ENVIRONMENTAL LAW AND REGULATION - Potential Impact on Financial Transactions

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Good afternoon ladies and gentlemen. As I was sitting on the podium hearing Dan's excellent address my mind went back to an occasion not so long ago where I was at another forum in Auckland and on that occasion I was addressing the Royal Forest and Bird Society. And I must say that that audience was certainly more adversarial than the one I have before me.

I am very pleased to have been given the challenge from the position of a corporate lawyer to give you an insight into the impact of environmental law on financial transactions in New Zealand. I am in a very particular position in relation to this issue having been through a most interesting and stimulating period with the Electricity Corporation when the business was being purchased from the government. The Corporation placed considerable emphasis on ensuring on-going access to resources to ensure its financial success.

Twenty or thirty years ago it was probably true to say that when business was in conflict with the environment it was generally the environment that gave way. The opposite is probably now true in that if major environmental issues arise in relation to the operation of the business, then the costs will more likely be loaded on to the business and not loaded on to the environment. Therefore when purchasing a business or lending to a business or when involved in the on-going financial management of a business, environmental issues cannot be ignored, and in businesses such as the one I am involved with, they are crucial.

As you may know, the Corporation is not only one of New Zealand's largest companies, but it is an organisation which has significant impact and interaction with the environment. Four years ago, when, as I mentioned, we were purchasing the assets of the Electricity Division from the Crown, environmental issues formed a major part in negotiations. Some of those issues are practical examples of those things discussed by Dan a minute ago. And there were some other interesting questions that were purely of a New Zealand nature. But before I launch into these practical examples, I must give you a quick sketch of the present law in New Zealand in relation to the management and allocation of resources, and then attempt to paint a very watery picture of the new proposals. Watery I say, not only because of Electricity Corporation's obsession with water, but because we have not actually seen the form of the Resource Management Bill as it will be introduced back into the House after the work of the review group and government consideration. And lastly if I have the time I will look at the issues the

present and the proposed legislation will throw up in relation to purchasing finance and generally managing a large business in New Zealand. And I will try to use the practical examples at my fingertips, but I must in some cases claim diplomatic immunity.

The present law in New Zealand in relation to allocation of resources and the management of those resources as everybody knows is spread over many statutes. Things like the Water and Soil Act, Town and Country Planning Act, Mining Act, Coalmines Act, Public Works Act, and I can go on for some time. In most cases the allocation procedures do not follow a consistent pattern and are underpinned by various criteria. They do generally have one thing in common - a judicial allocative approach and the provision of sanctions against the failure to comply - which goes either to the heart of the allocation or are in the nature of a fine. Some cases in great, and some cases in moderate, proportions.

It can be said that these allocation measures are by and large cumbersome and inefficient. They are certainly a haven for lawyers and have been described as a graveyard for developers.

In relation to the management of allocated resources there are the Acts which set out the standards - maximum and minimum - in addition to the provisions inherent in the allocation instrument, such as the permits, licences, for example. And statutes such as the Clean Air Act and the various empowering Acts, in my case the Electricity Act and Local Government Acts, come to mind in this area.

In relation to liability issues the law in New Zealand, apart from certain specific exceptions, relies largely on common law interventions to protect other users of the resource or society in general. There is not in the existing statutes the concept of sheeting home liability for environmental degradation which goes beyond the actual granting of the resource use or the suffering of damage outside the boundary for that resource.

The accident compensation regime in New Zealand has allowed this happy state of affairs to continue since the drive that insurance would provide to remedy the situation has not occurred while there has been the underpinning of personal damage through the accident compensation arrangements. With the refocussing on reform of this part of the New Zealand law one can anticipate a change in relation to matters such as exposure to environmental hazards and the possibility of the resource user bearing more of the consequences. But at the moment we have the combination of the common law and the accident compensation situation. And so our law has remained relatively static.

