmental additionality

13. A project will only be eligible if it demonstrably achieves real net emission abatement. The project must reduce emissions that are counted in New Zealand's greenhouse gas emissions inventory and consequently have a direct impact on reducing the Crown's liability for emissions in CP1. The environmental additionality test will be used to establish whether a project achieves real abatement beyond business as usual as indicated by its proponents, and quantifying any abatement so that it can be accurately incorporated in the subsequent assessment of the project.

14. Emission benefits need to be based on a plausible counter-factual analysis for the life of the project (at least to 2012 and possibly longer if post-2012 abatement is given any weight in assessment) demonstrating what emissions would occur in the absence of the project. A conceptual boundary will need to be established for a project to determine what emissions are considered to be material and will need to be monitored through its life. Any trade-offs or potential leakage issues² across the boundary need to be identified and accounted for.

15. It is anticipated that proponents will be asked to carry out their own assessment of the emissions abatement to be achieved, based on simple principles and some standard emission factors.

16. For energy efficiency and renewable energy projects, indirect emissions from grid purchased electricity will be an important part of determining the emission benefits. It is intended that an electricity emission factor (tonnes CO₂ abatement to be claimed per GWh of electricity reduction) will be published for each Projects round. The emission factor would be based on a 'most likely' scenario for the generation

² Leakage refers to effects where a project achieves abatement but generates actual or potential increased emissions elsewhere.

market through to 2012. It would be updated before each Projects round, if necessary, to reflect any new market information available and to take into account the impact of any projects committed from previous rounds.

Eligibility – application of additionality tests

17. The assessment team will carry out the financial assessment (required for investment additionality) and the technical assessment (required for environmental additionality) based on the information supplied by the proponent. From that point, the assessment team would be able to accept the proposal, unaltered, or reject it as non-additional, if the information supplied is clear-cut and supports either outcome.

18. It is likely that for some proposals the assessment team may disagree with the proponent's claims for the level of abatement or the level of support required. In this case the assessment team would have the ability to invite proponents to modify their proposals so that these claims are sound and so that the proposal can be ranked accurately. If there is no agreement on such modification, the proposal would either be rejected or allowed to proceed to assessment with appropriate consideration of the risk that such disagreement creates.

Eligibility – other

19. Three other broad eligibility criteria are recommended, a size of abatement threshold, a limit on units claimed relative to abatement delivered in CP1, and the management of overlaps with other climate change policies.

A size threshold

20. Projects schemes internationally apply a size threshold for proposals for reasons such as managing the transaction costs of both parties, the potentially significant costs of processing a high number of proposals and the monitoring and verification costs for a portfolio of projects. Workshop participants were very strong in their views that the suggested threshold of 100,000 tCO₂(e)³ over CP1 (or 20,000 tCO₂(e) per annum) was too high and would exclude many industrial heat load or smaller scale renewable energy proposals.

21. Assuming that the effort put into assessment of proposals is related to their size; then a significant reduction in the size threshold is considered desirable. It is proposed to apply a size threshold for the exploratory round of 10,000 tCO₂(e) over CP1 on the basis that it would facilitate the participation of typical sized industrial and commercial heat loads and if the transaction costs are too high for applicants, then that itself will discourage participation. For example a 3.5 MW wind farm would reduce emissions by about 25,000 to 30,000 tCO₂(e) over CP1 and a typical 5 MW geothermal plant would reduce emission by about 175,000 tCO₂(e) over CP1. This threshold is likely to facilitate participation by some but not all small to medium enterprises (SMEs).

22. Due to the low size threshold proposed, it is possible that a large number of proposals may be received for the exploratory round. Should this occur, priority will

³ Please note that CO₂(e) refers to any greenhouse gas expressed in terms of an equivalent quantity of CO₂.

be given to larger proposals that contribute to near-term electricity security. These proposals will given priority in negotiating project agreements and may be given priority in the timing of assessment. (see paragraph 62 for proposed timetable). Remaining projects would be dealt with once the first group of proposals has been processed. The prospect of delay for smaller projects will be made explicit at the time the request for proposals is made.

