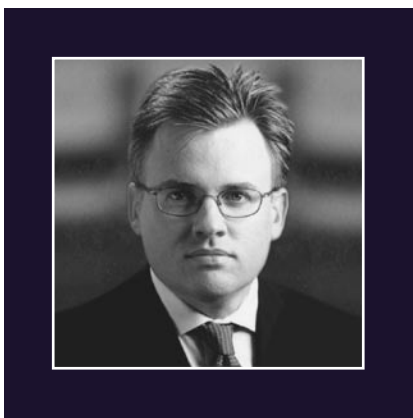


## Tendering for climate change projects: the second round

“Under the “Projects to Reduce Emissions” mechanism, the Government awards each qualifying project with Kyoto Protocol emission units in return for the emission reductions they achieve.”



Simon Watt - Partner

The second round of the “Projects to Reduce Emissions” tender is now open. The “Projects to Reduce Emissions” mechanism is a key component of the Government’s climate change policy.

Under the “Projects to Reduce Emissions” mechanism, the Government awards each qualifying project with Kyoto Protocol emission units in return for the emission reductions they achieve. Project owners are expected to be able to trade these emissions in an international carbon trading market.

In the first tender round, 15 projects were successful in gaining a share of the four million emission units (worth approximately NZ\$40 million) on offer in that round.

In this tender round, the Government has set aside six million emission units (worth approximately NZ\$60 million).

The second round of tenders closes on 15 October 2004.

One emission unit corresponds to an emission reduction of one tonne of CO<sub>2</sub> or CO<sub>2</sub>-equivalent.

To be eligible for emission units, a project must reduce emissions below a level that would have occurred in normal business conditions.

The value of the emission units is intended to tip the balance so that an otherwise non-viable project becomes financially viable.

Participants will gain value from emission units by selling them on, most likely to international buyers.

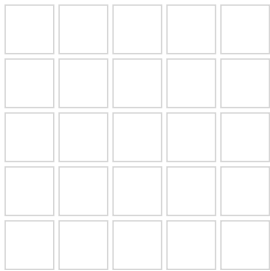
The types of projects that are likely to qualify include those using renewable energy sources such as wind or bio-energy, projects associated with the waste, agriculture and transport sectors, and projects that propose fuel switching.

The tender documentation is available on [www.gets.govt.nz](http://www.gets.govt.nz) or you can visit [www.climatechange.govt.nz](http://www.climatechange.govt.nz) for further information on the “Projects to Reduce Emissions” mechanism.

### Key differences in the second round

There are four key differences between the first and second tender rounds.

1. The number of emission units on offer has been increased from four million to six million.
2. The priority given in the first round to projects that contributed to electricity security has been removed.
3. Unlike the first round, no extra weighting will be given to projects that reduce greenhouse gases before the first Kyoto Protocol commitment period (i.e. before 2008).
4. Projects offering the most reduction in emissions in exchange for the least number of emission units in this tender round will be ranked highest (subject to the assessed risk of the project).

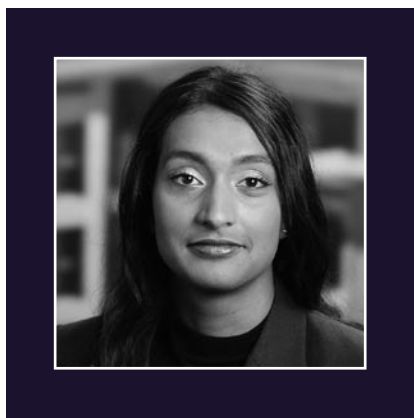


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## Environment

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“Any organisation negotiating NGAs with the Crown will not be eligible to apply for a project until its negotiations have been concluded.”



**Anchali Anandanayagam - Solicitor**

### Legal risks

We consider it important to highlight again the commercial and legal risks associated with the projects mechanism and the subsequent Project Agreement. These risks should be factored in when assessing the financial benefits of participation.

Key issues include:

- Timing;
- Pricing and on-sale of emission units;
- Negotiability of agreements;
- Onerous contract terms;
- Confidentiality.

