Clean Energy Finance Corporation: Expert Review

Introduction

This submission is a response from Grattan Institute to an invitation from Jillian Broadbent, the Chair of the Review Board. This brief submission is structured to make some general observations and recommendations, followed by specific responses to the questions raised in the Request for Submissions. Grattan Institute offers to engage further with the Review on the matters raised in the submission on any other aspects of the Review where we could usefully add value.

General observations

Clean energy projects are being financed in Australia. There is not essentially an endemic problem of capital availability, but of projects that meet the financial return hurdles of investors. In some circumstances, there may be a problem of capital mobilisation. Where policy mechanisms have been in place for some time, and reasonably stable, such as the Renewable Energy Target, projects have been financed. Policy instruments like this deliver outcomes consistent with their design. These outcomes may not be what the designer intended or may not align with the objectives of a range of commercial or political interests. The CEFC should not have a role to address these issues.

The clean energy sector has more than its fair share of companies and organisations seeking government subsidies for their models, and this is very much complicated by the political overtones and influences that surround green, clean or renewable energy. This has resulted in a plethora of policies, instruments and regulations across the Australian Commonwealth, State and Territories governments that have some aspect of their justification bedded in supporting clean energy. The objectives of these vehicles are often poorly defined, and unintended consequences are common. Grattan Institute's Report, "Learning the hard way: Australia's policies to reduce emissions", documents much of what is wrong with approaches that have been adopted to date. The CEFC should not become a response to these problems, nor should it be subsidising an industry that is simply not commercially viable.

Rationale for public funding or public sector support

By definition, government intervention means that something will be impacted, and many attempts by governments to intervene in markets, often for well-argued reasons end up with unintended consequences. This is the nature of markets and is both their strength and their potential weakness. Hence, government intervention needs to be well considered, and the primary test should be that the nett benefits will outweigh the costs. The proposition that intervention in a financial market by government has no impact on the private sector is simply wrong: some investment decisions will be different, and some investors will have reason to be unhappy. For example, proponents with projects that are being financed within today's policy framework, eg wind developers, will not welcome intervention by the CEFC that would crowd out, or adversely impact the returns for, their projects. A similar issue arose when state governments introduced subsidies and rebates for solar hot water systems with a consequence for the renewable energy market.

In the area being contemplated for the CEFC, the core rationale would seem to be that the emissions trading scheme (ETS) by itself will not deliver the optimal investment outcome. If it is accepted that the ETS will meet the emissions constraint that represent the climate change externality, then the

rationale for further intervention can only be based on relative costs, particularly where the energy system transformation involves investment decisions on capital-intensive, long-life assets. It may argued with some justification that an ETS does a fine job at forcing switching between fuels and available technologies, but a poor job at developing and deploying technologies with the potential to be lower cost into the future. Many NGOs and some political groups may argue that the ETS under-represents the climate change externality due to a lack of political will by incumbent governments. This would seem to more a political argument and less of an issue for the CEFC.

The spill-over argument that justifies public funding for research and development is also sound. However, we understand that this is area is to be addressed by ARENA, and not by the CEFC.

Key criteria for public sector support

There are several criteria that we would suggest should be applied. Whilst superficially simple, they are oft honoured in the breach, and should be kept front of mind:

- The activity of the CEFC should directly be addressed to overcoming identified capital market barriers. That means that such barriers need to be identified.
- Without CEFC activity, investment decisions will still be made. They will be different. The CEFC must ensure that the result of its activity delivers a nett positive outcome. The appropriate metric should be that the CEFC's activity delivers technologies sooner or different such that emissions constraints are met and energy security is maintained at lower cost than if such activity had not occurred.

Possible areas for public sector involvement via the CEFC

At one level, it would be possible to conclude that there is unlikely to be role for the CEFC that meets robust criteria. This could be concluded from either theoretical analysis of market failures or from empirical observation of the success of interventions adopted in other places and times:

- Loan guarantees and similar vehicles used in the USA have really only been effective in facilitating projects where there are existing policies to provide the primary revenue stream. Most commonly, these have been Renewable Portfolio Standards that have caused utilities to have an incentive to enter into firm PPAs. These have then provided the financial certainty to make sense of a loan guarantee, where the latter is provided at close to commercial rates or even at a premium on the basis that there are risks that governments can take but are more highly priced by the private sector, at least in early stages.
- A credible, predictable forward market in low emissions driven by clear policy should deliver the lowest cost outcome. The experience with RET in Australia and renewable targets in Europe tend to suggest this can be the case. Whilst the presence of other instruments such as banding or feed-in tariffs could suggest the need for additional policies, it is equally plausible that these policies were driven by other government policy objectives.

There may be a suggestion that the CEFC should provide funding at a government's cost of capital, on the grounds that the cost premiums created by the private sector's risk aversion create a funding barrier. This would seem to be highly problematic. Firstly, it raises the issue of the CEFC competing

with the private sector, and secondly it would seem to reverse a clear policy direction in Australia away from nationalisation of the energy sector.