Units requested not to exceed CP1 abatement delivered

23. Where the number of units requested by an applicant is greater than the tonnes of CO₂-e reductions expected to be delivered by the Project in CP1, these applications will not be considered further in the tender round. To provide more units to a Project for CP1 abatement than actually is reflected in New Zealand's inventory would result in a net decline in our Kyoto "account". It is not yet clear what the rules and targets will be for CP2 will be so at this stage it is not appropriate to allocate units associated with this period. In addition rewarding CP2 abatement would complicate the additionality assessment in particular.

Policy overlaps - NGAs

24. One example of a potential policy overlap is for firms with Negotiated Greenhouse Agreements (NGAs). The process of negotiating NGAs that are broadly equitable with other NGAs becomes significantly more complicated if there is uncertainty about whether a firm is also eligible for a Projects incentive.

25. The option of excluding firms with NGAs from the Projects mechanism (or vice versa) was considered but rejected because it was considered that significant abatement potential existed within NGA firms (perhaps in not-at-risk parts) that the mechanism could beneficially address. A no double-dipping principle is recommended, meaning that the Projects incentive could not be used to assist in achievement of NGA targets. The Project incentive would be for abatement additional to the NGA target. Conversely, if a firm submitted a successful Projects proposal and then subsequently sought an NGA then no double-dipping would require the Project to be considered in the assessment of eligibility and would be excluded from the scope of their NGA.

26. Thus it is considered feasible for a firm with an NGA to participate in the Projects mechanism and similarly for a firm with a successful Project to apply for NGA status. However, it is not considered desirable to have a firm in the process of negotiating an NGA to participate in the Projects mechanism when the details of its NGA are unknown. This makes management of the no double-dipping principle problematical and potentially reduces the integrity of both mechanisms. It is recommended that firms in the process of negotiating an NGA with the Government be ineligible to participate in Projects until their NGA is concluded. Similarly firms that have a proposal being processed under Projects but wish to promptly negotiate an NGA could temporarily withdraw their proposal and subsequently submit their proposal into a later round following the conclusion of their NGA negotiations.

27. There will be some challenges in applying the no double-dipping principle to firms with or seeking NGAs. The key issue is the integrity of the boundary applied to activities covered by the NGA and this issue will need to be carefully monitored.

Policy overlaps – forest sinks

28. The Government will soon consider proposals for mechanisms to encourage forest sinks, including a permanent (non-harvest) forest sink programme likely to involve incentives via promissory notes for Kyoto compliant emission units. Initiatives to directly encourage production forest sinks (such as issuing promissory notes to commercial forest growers) would create a complex matrix of flow-on effects throughout the forest sector. Such effects could include incentivising deforestation of pre-1990 forests including forests on Māori land. Therefore, any such measures must be thoroughly analysed before they can be considered for introduction.

29. It may be desirable that in the long term New Zealand moves to a consistent treatment of emissions and sinks thereby enabling sinks to qualify for the Projects mechanism. However, given the decision not to devolve sink credits and harvesting liabilities to forest owners (Cab Min (02) 26/16 refers) then there must be separation at this stage. Forest sink incentive schemes would not be eligible for the Projects mechanism at this stage. Similarly sequestration by land use change and management activities (covered by Article 3.4 of the Protocol) would not be included in the Projects mechanism because at this stage the Government has agreed in principle not to account for these activities in CP1 (and the rules for CP2 are not yet determined).

International Issues

Joint Implementation

30. Proposals for Joint Implementation (JI) schemes like the Netherlands ERUPT⁴ programme would not be considered separately from the domestic Projects mechanism. Where a proposal for a JI project is made it will be assessed under the domestic Projects mechanism, with the level of incentive to be provided determined by this assessment rather than by any international criteria.

Clean Development Mechanism (CDM)

31. The Clean Development Mechanism (CDM) potentially generates additional emission units should New Zealand entities undertake approved abatement activities in non-Annex 1 countries. Policy has not been developed, nor any decisions made, concerning CDM, and the Projects mechanism is not intended to determine the Government's policy on CDM activities. Officials' consider that this issue is best dealt with as part of the Business Opportunities work programme.

