



Status Report

on

**Completion of nitrogen contracts to
meet project target**



1.

Introduction

This report seeks to update and inform the Joint Committee on progress to meet the projects objectives of reducing manageable nitrogen by 20%. It also looks to advise and recommend on what the Trust sees as key decisions to be made to ensure satisfactory conclusion of the project out to 2018/19.

In tandem with the above the Trust makes recommendations on the continuance of the Trust, its new proposed membership, responsibilities into the immediate future and the existing and projected end of term financial position of the project.

The project is governed by a series of founding documents which have guided activities and responsibilities and the report looks to reference these and briefly highlight achievement against them. These documents include the Lake Taupo Project Agreement, the Project Funding Deed and its Variation, and the Lake Taupo Protection Trust - Trust Deed and its Variation.

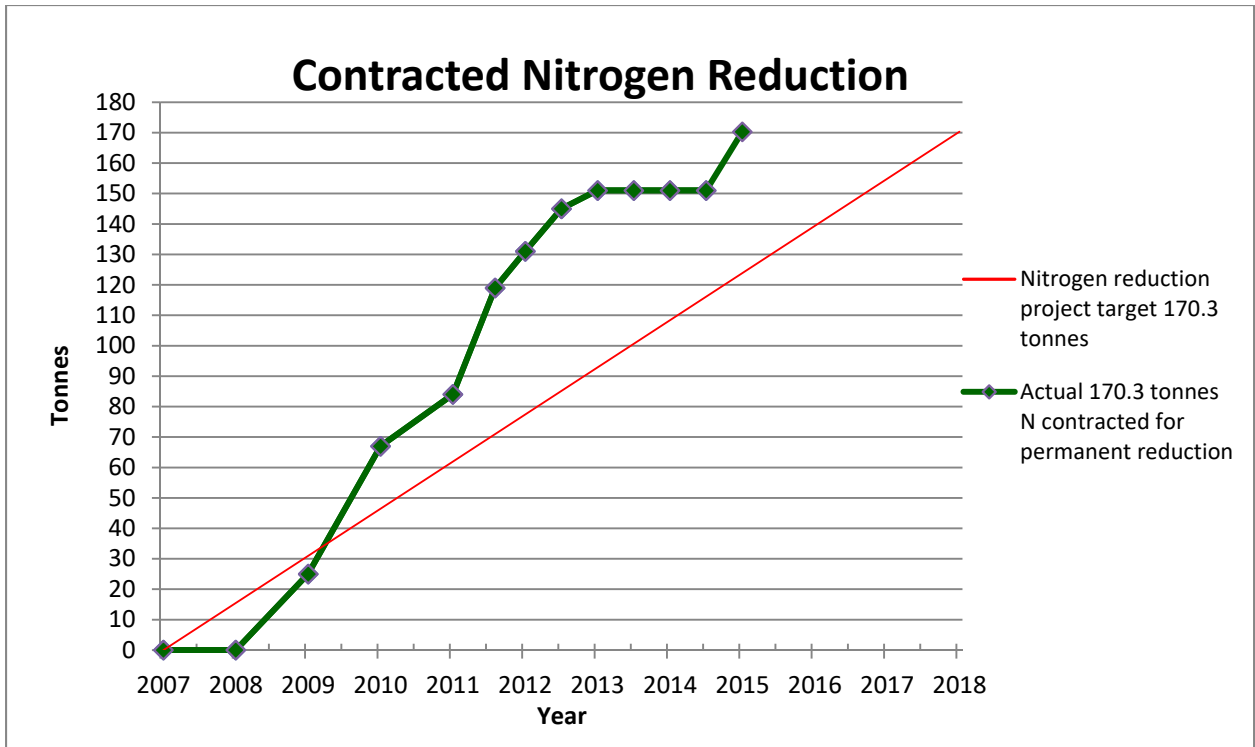
A number of other key policies and processes have been of importance and these include the operation of the Trust as a Council Controlled Organization, the Trust's Strategic Plan and relevant policies developed by the Trust to govern operations and ensure accountability of the project against its mandate. Reference is also made to the five year external review of the project and the likely role of the Trust arising from recent Monitoring Deed and Monitoring Plan.