In our view, the above considerably narrows the role of the CEFC, and any role must be subject to rigorous testing. The following proposed activities could meet the criteria:

1. The forward emissions price, driven solely by the ETS may not carry sufficient credibility to mobilise investments in capital-intensive assets with reasonably high technology risk. Grattan Institute is undertaking research in the area and will shortly publish two reports that explore it in detail. We will ensure that they are made available to the Review. The outcome could be investment that is sub-optimal from a societal perspective. There is likely to be a case for government support to address this capital market barrier. The outstanding question is whether this is a role best carried out by the CEFC. Grattan Institute recommends this as an area for further evaluation. Whilst the case for intervention is likely to be sound, the nature of intervention will need to be carefully crafted to avoid unintended consequences in the Australian energy and low emissions markets.
2. There has been some discussion in Australia regarding the use of some form of infrastructure bonds to support low-emissions technology and to mobilise sources of finance from superannuation funds or institutional investors with an appetite for this asset class. This market does not currently exist and it may it make take considerable time for such a market to emerge with any degree of liquidity. The CEFC could play a role in catalysing the creation and operation of Clean Energy Bonds, act as both a buyer and seller, and subsequently withdraw when sufficient market liquidity has been established.
   An extension of this approach would be to make such bonds tax exempt. We understand that this is an area outside the scope of the CEFC. However, it was a mechanism applied in the mid 1990's to some good effect in regard to infrastructure projects. Whilst there were some aspects of its implementation that became problematic, they are avoidable.
3. There may be project/technology/proponent combinations that, despite appearances of commercial viability, are not able to attract finance on terms that make them commercially viable. For example, the project does not have sufficient balance sheet substance to finance within the entity and firm offtake agreements are not sufficient to under-write access to affordable debt. The result is that finance is effectively unavailable. The provision of a tranche of debt, quasi-equity or a form of mezzanine debt product by the CEFC, on commercial terms (or even with a small premium), might both lower the cost of capital and encourage the entry of commercial banks etc. In this case, the CEFC would be taking a level of risk reflecting the status of government policy (as per proposal 1, above), and such a role would need to be mandated by Government in a clear, transparent and predictable way. The potential benefit would need to be balanced against the risk to the market operation and existing investors.
4. Loan guarantees have recently been criticised in the USA in the light of project failures. In assessing loan guarantees of other similar structures, it needs to be remembered that one direct consequence of government involvement is almost always a transfer of risk from the private sector to the public sector. This means that failures will happen, indeed if they do not, then it may be an indicator of other problems. Loan guarantees can be effective in addressing specific risks, and they could range across partial risk guarantees, partial credit guarantees, full debt service undertakings and first loss guarantees. Loan guarantees in the

USA have been effective when the project was well progressed, usually with a power purchase agreement or offtake agreement, but was facing a financing barrier. This implies that a loan guarantee is not, per se, a solution to financing clean energy projects. Rather, it would be crafted within the broader policy framework.

In responding to the questions raised in the RFS, we particularly note the following:

1. The objective is to overcome capital market barriers.
2. The CEFC is not intended to compete directly with the private sector
3. Capital is expected to be returned and reinvested

Further, it appears that the role of the CEFC is different from the UK's Green Investment Bank in several critical areas, and that the CEFC's proposed activities can only be sensibly considered in the currently anticipated policy environment (ie with the various legislation and government emission targets that are in place or proposed). This means that the CEFC's role will be qualitatively different from any similar entity or activities in other jurisdictions.

Scope of the CEFC

Actions by the CEFC to address the capital market barriers should be best focused on leveraging private sector funds. That means that addressing ways to improve debt availability and terms would be a better use of the CEFC's available funds than direct investment or co-investment itself. The capital intensity of most clean energy projects is such that debt tenor and leverage has a very significant impact on the levelised costs of energy, and therefore on the commercial viability of the project.

The criteria should be solely focused on those described above. Emissions should be covered by the ETS (and if they are not, then fix that problem).

As described above, the CEFC may be able to catalyse private sector debt or equity funding through its activities. Therefore there may be a case for the CEFC to formally partner with private sector providers of debt and equity to leverage its own funding. This opportunity seems worthy of further evaluation.

The market gap and overcoming it

As described above, the core rationale for the activity of the CEFC is to address a failure of the private capital market, primarily associated with the risk combination of technology and policy uncertainty. It is likely, and probably a secondary benefit of the CEFC, that its actions will lower the perceived risk to other financial institutions.

The term, cost and availability of funds are not problems themselves, nor is this a problem of technology. The challenge is to align the risks inherent in the technology and market with these financial parameters. Improved term and cost of capital have a material impact on the commercial viability of low-emissions projects, given the capital intensity of most relevant clean energy technologies. However, the primary issue is around market risk.

The primary non-financial factor that can inhibit clean energy projects is political, ie will the forward market for low emissions have credibility, flexibility and predictability?

There are many claims, and some evidence, that investment in energy efficiency and "smart grids" is less than optimal. We suggest that the barriers in this area are complex and the costs of their removal usually under-estimated. There is a potentially valid claim that activities or projects in this area suffer from a mis-match of scale and available finance, and again of liquidity. The work of Low Carbon Australia is likely to be targeted in the right direction, and the CEFC could usefully look to substantially lift this effort.

Other issues

The CEFC will operate in a complex policy environment, and this will be unique to Australia. Therefore, the actions of the CEFC, if it is to fulfil its mandate, revolve around a well-informed assessment of the rationale for intervention in the market and determining that such intervention will deliver a benefit in excess of the costs, both direct and indirect.