ALLEN & OVERY

Characteristics of the Australian Renewables Sector

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Introduction

After years of uncertainty, Australia's renewable energy sector is taking off. A number of previously planned wind and solar projects have been revived recently and the sector must grow rapidly for the next two to five years, in order to achieve Australia's now-confirmed Renewable Energy Target (RET) by 2020.

This document summarises some of the key characteristics of the Australian renewables sector which may be of interest for German investors and German banks. It looks at the incentive schemes that have been initiated at both the Federal and State level and the entities that have been established to promote the growth of the sector. It also provides commentary on one of the key threshold issues that has so far held back the explosion of the renewables sector: the availability of long term power purchase agreements with energy retailers. A snapshot has been provided of recent greenfield projects and some of the equity investment and acquisitions that have recently come to market.

Given the current regulatory banking environment it is still a challenge to secure the long-term financing of renewable energy projects in Australia and other parts of the word.

This paper, in addition, sheds some light on re-financing programmes provided by German development bank Kreditanstalt für Wiederaufbau (*KfW*) to support German investors with their projects and how to make use of KfW's renewables refinancing programme in Australia.

Who we are

Allen & Overy offers the unique combination of expert Australian knowledge backed by our German team's in-depth experience with KfW's refinancing programme. We are at the forefront of the global renewables market, advising domestic and international sponsors, developers, project companies and financiers across the renewables spectrum on all aspects of renewables projects. Our sector expertise, focused legal skills, ability to keep up to date with the energy and utilities sector (which is one of the fastest moving marketplaces in the world) and global reach give our clients access to the best advice.

Key contacts

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Federal and government initiatives and incentives

The Federal Government's Renewable Energy Target

The Federal Government has committed to source 33,000GWh of renewable energy per year by 2020, which will require approximately 6000MW of new renewable capacity to be built by 2020.

Participation in this scheme is incentivised by a tradeable certification programme. Each year, each energy retailer who draws electricity from the grid is required to submit to the scheme's operator a certain amount of "Large-scale Generation Certificates" (**LGCs**) based on the volume of electricity that they have drawn. LGCs are created and initially owned by the generators of renewable energy, and if an energy retailer does not have sufficient LGCs in any one year, then they incur a charge at a rate of AUD65 per MW of shortfall.

This creates a supply and demand market for these green instruments, encouraging energy retailers to invest in and/or enter into offtake arrangements with renewable projects in order to guarantee a supply of LGCs. It also provides renewable project developers with an additional revenue stream to improve the viability of their projects.

Clean Energy Finance Corporation (CEFC)

The CEFC is a governmental green bank that acts as a traditional financier, working with private sector financers to support renewable projects. It is able to provide concessional finance to assist projects struggling to raise funds (giving lower pricing, taking higher risk or allowing repayment over a longer period); however, the CEFC may not make grants. It will receive AUD10 billion of funding between 2013 and 2017. Since its creation, it has provided cornerstone investment for financial institutes green bonds issues, provided debt financing to renewable projects and invested in renewable funds managed by third parties.

Australian Renewables Energy Agency (ARENA)

ARENA is a state funded body that provides grants to improve the competitiveness of renewable energy technologies and increase the supply of renewable energy in Australia. It recently completed a solar tender and awarded over AUD100 million of grants to 12 solar projects. The Federal Government were considering defunding ARENA but instead decided to reduce its funding. It will now have a total of AUD800m to spend over the period to 2022 with a new focus on renewable storage projects.

State based incentive schemes

Some Australian States have specified their own renewable energy targets and in some cases have launched their own incentive schemes to meet those targets.

The Australian Capital Territory (***ACT***) has completed a series of reverse auctions that awarded successful projects Contracts for Difference (**CfDs**). These CfDs guarantee each project's revenue stream for 20 years by making up the difference between the market price paid for electricity and the pre-agreed feed-in-tariff bid by the project developer.

Victoria has recently announced a 40% renewables target by 2025, which will entail the construction of 5,400MW of renewable power generation. They contemplated 80% of this being target being met by wind generation. To assist the realisation of this target, CfDs will be auctioned in a process that mirrors the ACT's programme.

Queensland has set a renewables target of 50% by 2030. Under its Solar 150 programme, which compliments ARENA's solar tender, 20-year CfDs have been provided to four solar projects in Queensland, which will have an aggregate capacity of 148MW.