This report does not seek to act as a comprehensive review of the project in total but rather looks to identify the present position and put it in sufficient context that the Joint Committee can confidently identify the next steps to overall completion. The Committee in its governance role has been receiving regular three monthly reports, annual 'statements of intent' and annual reports. The Trust has in addition always operated on a "no surprises" basis therefore it is unlikely that this report will introduce many unknown factors.

Despite that the Joint Committee has recently had changes in appointed representatives and accepting the importance of the current round of decisions it seems to be appropriate to reflect on the projects background, activities, and achievements before looking to the future.

Current position

The Trust is pleased to report that on 29th June this year the final contract will be completed which will secure the 20% nitrogen reduction target of 170,300kgs. It is important to highlight that while these contracts will be in place and supported by a range of legal and financial safeguards many of the contracts will not actually complete until 2018.



There are a number of reasons for this delay in contract completion:

- Trust funding streams are provided on an annual basis until 2018 therefore necessitating annual payments for nitrogen reductions
- The Trust’s strategic decision not to borrow to fund immediate payments
- Delayed longer term contracts allow for a more realistic approach by allowing gradual change to farming operations thereby helping clients with such issues as selling stock, buying tree stock from nurseries and gradual afforestation.
- Recognizing that a small delay in completion was relatively immaterial to the primary goal of achieving permanent nitrogen reduction for 999-years
- Alignment with the Trust Deed which foresaw completion of the project in 2018/19.

Notwithstanding the above the funding partners were able to provide increased annual payments where the Trust was able to negotiate agreements which had good business outcomes but needed cash payments up front. This was often the case where private land was involved and where funding for land change was being borrowed by the other party at the going bank interest rate.

The overall effect of this is that while the project has reached a significant milestone whereby we can have confidence that the nitrogen reductions will occur there is a need to maintain an operational and governance component at least out to 2018/19 when both payments and nitrogen reductions complete. It is with this knowledge that recommendations in relation to the Trust are made.

Contractual understanding

It is important to highlight that there is some complexity to the nitrogen reduction methods used by the Trust to secure the reductions. Central to these is the requirement on the Trust to secure the reductions in *perpetuity*. In legal terms this is 999-years. As can be imagined ensuring reductions over this time frame involving land changes and farm operational changes had some challenges. The Trust addressed this challenge with a “belt and braces” approach which involved the following:

- A private contract with the Trust. Effectively this is a detailed sale and purchase of nitrogen agreement which includes extensive penalties for non-compliance. These contracts are for perpetuity. (999 years).
- Ensuring that the required nitrogen reduction matches the Resource Consent issued by the Regional Council for the changed operation.
- Requiring that a covenant is placed on the land title ensuring that any new owner must still comply with the requirements.
- In a number of cases which involved forestry conversion the use of a legal Forestry Right which would allow the Trust in any failure situation to plant the land and gain the returns.
- Noting that a covenant on the title was not able to be placed on Maori land due to legislative restrictions however on application for a judgement the Maori Land Court agreed that the contract restrictions did not alienate the land and were permissible. Given it is highly unlikely that Maori land would ever be sold it is not considered that not having a covenant weakens the intended contracted outcome

In all of the contract documentation the transfer of the contract responsibilities from the Trust to another suitable party has been allowed for. While this is not an immediate concern it is not envisaged that the Trust would be the long term guardian of these contracts and that at some point the responsibilities will be transferred.

Understanding the purchase and price for Nitrogen

The funding of the project was subject to considerable debate and investigation by the funding partners in the early days of projects inception. Eventually a method was used which involved comparing the price to be paid for farmland against its transfer into forestry. This difference in value was then multiplied by the estimated amount of land change needed with the resulting outcome being an initial sum of \$72M being paid in yearly installments out to 2018. Following a better understanding of the amount of nitrogen needed to meet the 20% target the total sum finally allocated was \$79.2M. The cost sharing was agreed to with the Crown paying 45%, the Regional Council 33% and Taupo District Council 22%.

There was a delay of approximately two years between these land value estimates being made and the commencement of the Trust operations. During that time the price for farmland had increased by approximately 30% while forestry land valuation remained static. This had the effect of making the ability to purchase farm land and convert to low nitrogen uses and in particular forestry financially challenging.

The initial contracts for nitrogen reduction involved the purchase of farms and their subsequent on sale with nitrogen restrictions in place to forestry. This was found to be an unsustainable approach to achieve the nitrogen reductions required within the budget provided. This was reported at the time to the Joint Committee who supported the need to maintain momentum on nitrogen reductions while trying to manage the effects of these changes.

