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Mandatory Renewable Energy Target Review Panel
MRET Review Secretariat
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Dear Sir

The Commonwealth Bank of Australia is writing to the Mandatory Renewable Energy Target (MRET) Review Panel as a lender to, and supporter of the Australian renewable energy sector. The purpose of this brief submission is to firstly, highlight issues confronting the sector from a lending perspective for consideration by the Review Panel, and secondly, to more broadly contribute to the discussion of the development of Australia's renewable energy generation capacity.

Commonwealth Bank's underlying premise for being active in the renewable energy sector is supported at the highest levels of the Bank and reflective of:

- Australia being committed to achieving a world class, commercially viable renewable energy sector through the creation of a Mandatory Renewable Energy Target,
- The private sector is to undertake the construction, operation, financing and ownership of these assets,
- The provision of economic and human capital which is not only remunerative, but to the nations betterment.

The prevailing structure of the renewable energy sector has several characteristics that we consider to be inhibiting growth and the MRET Review provides the means to address these issues. Specific attributes of the sector are:

- High capital value of installed generation, being above conventional thermal technologies, requiring long financing terms that achieve cost competitiveness along with equity and debt payback.
- Extremely limited pool of equity funds, in part reflective of the frequent "smallness" of projects, illiquidity of investments, comparative poor risk/return profile and significant regulatory uncertainty.
- Limited debt capacity, with those lenders active cautious given (i) concern that the regulatory structure may adversely change impacting on existing projects (irrespective of grand-fathering), and (ii) the marginal economic profile of many projects when evaluating combined electricity and Renewable Energy Certificate (REC) values. The need to provide long term financing also calls for heroic assumptions regarding medium and long-term demand and prices, carrying a high risk of error.
- Widespread concern as to the scope and frequency of reviews and changes to the regulatory framework underpinning the sector. While the desire to improve the structure is

commendable, it also stymie's investment given concern that changes may result in adverse outcomes for existing projects with little means of rectification.

- Sale of renewable generation and REC's are typically bundled, with the "black" electricity component receiving a price commensurate with market conditions (ie a price set by electricity generated by thermal means). Consequently renewable generation is substantially dependent on REC values to compensate for the current incremental cost of green generation.

- Level of debt required to support renewable energy projects is comparatively high, necessitating long term stability of earnings.

Addressing the Review Panel's Terms of Reference, which provides an immediate means to further stimulate the sector, our comments are below. For ease, the same numbering system has been used.

(a) the extent to which the Act has:
i. contributed to reducing greenhouse gas emissions
ii. encouraged additional generation of electricity from renewable energy sources.

The combination of relatively low interim targets (baseline generation easily meeting targets for several years) and the extended periods being experienced to obtain planning consents has acted to restrict the level of new development under way. As a result it is considered premature to introduce an alternative approach, particularly when the incentives for immediate development have been set a low level. In contrast the pipeline of potential developments across all technology groupings indicates a basic underlying acceptance amongst sponsors of the existing framework.

The introduction of an alternative regime also needs to be balanced by the overriding objectives of the Act being greenhouse gas reduction and increase in renewable energy generation. Development activity is likely to be significantly curtailed if an alternative approach is recommended by the Review panel, with wide scale resumption of development unlikely until a degree of regulatory certainty returns. This period could be as long as several years given the likely need for further consultation, political adoption, drafting and implementation. In the intervening time, development momentum would be lost, in direct contrast to the objectives of the Act.

(c) the mix of technologies that has resulted from the implementation of the provisions of this Act.

The present economics of renewable energy generation undeniably requires a form of subsidy, more so given the prevailing low thermal based power prices, whilst the level of subsidy needed varies widely by technology. At present wind energy is regarded to be the lowest cost and also operationally robust. The effective level of subsidy at $40 pre tax (and declining on a real basis) is however potentially inadequate to support less efficient means of generation, ie photovoltaic, and as a result the mix of technologies will continue to be skewed towards those being the most economically competitive.

As discussed in section f below, introduction of mandatory technology targets / caps are not considered appropriate.

(d) the level of penalties provided under this Act.

The level of penalty is one of the key factors in establishing a viable renewable energy sector in Australia, with the value of the penalty effectively acting as a ceiling to the market price of REC's. In this regard the decision not to allow a tax deduction for the penalty is an economic positive.