Timing and nature of the Projects incentive

32. In the exploratory Project round, the incentive will be provided by the promise of emission units conditional on the delivery of measurable emission reductions during CP1 (2008-2012). Emission units, relating to the measurable emission reductions achieved in the preceding year, will be transferred to the promissory note holder for the Project and recorded in the national registry, once the emission reductions have been verified.

33. Successful applicants will receive a promissory note for the number of emission units contracted for in the project agreements. This note is a financial instrument that

⁴ Emission Reduction Unit Procurement Tender, and involves the Netherlands Government providing financial support for abatement in other Annex 1 countries in exchange for (surplus) emission units.

can be used by the recipient to generate cash by either trading or borrowing against. Applicants can choose when or how they wish to convert the note into revenue, either prior to the commitment period, or waiting until the commitment period to sell the emission units themselves.

34. Applicants bear the risk of the price that the promissory notes or emission units can reach on the market, and will have the benefit of any upside gains in value over time. The risk will be shared by the Crown to some extent, however, due to possible discounting of promissory notes by the market, which may require the Crown to offer more units to ensure that projects go ahead.

35. The risk of non-delivery of abatement, and the risk of changes that affect additionality, will be managed by conditions placed in project agreements and in the terms of the promissory notes. The Crown wishes to ensure that if the abatement is not delivered, or is shown to be non-additional, it will not be called upon to transfer the emission units. The management of this risk, and the extent to which it is covered by project agreements or directly in the terms imposed on promissory notes, will be addressed in the project agreements report back due by 30 June 2003.

36. For at least the exploratory Projects round, direct financial support will not be available to applicants. Officials are currently considering whether it is possible for the Crown to manage its price risk through contracts, and the bid-in rounds and international emission units selling processes. This process may result in decisions to offer some cash incentives in the future; however it is a complex issue and will not be resolved in time for the exploratory Project round.

37. It is important that the credibility and value of promissory notes are adequate to address concerns expressed by potential proponents that they are not in a position to accept the price risk involved in using notes as the incentive (the notes might be discounted as a result of their conditionality). This in turn could affect the number of applications received for the exploratory round.

Assessment

38. The first tender round is an exploratory round. This paper addresses the criteria for the first tender round. These criteria and their application will be reviewed after that round and amended if appropriate.

Ranking and Selection of Projects

39. Applications will be ranked by the Assessment Team against the criteria of how cost-effectively they enable New Zealand to meet its Kyoto commitments, and their contribution to a better balance of electricity supply and demand over the next five years. For the exploratory round the relative ranking of each application will be determined by the formula:

Number of emission units requested by applicant divided by the total CO₂(e) reductions from the start of the Project to 2012.

The smaller the final ratio is, the higher the ranking of the project.

40. Benefits to the economy, such as security of energy supply and learning-by-doing, are recognised in the assessment through recognising emission abatement prior to 2008.

41. Where there are projects from non-carbon charge sectors, the assessment will need to ensure that projects from these sectors are not discriminated against as a result of the higher price hurdle that they must overcome relative to projects from sectors covered by the charge.

42. Starting from the Projects with the lowest ratio (but taking into account the size of projects and their ability to contribute to near-term electricity supply), the Assessment Team will make a provisional selection of Projects in order of increasing ratios until either available emission units are fully allocated or no more applications that have made it through the initial assessment (Step 4) and the eligibility assessments (Step 6), remain as outlined in the Projects cycle schematic.

Ranking and Selection of Projects – managing risk

43. In formulating its recommendations to the Decision Maker the Assessment Team will consider the risk of each provisionally selected project not delivering the promised emission reductions through to the end of CP1 (includes technology and commercial related risks) and the risk that the decision that the project meets the additionality tests was wrong. The Assessment Team will consider the magnitude of such risks and whether it is likely that the risks can be managed adequately through the project agreement. The risks of each proposal and how they might be managed will form part of the Assessment Team's recommendations to the Decision Maker. In cases where the Assessment Team considers that there are significant risks and that it is unlikely that the risks can be managed adequately through the project agreement, the Team will recommend that the Project not be supported. There is also a potential risk of proponents gaming the process. This will be addressed through project agreements and considered further for the 31 May report back.