### Timing

#### **Ratification puts Kyoto in doubt**

As project emission units are tied to emission units available under the Climate Change Response Act 2002 and the Kyoto Protocol, participants are taking a risk if they incur substantial project costs before Russia has ratified the Protocol.

The Russian decision is still awaited, but if Russia does not ratify the Protocol, it is not expected to come into force.

In that case, the Crown would not be liable to transfer any emission units to the project participant, and any benefits due under the Project Agreement to the participant would cease.

The participant might still be able to derive value from emission reductions through some form of emissions trading, possibly under a new climate change policy regime.

#### **No reductions recognised beyond 2012**

Emission units will only be provided for the five-year period from 2008 to 2012.

Although projects may continue to generate emission reductions beyond 2012, these will not be recognised.

It is worth checking with the Crown during the tender process the possibility of participants securing benefits from emission reductions beyond 2012, whether through further emission units or in some other form.

#### **Choose between Projects or NGAs**

During the project tender process, the Government will also be prioritising and progressing negotiated greenhouse agreement (NGA) negotiations.

Any organisation negotiating NGAs with the Crown will not be eligible to apply for a project until its negotiations have been concluded.

Any organisation that meets competitiveness-at-risk criteria for NGA eligibility and is prioritised for negotiations will have to decide whether to tender for a project or to await an NGA negotiation. The amounts at stake for an organisation under an NGA are likely to be significantly higher.

#### **Possible delays in receipt of emission units**

The Crown will only transfer emission units to a participant after the end of the

calendar year in which the emissions are achieved – and the Crown will not necessarily accept a participant’s claimed emission reductions at face value.

There may be a delay in the transfer of emission units if the Crown audits, verifies, and possibly disputes claimed emission reductions.

This possible delay should be considered before committing to any proposed on-sale of emission units after they are received from the Crown.

### **Pricing and on-sale of emission units**

#### **Sale of emission unit rights**

The exact value of emission units will depend on international market conditions. Last year, Meridian Energy sold its emission units to the Netherlands Government in a tender round where the average price was NZ\$10.50 a unit. However, each tenderer will have to make its own assessment of the value of emission units.

Although emission units will only be transferred to participants after emission reductions have been achieved, participants can sell their rights to future allocation of emission units – and this may help finance their projects.

The value of emission units under any advance sale would no doubt be discounted to reflect uncertainties around eventual achievement of the emission reductions and future delivery of the units.

#### **Risk of emerging market**

As the emissions trading market is still emerging, participants will be taking a risk on the liquidity of this market and their ability to sell at an acceptable price at a future date.

#### **Counterparty/credit risk**

Sale of emission unit rights will entail counterparty or credit risk on both sides, dependent on the parties’ ability to meet contractual obligations, such as payment for or transfer of emission units.

#### **Trading terms**

There is a range of other issues associated with the sale of emission units. Participants should consider not only the implications of the Crown’s proposed Project Agreement but also the tradability of emission units and the sorts of terms and conditions that would apply to any emission unit rights transactions.

#### **Tax treatment**

The Crown has no view on the tax treatment of emission units, so participants should get their own expert tax advice.

#### **Negotiability**

##### **Agreement non-negotiable**

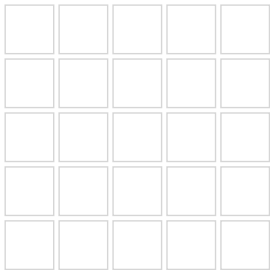
The Project Agreement is essentially the same as that used in the first round.

The Crown sees the Project Agreement as non-negotiable. Project-specific details can be included in schedules but the standard terms in the body of the Project Agreement will prevail in the event of any conflict with the schedules.

If participants are uncomfortable with provisions in the Project Agreement, they should address these issues with the Crown before submitting a tender.

There may be scope for further benefits to participants to be incorporated in the schedules, provided these do not conflict with the standard terms.

“The Crown has no view on the tax treatment of emission units, so participants should get their own expert tax advice.”



**“The provisions of the Project Agreement will require rigorous monitoring and recording of emissions.”**

### **Finalisation of agreement**

The tender process document says that the Crown will “finalise the contract agreement, schedules and other provisions” with the participant after acceptance of a tender.