Energy retailers' attitudes to offtake arrangements with renewable projects

The main Australian energy retailers are starting to show more of an interest in entering into long term power purchase agreements for the energy produced by renewable projects.

To date there has been a certain amount of reluctance to do so, and as a consequence renewable developers have found it difficult to obtain financing for their projects unless they were able to obtain certainty of revenue from one of the state sponsored schemes. This has been one of the key threshold issues holding back the development of more renewable projects in Australia.

Their reluctance was caused in part by uncertainty over the government's position on renewables, which has been clarified to an extent following the confirmation of the RET along with other factors, such as Australia's signing of the Paris principles on climate change. The reluctance has also been fuelled by inconsistent electricity prices, which mean energy retailers are more likely to gamble on merchant market prices being lower than those agreed in a long term PPA.

This attitude has shown signs of thawing, particularly as falling renewable technology prices lead to cheaper renewable energy.

- *Origin Energy* entered into two PPAs with FRV (a solar developer) earlier this year, one with a 15-year term for the output of the 56MW Moree Solar Farm and the other with a 13-year term for the output for the 100MW Clare Solar Farm. Origin has also offered to enter into PPAs with the buyer of its Stockyard Hill wind farm.
- *Ergon Energy* entered into a 12.5 year PPA for the output of the 170MW Mount Emerald Wind Farm in May this year following a reverse auction that shortlisted seven projects. It also entered into a PPA with the significantly smaller (4.5MW) Normanton Solar Farm wind farm, although it is worth noting that this was primarily funded by an ARENA grant.
- *AGL* will enter into five to ten year PPAs with each project acquired by the Powering Australian Renewables Fund (**PARF**) it established earlier this year. Rather than sourcing equity on a project-by-project basis, AGL has launched this unlisted AUD3bn fund on the premise of providing an opportunity for large institutional investors to finance a portfolio of renewable assets, in order to diversify risk and reduce costs. It is expected that a number of existing AGL-owned assets will be sold into the fund, which will then acquire additional operating assets and greenfield development projects to reach up to 1000MW of total renewable generation capacity.
- *Synergy* has recently announced that it also intends to launch a renewables fund, and though the details have not been confirmed, PPAs may be offered for the projects developed by that fund.
- *EnergyAustralia* has not entered into any renewable PPAs recently, although has precedent for entering into PPAs with renewable projects, entering into 15-year PPAs for 50% of the output of the 111MW Waterloo Wind Farm and a 15-year PPA for the output of the 113MW Boco Rock Wind Farm, although it has not entered into any new PPAs recently.

While there is still no abundance of PPAs available this thawing is a promising sign for the Australian renewables sector. Financiers of renewable projects will still view PPAs with a term of 15 years plus and for 100% of electricity produced as ideal; however, it may be that PPAs are offered with shorter terms or for only a proportion (rather than 100%) of the electricity produced by renewable projects.

Snapshot of some current renewable developments and acquisitions

Greenfield developments

Clare Solar Farm, a 100-150MW solar project, is being developed by FRV in north Queensland. Construction is expected to start later this year with generation commencing late 2017 or early 2018. FRV has also developed two other solar projects in Australia, the 24MW Royalla Solar Farm and the 56MW Moree Solar Farm. FRV has plans to construct further solar farms, including the 150MW Lilyvale Solar Farm in Queensland.

Sapphire Wind Farm, a 260MW wind project, is being developed by CWP Renewables in New South Wales. The developers are currently seeking financing from the CEFC, Danish export credit agency EKF and commercial banks CBA and SMBC. Those banks have not yet been mandated. Financial close is expected to be reached before the end of the year. Sapphire will be powered by Vestas turbines. The project has a right to sell 100MW of power to the Australian Capital Territory at a tariff of AUD89.10 ($67.01) per MWh.

CERES Wind Farm, a 600MW wind project, is being developed by REpower Australia (part of the Suzlon Group of Companies) in South Australia. It will consist of 199 turbines and a submarine cable supplying electricity from the Yorke Peninsula to Adelaide.

Neoen is the owner of three of the solar projects successful in the ARENA funding round, being the 50.6 Parkes Solar Farm in New South Wales, the 25MW Griffith Solar Farm project in New South Wales, and the 24.2MW Dubbo Solar Farm in New South Wales. Neoen is currently sourcing funding for these projects, which are scheduled to come on line before the end of next year, and has secured some funding from the CEFC.