44. At the end of this process the Assessment Team will recommend a portfolio of Projects to the Decision Maker with proposal rankings and associated risk analyses for final decisions.

Design of tender process

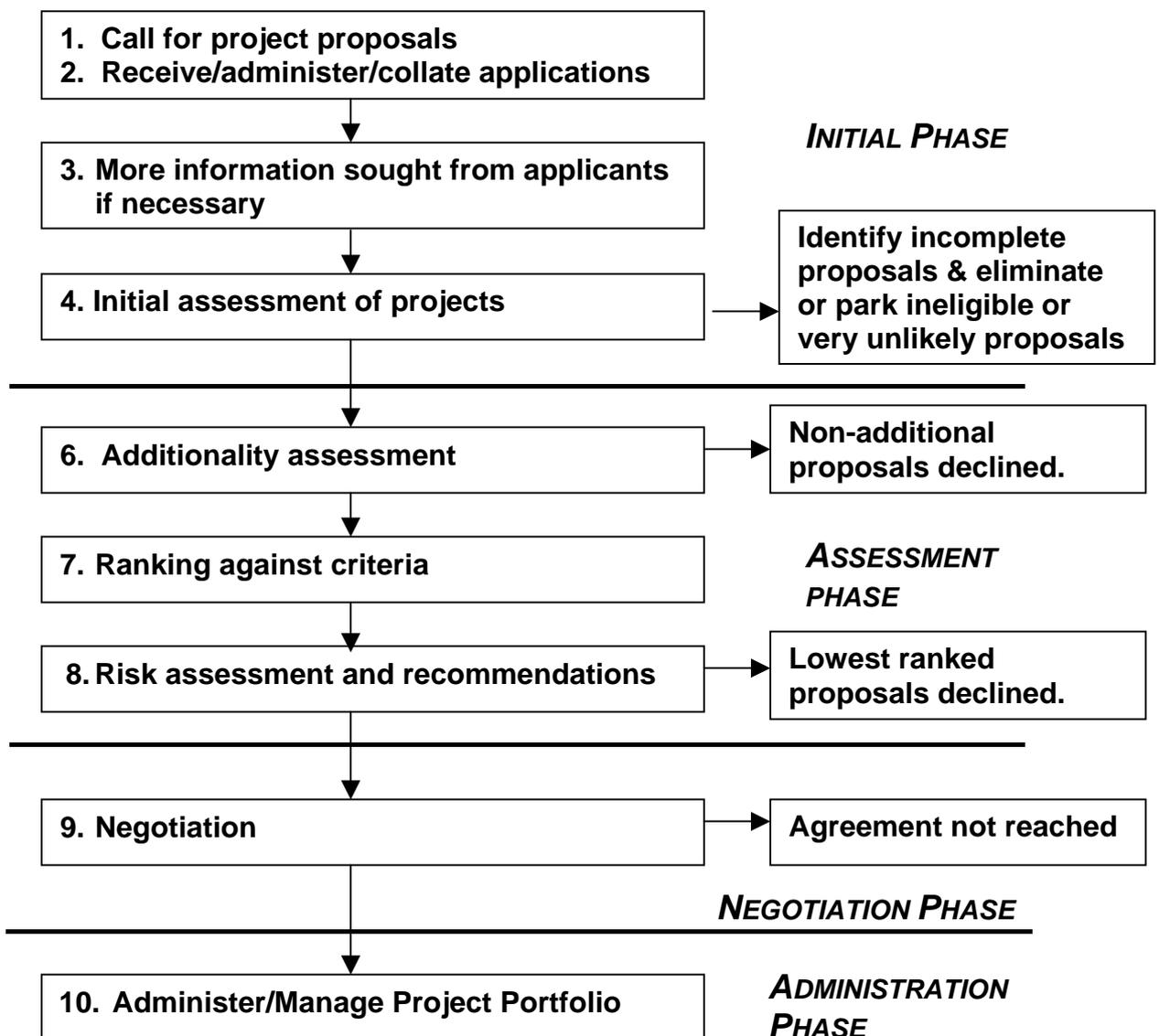
45. Negotiations with successful participants would proceed on the basis that the government would not pay above the number of units requested in each bid. This will allow the government to focus resources on the most cost-effective proposals.