Perhaps I should turn to the proposals finding the final form in the Resource Management Bill and its twin, the Crown Minerals Bill. The first point to be made is that it is the expressed intention of the Minister of Environment that in due course the environmental regime in New Zealand will allow market mechanisms to allocate resources while the environmental law sets maximum/minimum standards, quality requirements etc to deal with the externalities. It is my considered opinion that these are very worthwhile aims and it is to be hoped that they will be achieved. However, regrettably at present the Resource Management Bill does not leave it to market forces to deal with allocation decisions. And though there are quite a few people in New Zealand very actively working on such proposals, at the moment they have no legislative expression, although they could form the phase 2 stage of the present resource management reforms.

The Bill, as we are led to believe from recent press releases, has had some minor changes, particularly in the purposes and principles sections where we are told the meaning of sustainable management has been clarified and the Treaty of Waitangi issues are said to be expressed in a more clear way. And as well, we are told that matters of national importance must be recognised and provided for by those making decisions under the Act.

So on the one hand in the new regime we will have more consistent and coherent resource management and allocation law, hopefully in relation to allocation less law and more market, and on the other hand in the new regime there will be the provisions for the use of economic instruments such as taxes, levies, royalties, bonds etc, to deal with the environmental concerns.

Looking at that second area, one can see this arising in the area of CO_2 emissions, where currently there is a discussion paper going around the traps on the proposals for a CO_2 emissions tax. These proposals deal with a common thread in the environmental debate that businesses do not pay for any of the environmental assets that are vital to the business operations. A classic example is pollution, where discharges of wastes into the air and into water are not paid for even though the right to do so is extremely valuable for many businesses. Environmentalists argue, quite rightly, that until businesses start facing the costs of the use of the environment, those costs will never be incorporated into investment analysis, and progress in improving environmental standards will be limited.

As I mentioned before, what we are likely to see increasingly in New Zealand is market based regulatory responses developed to resolve environmental issues. And that includes this idea of charges or taxes on air pollution or water pollution, and charges for other environmental assets such as water.

If you think about the greenhouse effect, it is a good way of getting into the argument. The possibility of either a CO_2 tax or a system of tradeable CO_2 emission permits is under consideration as I mentioned, both in New Zealand and throughout the world. This would see major industries either paying a substantial tax based on CO_2 emission from their plant or having to purchase a CO_2 emission permit. The cost of this permit would be determined by the market value given that the emission permit would be tradeable. And from this idea of tradeable economic instruments for discharge in the air, one can go and consider the possibility of a water market which would see scarce water resources competed for on a pricing basis rather than the resource management type approach. So one can see from the angle of the owner, purchaser or lender to an organisation such as the Electricity Corporation, the possibility of environmental issues taking a different form and having different inherent risks.

I think I will take the time to go through quickly the sorts of issues under the New Zealand law for the purchase of an organisation such as our organisation would have to consider in relation to environmental challenges. The first, as Dan has mentioned and the first that came to my mind, was the valuation of the business, and the analysis of the risks inherent in that valuation. And that leads one immediately into areas such as regulatory risk and the area of taxes, royalties etc. And I can assure you that this was an issue that exercised the mind of the Corporation a great deal when we were negotiating the purchase with the Crown.

A specific point during those negotiations was the matter of the future imposition of royalties on water or geothermal steam used for electricity generation. And this did

result in an indemnification clause in the Corporation's agreement for sale and purchase with the Crown which will preserve the value of the assets purchased by the Corporation from any diminution through a royalties or special taxation regime.

There are numerous other examples of valuation issues which have a very strong environmental flavour to them. And the most obvious area that I just want to touch on is what we call the "environmental time bombs", some of which the Corporation did purchase along with its assets. The Corporation has accepted environmental liability in that area and the area of asbestos comes immediately to mind where we have accepted in purchasing the business that in installations we have asbestos which has to be removed.

It is to be noted that in taking this risk we were mindful of the fact that the accident compensation regime protects the Corporation from the full extent of environmental liability. But in just pure removal costs, I would mention that it is costing us around NZ$10m to clean up just one power station.