Sales and acquisitions

Stockyard Hill Wind Farm is a 536MW wind project currently owned by Origin. Once completed it will have 149 turbines and have an annual generation capacity of around 1,900GWh. The project is due to be completed by 2020. Origin is currently selling this project in a competitive bid. The winner will receive an offtake agreement from Origin for 500MW which will allow the developer to partially contract electricity from Stockyard Hill or transfer part of the PPA to other renewable projects. The amount Origin pays for the power purchase agreement will be set via the bidding process. Origin previously sought to sell Stockyard Hill in 2012, but cancelled the process in early 2013, despite strong interest from bidders.

Ararat Wind Farm is a 248MW wind farm project owned by GE, the UK’s Renewable Energy Systems, Switzerland’s Partners Group and Canada’s OPTrust. GE is selling its 25% stake in the project. Ararat’s turbines are in place and generating power, but the wind project has not yet been fully commissioned. The Ararat project is partially contracted, via an 80.5MW power purchase agreement priced at AUD87 per MWh with the Australian Capital Territory state government. SMBC, the CEFC and Export Development Canada provided debt financing to the project.

Kidston Solar Farm is a 50MW solar farm being developed by Genex Power. Genex is currently looking for equity investments in the project. The project won an AUD8.85m grant from ARENA and has a 20-year power purchase agreement with the State of Queensland. Genex has also signed an establishment contract and an ongoing connection contract with Ergon, Queensland’s state-owned distributor. The developer is considering expanding the project to 150MW and has been funded by ARENA to conduct a feasibility study for a pumped hydroelectric energy storage facility.

How to make use of KfW's renewables refinancing programme in Australia?

German development bank Kreditanstalt für Wiederaufbau (**KfW**) which is, in terms of balance sheet total, the third largest bank in Germany, offers various (re-financing) programmes to support renewable energy projects. The programmes, for example programme 270/274 – the standard renewable energy programme of KfW – are not designed to provide direct loans to SPVs but rather to constitute refinancing instruments for commercial banks (which need to be KfW eligible itself) which directly provide the funds for the relevant project. Up to 100% of the investment costs (up to a maximum amount of EUR50m) for a KfW eligible project can be refinanced by KfW. For the purpose of any such KfW refinancing loan, the commercial lenders operate as so-called "house banks" (*Hausbanken*) of the borrower and the borrower is a so-called "end borrower" (*Endkreditnehmer*).

The construction, extension or purchase of renewable energy sources, which comply with the conditions of the German renewable energy act, in particular:

- Electricity from solar energy (*photovoltaics*), biomass, wind energy, hydropower, geothermal energy; and
- Electricity and heat from renewable energies, generated in combined heat and power stations

are eligible for programme 270/274. Projects located abroad can also make use of such refinancing instrument, provided the project is comparable to those listed above and the operator of the project is a German entity, a subsidiary of a German entity or a joint venture with a major German involvement.

The financial conditions of such programmes are very attractive: KfW offers long term loans (five, ten or even 20 years) with fixed interest rates and one, two or three repayment-free starting years. The actual fixed interest rate depends on a risk assessment of the project to be undertaken by the commercial bank; eg onshore wind parks with a fixed feed-in tariff usually qualify as risk class B. As of 22 July 2016, this means that the fixed interest for a ten-year period amounts to 1.45%. The availability period for the KfW refinancing funds is twelve months following KfW's financing consent. The commitment fee amounts to 25bps per month on the undrawn, uncancelled amount of the relevant KfW loan.

If a project intends to make use of KfW's programme 270/274, the following points will, *inter alia*, need to be taken into account when drafting and structuring the loan documentation: (i) the KfW terms and conditions for programme 270/274 apply to the loan agreement and must be observed; (ii) interest payment dates, interest periods, repayment dates etc must be aligned to the provisions set out in the relevant KfW consent letter; (iii) the request for the the KfW refinancing must, at the latest, be made when 50% of the construction works for the relevant project have been completed; and (iv) the lenders are subject to certain obligations *vis-à-vis* KfW and the borrower must agree to take this into account and to support KfW where legally necessary. We understand that KfW prefers and this is in line with our loan market perception, that the underlying credit documentation should be governed by German law. There are also good legal reasons why this is convincing to us.

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