The Trust developed a Nitrogen Reduction Policy which allowed staff to negotiate nitrogen agreements within a set of financial and operational requirements. In conjunction with a strategic approach based on that *'we are good to do business with'* - the Trust approached nitrogen reduction contracts in a different manner.

Our new approach was based on creating business opportunities for landowners to still own or stay on their own land and also complete nitrogen reduction contracts. Key to this was the Trust being able to facilitate carbon reduction contracts with Mighty River Power (MRP) under the Emissions Trading Scheme and legislation. MRP became a major partner in purchasing carbon on a long term basis from new forestry planted, while the Trust completed the business opportunity through nitrogen reduction payments.

This win/win/win approach has been central to completing the project within budget and to the financial benefit of participants. Important in this regard was the active involvement of many of the larger Maori Economic Authority farming groups where the potential capital value decrease in moving from farming to forestry was established to be of lesser importance.

The budget given to the project also had a number of other demands upon it within the founding documentation including paying for all the benchmarking undertaken by the Regional Council, administration costs of the Trust and allocations of funds for nitrogen reduction research projects.

With the Trust having to operate in a competitive market for purchasing nitrogen, the Trust was obliged to work in a fairly confidential manner negotiating each agreement as it arose according to its circumstances. The price paid for nitrogen did vary but always there was intent to be fair and as much as possible in an open trading market to be transparent.

When dealing with Maori economic authorities however the Trust did not wish to negotiate differently with each group and a set price based on what we could possibly pay was set. This approach and with the Trust offering to part fund strategic research on these farms significant momentum was achieved and Iwi farms became the major contributor to achieving the nitrogen reduction target.

As will be seen in the cash flow (being presented today) the price of nitrogen fluctuated mainly between \$300/kg and \$400/kg with the initial farm purchases being in the higher range of approximately \$500/kg being the difference from what we paid for the land and what we could sell it for in the open market with the nitrogen restrictions in place. As can be seen agreements involved significant nitrogen payments involving millions of dollars. While these sums on face value appear significant it is important to remember that the party is not only selling nitrogen but also the rights to the use of the land in perpetuity which for private land in particular may have a significant effect on their capital value.

As one participant put it *"It's as if I have a 5 bedroom house and you are buying 3 bedrooms that can't ever be used again....what is my house worth?"*

The agreements achieved therefore had to be sufficiently attractive to compensate for the effects of the restrictions applied.

Policy Alignment

The Trust was formed as a Council Controlled Organization (CCO) and without doubt this was an inspired decision. Along with the appointment of a competent Trust Board who were able to act in a commercial manner, this has been one of the key factors to the success of the project. Handing over public money to an external body no doubt was seen as a risk at the time however it was tempered by the requirements of the Local Government Act which still required a large degree of accountability and public reporting.

The founding documentation and in particular the Trust Deed has provided a secure and clear lead to how the Trust should operate. This remains our singular most important document for reference from which the Trust has been able to build operating policies around including a Treasury and Investment Policy, Staff Delegation Policy, Nitrogen Reduction Policy, Communications Plan, Sensitive Expenditure Policy and Risk Management Policy. Performance against these policies is reviewed annually by the Trust and their operation audited and checked by Audit NZ.

With these clear policies in place the Trust has been able to keep staff resources to a maximum of two personnel. To achieve greater external third party scrutiny of accounts the Trust has in addition used an external accounting firm where appropriate. The overall outcome has been that we have been able to achieve approved and unmodified annual Audit NZ reports since the Trust began operations.

The certainty the Trust achieved through the funders commitment of funds through the Funding Deed document has been invaluable to having the confidence to enter into legal contracts and to plan our financial obligations into the future. The cash flow used by the Trust is totally dependent on this funding commitment to ensure our contract commitments can be met. The Trust also highlights the responsiveness of the Funders to deal with issues as they arose and to adjust the Funding document as needed. This was particularly important when the nitrogen target was increased.

The Project Agreement required five year reviews and one such review was carried out and reported to the Joint Committee on 14th February 2011. In short it concluded that the project was working well and in accordance with its intent. A further review is imminent although given the advancement of the project the funders could decide to delay its completion until a more suitable date.