Another issue to be considered in this area is the transferability of permits or rights of an environmental nature. As I mentioned before when I ran very quickly through the present legislative provision, there is not a great deal of coherence across resource management regimes and this is particularly so in relation to transferability of rights and permits. The possible introduction of these tradeable property rights such as I have mentioned for water would make this a matter of valuation rather than the access to the resource and is something we would applaud. But going back to the present law, there were some rights which the Corporation wished to purchase which would have required statutory transfers to make them effective, although to be fair this was partly due to the fact that the Crown rights lacked the clarity necessary for us to identify them and purchase them by normal mechanisms.

Turning to the Corporation's water rights, I think one can see the issue very clearly. Matters of valuation came into account in considering purchase of water rights and also the pure mechanism of transferring those rights to the Corporation. The Corporation, as I do not need to stress, is very dependent on access to water for hydro-generation and we are particularly exposed to substantial costs if that access to water is restricted in any way. And that is obviously because a hydro-dam is essentially a sunk investment. By way of illustration the Corporation has estimated that a potential loss of water right could have a value up to NZ$1.6 billion in NPV terms. So therefore this was a crucial negotiating point when buying the business from the government. In the end the Corporation agreed to bear the risk, and in fact it still bears the risk. It is one of the major issues in relation to the possible privatisation of the Corporation which is outstanding. So long as we are an SOE the cost of water rights in the end will be met by the Crown, either by a reduction in dividends or through a lower asset value.

But if the Corporation is to be privatised, any investor is going to significantly down-value, on a very conservative basis, the value of a hydro station because of the risk that regulatory change may reduce the access that station has to water. So in this respect it is a valuation issue. But it is also a transfer or rights issue in that our water rights are in the nature of existing rights for only a limited term and requiring under present arrangements a completely new allocation procedure in respect of each individual right.

Now some of you will know that is not an easy matter. And arguing purely to maintain a minimum flow regime in the Wanganui River we have successively had a reduction in water amounting in NPV terms, of NZ$76m at first instance, and then NZ$42m at the

Planning Tribunal stage. It is easy then to see why the introduction of the concept of property rights in water use is a very attractive proposition to the Corporation.

I have not got much more time so I will just touch on a couple more environmental issues that are relevant to purchasers or financiers of a business in New Zealand. One, is only relevant to SOE so I will pass by it quickly; this involves Treaty of Waitangi issues and it is interesting that treaty issues in the Corporation's context also lead into issues of access to water. But I will say no more. The other issue involves environmental due diligence.

The Corporation did not itself indulge in diligence to any great extent for the obvious reason, that the people purchasing the organisation were personnel by and large from the old organisation and knew more about the environmental status of the organisation than the Treasury officials they were negotiating with. But we do envisage that as we go into the privatisation mode that we will be subject to considerable due diligence and that raises the whole issue of environmental audit or environmental accounts - something that we are grappling with and finding a most difficult issue.

There are two other issues of an environmental nature that go to financial transactions and they are really of a more esoteric nature. I could define one as international green consumerism and the other one, which is more relevant to my company, the acceptability of the product and its environmental effect, which leads in our case to arguing the environmental positive nature of a hydro-based system.

The last brief point I wanted to make was to reinforce what Dan was saying from a credit underwriting perspective and that is to say that the rating agencies do take a very active interest in environmental issues, would quiz and are quizzing an organisation like ours on environmental audit, and are paying very close attention to development of laws such as the Resource Management Bill because of the issue of regulatory risk. It is uppermost in credit agencies' minds and that is one of the reasons that the Corporation has argued long and hard that regulations must provide secure access to resources to facilitate business investment and to ensure that the value of businesses which rely on access to environmental resources are not substantially devalued.

I cannot stress this point too highly. Regulatory risk in relation to environmental matters in the New Zealand context is never to be underestimated. Thank you.