Therefore, it is not clear that the participant is immediately bound by the terms of the Project Agreement upon the Crown’s acceptance of its tender.

However, assuming the Crown maintains its stance of non-negotiability, the process of finalising the contract will probably focus more on incorporation of relevant technical and project details into schedules rather than negotiation of fundamental terms.

### **Onerous contract terms**

#### **Cost of monitoring**

The provisions of the Project Agreement will require rigorous monitoring and recording of emissions.

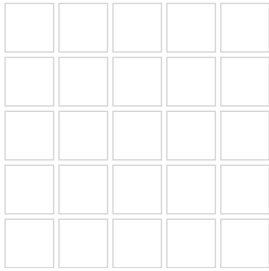
While this is to be expected in order to ensure that emission reductions are actually achieved, these requirements are likely to incur reasonably substantial costs that should be factored in when assessing the overall benefit of participation.

#### **Agreement clauses**

Specific clauses in the Project Agreement that are onerous or put at risk the benefits of participation include the following:

- Clause 5.4 excludes the Crown from liability to transfer emission units to the participant if the Kyoto Protocol does not come into force or ceases to be in force for any reason.
- Clause 5.5 largely excludes the Crown from liability if the participant is unable to trade emission units.

- Clause 8.3 allows the Crown unilaterally to change the reporting requirements under the Project Agreement, albeit linked to compliance with the Kyoto Protocol.
- Under clause 9, the participant could be required to reimburse emission units to the Crown, or pay the current international price for the emission units, where emission reductions are in fact less than those reported and accepted by the Crown. This is not unreasonable but could be a costly contingency to deal with.
- Despite the fact that participants carry the greatest risks under the Project Agreement – bearing in mind the Crown’s key obligation is to transfer emission units and it only has to do this after the participant’s obligations have been performed – under clause 11, participants provide a broad indemnity to the Crown, which even covers consequential and indirect losses.
- Clause 18.1(b) allows the Crown to terminate the Project Agreement at any time prior to 1 January 2008 if the Crown reasonably considers that the Kyoto Protocol will not come into force. The termination provisions are generally weighted more heavily against the participant even though the participant carries most risk under the Project Agreement.
- There is a wide definition of a force majeure event, which means that under clause 19 either party could be excused from performance of its obligations as a result of a requirement, restriction or decision of “any review body whatsoever”. The Crown is more likely to be able to rely on this open-ended exoneration clause. The possibility of some form of review occurring that might affect Project Agreements cannot be ruled out, given the fluid climate change policy environment.



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## Environment

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### Confidentiality

#### Lack of confidentiality clause

Tenderers will be concerned to protect the confidentiality of commercially sensitive information included in their tenders or when reporting on their project if they are successful. There are, however, no confidentiality provisions in the Project Agreement.

The tender document asks for confidential information to be identified but recognises the possibility of disclosure under the Official Information Act or in Parliamentary reporting.

Unless tenderers can persuade the Crown to enter into a confidentiality deed before submitting their tenders, they should identify confidential elements of their tenders clearly and precisely, giving specific reasons why such information should not be released with reference to particular withholding grounds under the Official Information Act.

### Is it worth the risk?

While we have identified a number of legal and commercial risks, potential participants should weigh up the benefits of early mover advantage when considering whether to tender.

If you believe that climate change policy in some shape or form is here to stay, then it is likely that emissions trading will be an element of any future regulatory regime.

Given the complexities associated with emissions trading, and more generally with climate change policies, those businesses with early exposure will have an advantage when the more significant compliance costs (such as the proposed future carbon tax) start to bite.

### Information and advice

Bell Gully has significant expertise in climate change. We have advised businesses and organisations in a number of sectors on the implications of the Kyoto Protocol.

We have advised on the drafting of NGAs and a memorandum of understanding with the Crown in relation to carbon tax exemptions in return for emission reductions.

We have also advised on the development of a legal framework for trading in greenhouse gas emissions and on related aspects in the drafting of the Climate Change Response Act.

If you would like more information about the Projects to Reduce Emissions, please contact our team below.

For further information, please contact your usual Bell Gully adviser or:

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