Alignment with Variation 5

The introduction of Variation 5 to the Regional Plan created the framework and the methodologies for the project to proceed. This Plan change was both visionary and groundbreaking and introduced a regulatory framework based on:

- Holding and reducing nitrogen emissions on catchment farms.
- The use of a computer prediction technique based on farm operating data to allocate allowable maximum nitrogen emissions.
- Addressing long term nitrogen emissions.

- Requirement to have a Resource Consent to farm where nitrogen emissions were over minimum levels.
- Setting a maximum cap on nitrogen emissions using the above techniques.
- Creation of policies and processes which allowed nitrogen to be traded as a commodity within the catchment.

With this policy in place the funders were able to create the Trust to purchase nitrogen within the catchment. Without the Variation and the regulatory work of the Regional Council the project could not have commenced. All farms within the catchment now have Resource Consents and operate within the nitrogen cap placed on them.

When a purchase of nitrogen is made by the Trust it relies on the benchmarking and nitrogen allocation data developed and allocated by Regional Council staff. The integrity of that data is therefore paramount in ensuring public monies are spent appropriately. Similarly the Trust contracts rely wholly on the monitoring and ongoing assessment processes carried out by the Council staff. This is addressed in some detail by the Monitoring Deed and Monitoring Plan and now becomes the singularly most important part of the final phase of the project.

Relationships

Throughout the project the Trust has sought to develop constructive relationships with a range of parties and key stakeholders. At the commencement of the project landowners were naturally suspicious of the Trust operations in addition to still feeling some opposition to the requirements of the Variation and that their production capacity on their farm had been limited.

With a concentration on developing attractive business cases and dealing with parties openly and fairly this attitude has mostly improved. In addition Regional Council staff has also been able to reach a point where landowners are approaching them freely to discuss changes to their operation. It is essential that the development of these types of relationships continue and again the Monitoring Plan seeks to support innovative ways of how this can be achieved.

The Trust believes that it has had a very constructive and supporting relationship with the Joint Committee and would like to thank in particular the longer term members for that response. In particular in the early days of the Trust operation there was the potential for the Committee to become embroiled in the trading operations of the Trust. This was avoided and maintaining a “hands off” approach and concentrating on a governance role has enabled the Trust to operate with confidence in a commercial manner.

A highlight for the Trust has been the developing relationships with Ngati Tuwharetoa. While we were mostly dealing with individual farm trusts we were always aware of the broad support the project received from the Tuwharetoa Trust Board members. This proved invaluable for the Trust and opened doors to business opportunities for the Trust with Iwi within the catchment. The end result being that Tuwharetoa groups have become the major contributor of nitrogen reduction agreements and to the completion of the project to this point.

Financial Position of the Project

Attached is a projected cash flow [Doc # 25481] for the project out until 2018. The Trust has been obliged to work to long term cash flows to ensure that nitrogen reduction agreements paid up over time have sufficient incoming funds to meet its obligations.

While we were in the early years of entering nitrogen contracts the cash flow needed to estimate potential agreements into the future and while it gave the Trust an overall indication that we were on track and could complete the project within budget it has not been until the latter years that this certainty could be assured. We are confident now that the cash flow now provides certainty in completing the project within budget and that the projected annual financial positions outlined will need little adjusting .

The key components of the cash flow can be identified as:

- Annual income streams out to 2018
- Annual Trust administration expenses based on proposed changes to Trust operations and membership from July 2015 out to 2018
- Research and development funds continuance
- Allocated funds to support the monitoring plan implementation recommendations
- Allocated funds to meet nitrogen contracts out until 2018
- Maintenance of annual positive financial positions until 2018
- Contingency fund maintained out to 2018 with potential for small project surplus

Adjustments to the cash flow are made at the end of each financial year when preparing the following year's budget however given that the income and major expenditure patterns are now set the Trust does not foresee that major changes will require to be made. The contingency funds (small surplus) indicated by 2018 could be affected by unexpected expenditure particularly if legal action is required to enforce the provisions of any contract. The certainty of having a surplus and its amount will increase as the year's progress.

Notwithstanding the above the Trust is pleased to recommend to the Joint Committee that the project is financially on track and should be able to address any unknown draw on funds into the immediate future and until at least 2018.