46. To encourage disclosure of true costs by participants, officials will consider whether there should be an audit of costs of the successful projects following the exploratory round, as a condition in their project agreements. Officials will report back on this issue as part of the June 2003 report-back on project agreement design.

Proposed Project Cycle

47. It is proposed that a project cycle would run through the following four basic stages:

- (i) an initial phase (steps 1-4 below) where project proposals would be received and processed;
- (ii) an assessment phase (steps 5-8) where more detailed information would be sought from applicants, proposals would be assessed for additionality and then ranked against specified project criteria, and top ranked projects would be forwarded for negotiation;
- (iii) a negotiation phase (step 9) where project agreements would be negotiated for top-ranked proposals and then signed off by the Minister of Finance and the Convenor of the Ministerial Group on Climate Change; and
- (iv) an administration phase (step 10) for ongoing monitoring and management of the projects portfolio, including assessing performance against project agreements, and consequent allocation of units.



48. It is expected that for the exploratory round it will take approximately five months to progress from the call for project proposals to the conclusion of project agreements, with step 1 taking approximately six weeks, steps 2-8 approximately two

months and negotiation of priority Projects approximately six weeks. A detailed timeline for the exploratory round is provided in paragraph 62 below.

Institutional arrangements for the Projects mechanism

Programme administration

49. Responsibility for the Projects mechanism lies within the Climate Change Office (POL Min (02) 21/14 refers).

50. The Climate Change Office will be responsible for processing applications in the initial phase, providing a secretariat and other support to the assessment team and to contract negotiators, and coordinating ongoing administration and management of the Projects mechanism. In carrying out these functions it is anticipated that the CCO will work closely with EECA, and will contract out for specialised expertise as required.

Assessment Team

51. It is proposed that an assessment team will be made up of officials from CCO and EECA and will be open to participation from relevant departments where feasible with assistance from technical and financial experts as required. The team will assess Project proposals (steps 5-7 above) with support from the Programme Administrator.

Decision Maker

52. The decision maker will decide which ineligible or clearly unlikely projects are eliminated or parked at the initial phase based on the recommendations of the CCO, decide which projects will progress from the assessment phase to negotiation on the basis of recommendations from the assessment team, and will also provide a mandate for contract negotiations.

53. It is recommended that the decision making function should be carried out within a government department, because:

- the criteria to be applied in making decisions are not purely objective;
- the Projects mechanism relates to the management of the significant fiscal risks involved with New Zealand's emissions obligations under the Kyoto Protocol; and
- the objective of promoting public confidence in the fairness and impartiality of the decision making process for Projects can be sufficiently achieved within the departmental form .

54. It is proposed that the Chief Executive of the Ministry for the Environment, as the Chief Executive responsible for the Climate Change Office, would be the decision maker, with the power to delegate this function (but not to the Climate Change Office or assessment team officials, in order to maintain the separation between decision making and assessment).

Negotiation of project agreements

55. Contractual project agreements would be negotiated in accordance with the mandate supplied by the decision maker. The negotiator would be appointed by the Director of the Climate Change Office and could be a contractor or senior official with support from the Climate Change Office, Treasury and other officials as

required. Specialised legal and financial advice would need to be available to the negotiator, and this could be contracted through the Climate Change Office.

56. It is proposed that the final project agreements be co-signed by the Convenor of the Ministerial Group on Climate Change and the Minister of Finance.

Administration/Management of Projects Portfolio

57. The Climate Change Office will be responsible for coordinating the ongoing administration and management of the projects portfolio.

58. Officials will consider the institutional arrangements for monitoring and managing the Project Agreements in more detail as part of the 31 May report-back. This work will include ensuring that consistent approaches are applied across other climate change policy measures, and that any legal risks associated with the monitoring and review function are minimised.

Actions required to implement the exploratory round

59. There are some remaining key actions required to enable the exploratory round to begin promptly in financial year 2003/2004. They fall under two main headings: issues requiring further policy (or budget) decisions, and putting in place those resources and administrative arrangements necessary to operate the mechanism.

60. Cabinet has previously directed officials to report to POL by 30 June 2003 on the nature of a Project Agreement, including payment schedules, monitoring, timing and penalties for non-compliance. The planned use of promissory notes on emission units as the incentive for the exploratory round means that the nature of these promissory notes also needs to be specified in this report-back. To be able to run the exploratory round very early in 2003/2004 (and to assist in the negotiation of Project Agreements with the stand alone Meridian and TrustPower proposals which are underway (POL Min (03) 1/5 refers)), then this reporting deadline will need to be brought forward to 31 May 2003.

61. Early key steps required to undertake the exploratory round will include engagement of a financial advisor, development of the formats and information requirements for applicants, and development of a publicity strategy to advise of the call for proposals. This work needs to begin promptly and resources are available in the 2002/2003 CCO budget to complete these tasks.

62. The following timetable for the exploratory round is proposed:

- Engage a programme manager and then a financial advisor by the end of March 2003;
- Conclude key assumptions like the electricity factor by mid-April 2003 and announce the exploratory round timetable;
- Complete forms and documentation by mid-May 2003;
- Call for proposals by mid-May 2003 (followed by some explanatory workshops)
- Deadline for receipt of proposals by the end of June 2003;
- Receive proposals and begin assessment by the first week of July 2003;

- Complete assessment and forward recommendation to Decision Maker by the end of August 2003;
- Decision Maker finalises list of successful proposals by mid-September 2003;
- Negotiator is appointed and concludes selected high priority agreements by the end of October 2003; and
- Conclude remaining agreements by the end of February 2004.

63. Following completion of the exploratory round officials will report back to the Convenor of the Ministerial Group on Climate Change and the Minister of Finance on the operation of the exploratory round and any lessons learned, prior to discussions for the 2004 budget.

Consultation

64. The following departments have been consulted in the development of this paper: the State Services Commission, Te Puni Kokiri, Economic Development, Environment, Agriculture and Forestry, Treasury, Foreign Affairs and Trade, Prime Minister and Cabinet and Transport. The Energy Efficiency and Conservation Authority has also been consulted.

Financial, accounting and legislative implications

65. The pool for the first round needs to be sufficiently large to fund available high quality Projects and to show Government commitment to the use of the Projects mechanism as an abatement tool. However, the pool also needs to be sufficiently constrained to enhance contestability and to make the processing of applications manageable. In addition constraining the pool for the exploratory round will limit the risks associated with a new mechanism. It is proposed that promissory notes for up to four million units be available for the exploratory round.⁵ Should there be an insufficient supply of quality proposals the decision maker may choose not to allocate the full amount of units, and this will be made clear to proponents at the time that the request for proposals is made.

66. A bid for emission units is being considered alongside the 2003 Budget and other climate change initiatives. Those decisions will also include a proposal that the Convenor of the Ministerial Group of Climate Change and the Minister of Finance would be authorised to jointly issue promissory notes for Projects. The relationship between promissory notes and project agreements will be considered further and reported back to POL in the 30 June 2003 report back.

67. If the risks around delivery of emission reductions are adequately managed, the provision of promissory notes and transfer of emission units carries no risk of a negative fiscal impact for the Crown. This is because Projects reduce the Crown's liability for greenhouse gas emissions during the commitment period by, at least, an equivalent level. It is anticipated that these will be a positive fiscal benefit to the Crown, assuming more emission reductions are achieved than units are transferred.

⁵ Note that the 4 million units proposed for the exploratory round will not include any units allocated to Meridian and TrustPower for their early lower North Island wind farm proposals previously accepted by Cabinet (POL Min (03)1/5 refers).