Composition of Trust

This matter has been the subject to ongoing discussion with the Joint Committee over the last 12-months. We have indicated that when we had certainty on completion of the last contract that the Trust would recommend to the Joint Committee potential changes to the Trust operation and membership.

At present Trustees are appointed by the Joint Committee under the clauses 6.3, 6.4 and 6.5 of the Trust Deed. These clauses allow for the retirement of Trustees on rotation and are based on a three year cycle requiring retirement of half of the Trustees being based on "those who have been longest in office since their last appointment".

This year there is a requirement for retirement and rotation however the Trust due to the projects changed circumstances are now recommending that Trust members be reduced from a maximum of 8 to a maximum of 4 and to be appointed based on skill sets for the next phase of the project in accordance with 7.3 of the Trust Deed (Attributes of Trustees):

- Skills, knowledge and or experience relevant to the Project
- Appreciation of the wider public interest and ability to contribute positively to the achievement of the purposes of the Trust
- Understanding of governance issues
- High standard of personal integrity
- Time available to undertake the duties of the Trust
- No conflict of interest.

The Trust considers the ongoing roles of the Trust will still be in accordance with the Deed but with more emphasis on the delivery of contracts. The recommendation for the Trustees to remain is based on the following more detailed responsibilities.

Governance

- To provide an overall governance role which ensures the on-going credibility and public accountability of the project in respect to all financial aspects and delivery of its nitrogen reduction target by 2018.
- Approval and review of on-going strategic plans and annual business plans to ensure delivery of the goals of the project.
- Oversight of on-going operational activities to meet business goals
- Providing support as necessary to the sole Trust employee being the Trust Manager and acting as a good employer under relevant legislation
- Development and on-going review of Trust policies to ensure all operational activities are aligned with Trust goals and strategy
- Reporting to the public and the Joint Committee as necessary under legislation or as requested.
- Understanding of political and social influences on the project and reacting appropriately to those as they arise
- Overall ensuring a high level of confidence to the public, Joint Committee and stakeholders that the project remains credible and successful.

Financial acumen and experience:

- Overseeing management of all retained and incoming public funds and implementing a forecasted cash flow to meet the obligations of the Trust until 2018
- Overseeing and approval of all outstanding nitrogen contract payments
- Establishing and on-going review of key Trust financial policies which determine and enable efficient operating activities
- Approval and presentation of annual budgets in accordance with projected cash flow
- On-going liaison with Audit New Zealand and ensuring approval of annual accounts
- Reporting to the public and to the Joint Committee through annual report and audited financial accounts.

Legal knowledge and experience:

- Overseeing and establishing processes to ensure compliance with Local Government Act and Trust Deeds
- Oversight of contractual compliance assuring achievement of nitrogen target by 2018
- Responding to on-going requests for contractual alterations from other parties
- Determination on legal proceedings necessary to ensure fulfillment of contractual agreements where any failure arose.

Project / local skills:

- Determination on applications for research grants and ensuring the existing funding research delivers expected outcomes
- Maintaining on-going relationships with contracted parties and other stakeholders in the catchment area
- Ensuring that relationships with Ngati Tuwharetoa are maintained and strengthened and there is a broad understanding of their cultural and business needs and how they may affect the operation of the project
- An understanding of farming operations and where changes could impact on the delivery of the project.

These potential changes in the Trust membership numbers and operation have already been foreseen and are identified in the Variation to the Lake Taupo Protection Trust – Trust Deed agreed to on 1st July 2013 attached [Doc # 21745].

The Trust therefore recommends that in accordance with Clause 6.3 of the Trust Deed that the Joint Committee consider and approve that three Trustees retire from office and that the remaining Trustees be determined based on Clause 7.3 of the Agreement.

Should the Joint Committee agree to this approach our recommendation is that there is no need for external appointments and that Trustees Barton, Horton and Hura retire at the end of the financial year and that Trustees Clayton Stent, Sue Yerex, Jerry Rickman and Gerald Fitzgerald continue for the next three year period or until such period before that in the event of the Trust responsibilities being transferred.

The Trust wishes to highlight that this recommendation has been based on the best fit against future changing responsibilities and that the retiring Trustees all have significantly contributed to the project reaching this position. The Joint Committee may wish to recognize this contribution should the Joint Committee agree to this approach.

Clayton Stent
Chairman

Graeme Fleming
Chief Executive Officer