The commitment to provide emission units would be made when Project Agreements are signed, however, transfer of emission units to the Projects would occur from 2009-2013. Any transfer of units to the Project would be conditional on the Kyoto Protocol coming into force and the achievement of actual emission reductions that are measurable and verifiable from the Projects.

68. As proposed, the promise to pay emission units would represent a contingent liability to the Crown. The fiscal forecasts and Crown Financial Statements will need to disclose the projects and, to present this fairly, these statements will need to set the project in the context of the overall expected outcome of the commitment period.

69. It should be noted that there will be ongoing costs to the Crown related to running project rounds and, in future, to administering and monitoring the performance of concluded Project agreements. It is proposed that for the exploratory round the Crown will meet the costs for project assessment with applicants responsible for the costs of preparing their applications. It is considered that for the exploratory round it would be unreasonable to expect initial applicants to bear the higher costs associated with the round. A budget bid for the administration and assessment costs for projects is being considered as part of the 2003 Budget.

70. Legal advice is that the proposed Projects mechanism as outlined does not require recognition in legislation. The transfer of emission units for promissory notes will require Project participants to be able to hold individual accounts in a registry. The Climate Change Response Amendment Bill which has received priority on the legislative programme to be referred to a select committee in 2003 with a view to enactment in 2004 will contain provision for individual account in the register. There are some legal issues around project agreements promising allocation of units prior to the existence of individual accounts. This will be covered in the report back by 30 June 2003 on the content of project agreements.

71. [withheld under the OIA ss. 6(a) and 9(2)(h)]

Recommendations

72. It is recommended that the Committee:

Workshop

1. **note** that the generally well attended Projects workshop held on January 28th 2003 indicated wide interest in the mechanism and feedback received provided valuable input that informed the preparation of this paper;

Eligibility

2. **note** that eligibility for Projects requires proposals to pass an additionality assessment to avoid supporting business as usual proposals;
3. **agree** that this assessment involve consideration of both investment and environmental additionality;
4. **agree** that the size eligibility for the exploratory round be 10,000 tonnes of CO₂ equivalent (t/CO₂(e)) over the five years of the First Commitment Period (CP1) of the Kyoto Protocol;
5. **note** that for the exploratory round, priority in negotiation and assessment of projects will be afforded to larger proposals that contribute to electricity security;
6. **agree** that firms with Negotiated Greenhouse Agreements (NGAs) are eligible to participate in the Projects mechanism, but that a no double-dipping principle be applied so that the Projects incentive is not used to assist in achievement of NGA targets;
7. **agree** that for firms that have submitted a successful Projects proposal and subsequently sought an NGA, then that would be considered both in assessing their at-risk status and negotiating the detail of their NGA;
8. **agree** that firms in the process of negotiating an NGA with the Government be ineligible to participate in Projects until their NGA is concluded;
9. **agree** that applications where the number of units requested is greater than the tonnes of CO₂(e) reductions expected in CP1 will not be assessed;

International Issues

10. **agree** that while firms awarded promissory notes under the domestic Projects mechanism can potentially enter into an overseas Joint Implementation (JI) scheme, the level of incentive provided is determined within the domestic mechanism;
11. **note** that policy concerning the Clean Development Mechanism (CDM) has not been developed and that opportunities under CDM may be the subject of a future "Business Opportunities" report-back;

Incentive

12. **agree** that for the exploratory round the incentive for Projects will be promissory notes for emission units;
13. **note** that a promissory note is a financial instrument that can be used by the recipient to generate cash by either trading or borrowing against at any time appropriate to them;
14. **note** that officials are considering the feasibility of supporting some direct emission reduction initiatives for subsequent project rounds with cash incentives and will report to the Convenor, Ministerial Group on Climate Change and the Minister of Finance in time for the 2004 Budget;

Assessment

15. **agree** that the core criterion for assessing proposals be the ratio of the number of emission units requested by applicant divided by the total CO₂(e) reductions from the start of the project to 2012, with lower ratio proposals favoured;
16. **agree** that the ranking from the core criterion for each proposal is supplemented by an analysis of the risks associated with the proposal, which include technical risks, additionality risks, and the risks of any adverse spill-over effects;

Tender Process

17. **agree** that the tender process involve successful applicants being paid up to the amount of their bid;

Project Cycle and Institutional Arrangements

18. **agree** that the exploratory round follow the project cycle outlined in paragraph 47 above involving four stages:
 - initial information and pre-screening of applicants;
 - assessment and decisions on successful projects;
 - negotiation of project agreements; and
 - administration of a portfolio of agreements;
19. **direct** officials to report to the Convenor of the Ministerial Group on Climate Change and the Minister of Finance on the operation of the exploratory round recommending any changes arising from this review by 30 November 2003.
20. **note** that the Climate Change Office is responsible for the administration of the Projects mechanism;
21. **agree** that the Assessment Team be made up of officials from relevant departments and EECA supplemented by contractors as required for specialist financial and technical advice with support from the Programme Administrator;
22. **agree** that the Decision Maker is the Chief Executive of the Ministry for the Environment and that the Decision Maker determines which proposals

progress to the negotiation stage based on the recommendation of the Assessment Team, and provides a mandate for the contract negotiations;

23. **authorise** the Chief Executive of the Ministry for the Environment to delegate the decision making function to any person holding the position of Deputy Secretary or any other employee holding the position of manager at the Ministry for the Environment (but not to an employee of the Climate Change Office or a member of the Assessment Team);
24. **agree** that the negotiator for project agreements is appointed by the Director of the Climate Change Office and supported by the Office and other officials as required;

Project agreement report back

25. **note** that officials have previously been instructed to report to POL by 30 June 2003 on a model project agreement, but given the timetable proposed for the exploratory round officials propose to report back by 31 May 2003;

Legislative and financial implications

26. **note** that legal advice is that the proposed Projects Mechanism does not require recognition in legislation;
27. **note** that the incentive pool and administrative funding for the exploratory round is being considered as part of the 2003 Budget round process;
28. [withheld under OIA ss. 6(a) and 9(2)(h)]

Authorisations

29. **authorise** the Convenor, Ministerial Group on Climate Change to implement the exploratory round based on the model outlined above and the pending Project Agreement report back; and
30. **authorise** the Convenor, Ministerial Group on Climate Change and the Minister of Finance to adjust the Project Mechanism as required to facilitate implementation of the exploratory round.

Hon Pete Hodgson
Convenor, Ministerial Group on Climate Change

Annex 1: Summary of feedback from the January 28 workshop

The major points discussed at the workshop include the following:

- the suggested size threshold for eligibility (100,000 tCO₂(e)/CP1) was a matter of high concern for smaller scale proponents especially, and was seen as excluding potentially worthwhile abatement proposals;
- a renewable energy sector organisation argued against a focus on securing cost-effective abatement, and placing more emphasis on a transforming technology approach assessed against wider criteria (they also argued to exclude larger scale proposals, a point challenged by some energy & industrial attendees);
- uncertainty about overlaps with forest sink incentive schemes, particularly for sinks where other revenue streams are involved;
- uncertainty about how additionality will be assessed and concern about the desirability and feasibility of assessing the economics of proposals;
- maintaining commercial confidentiality was seen as very important, especially since proposals may be assessed at an early stage of development;
- public dissemination of experience from projects was considered important by some, while others were concerned about appropriation of intellectual property and thought that detailed dissemination of information would be a barrier to participation;
- waste sector interests have argued for landfill gas-to-energy proposals to be given a standard favourable baseline to increase the level of support they might receive;
- uncertainty about the value of promissory notes for future delivery of emission units and a general preference for direct funding support, especially among promoters of smaller scale projects;
- a perception that the Government will load most of the risks onto proponents and a strong view that risk assessment was a project assessment and not an eligibility issue;
- two parties expressed concern about unintended spill-over consequences of providing an incentive to use forest processing residues for energy and thus increasing costs for firms who use the residue as input to their products; and
- different interests argued to partition the incentive pool, some by size to separate low risk from transforming technologies abatement, and another to separate reforestation from emission abatement.