Analysis of the economic position of many renewable energy projects leads Commonwealth Bank to the conclusion that to fulfil the objectives of the Act, the level of penalty has been set too low (albeit tied to the issue of indexation) with project income positions being relatively weak under typical operating profiles. Such an initial economic position before consideration of potential declines in long term electricity and REC prices does not act to stimulate debt or equity investments, irrespective of a strong commitment to the sector.

As a consequence we would encourage the Review Panel to contemplate a modest increase in the penalty to ensure the initial viability of projects.

(e) the need for indexation of the renewable energy shortfall charge to the Consumer Price Index to maintain the real value of the charge and the associated penalty charge.

The decision not to index the penalty charge has created a number of results contradictory to the objectives of the Act:

- the value of REC's are widely assumed to be below the non-compliance charge, this acting as an effective price cap. With the real value of the charge declining in the absence of indexation, projects are also exposed to a real decline in revenues, (also dependent on the overall availability of REC's). The concern for lenders is that over time project cash flows become materially weaker and coupled with uncertainty of the residual market demand (that portion of the prescribed demand not contracted on a long term basis) of REC's, a relatively weak economic profile results on which to justify an investment decision.

- Absence of indexation leads to a reduction in future compliance costs, lessening the incentive to commit early to the purchase of renewable generation. Without the initial underlying purchase commitment, albeit not for the project / loan duration, it is highly improbable that either debt or equity could justify commencing development, ie construction. As a consequence investment deferral / lack of urgency is occurring.

Accordingly, our view is to that to maintain parity with future investment decisions and maintain an even flow of projects, indexation of the penalty is paramount.

(g) the possible introduction of a portfolio approach, a cap on the contribution of any one source and measures to recognise the relative greenhouse intensities of various technologies.

Commonwealth Bank's view is that this approach would be significantly damaging, in brief our rationale is:

- Introduction of caps is akin to the Government attempting to pick technology winners over the long term, ie those having the lowest cost of generation. Not only does this potentially stifle innovation / investment as caps on certain technologies are approached, it may also result in embedding higher cost generation in other technology clusters. To achieve greater community and industry acceptance of renewable generation the sector needs the flexibility to pursue the most cost efficient technologies. Further, it is also reasonable to question the ability of either the private sector or public sector to accurately predict technical advancements over the remaining 17 years of the MRET in order to set appropriate technology caps.

- Periodic changing / re-basing of caps is likely to follow any introduction of technology caps. In the event that caps are not producing the desired investment results, the Government is expected to amend the thresholds. Not only does this perpetuate the regulatory uncertainty in the sector, one of the greatest barriers to investment at present; it is also likely to significantly effect the income streams of existing projects. For example if Technology A is under utilised and Technology B is near or at full capacity, to encourage additional renewable generation the Government is likely to transfer capacity from Technology A to Technology B. This is likely to have the immediate impact of lowering the value of REC's produced by Technology B as the scarcity factor will have been reduced. Commonwealth

Bank's analysis is that generally renewable energy projects are not positioned to withstand economic shocks, thus it is reasonable to assume that in this simple example the viability of projects in Technology B would be significantly jeopardised. Lenders and sponsors cannot be reasonably expected to commit long term investments if this is a latent, uncontrollable risk.

- Debt and equity financing of renewable generation projects require a significant degree of long term (10 – 20 year) economic forecasting. Clearly forecasting for these periods entails a relatively high deviation factor and the introduction of technology caps and the possibility of subsequent change only adds to the risk of material difference from expectations. As indicated earlier, the financial position of a generic project does not withstand price shock, thus the consequence is more conservative financing which results in an increased cost of generation, or potentially investments are simply not made.

Overall , our conclusion is that the introduction of technology based caps would be adverse.

(h) the level of the overall target and interim targets

These targets are material in determining the pace of new build and the long term value of REC's. Commonwealth Bank's observations are that the current interim targets have been inadequate to stimulate meaningful development (defined as commencement of construction) with existing baseline generation being adequate to meet the immediate REC requirement. Further, application of a single GWh based target for the period 2010 – 2020 fails to address growth in the consumption of electricity in this period, giving tacit acceptance of a net reduction in the contribution of renewable generation to the overall level of generation. This appears be in conflict with the Act.

Of particular benefit to the sector would be an escalation of targets post 2010, at minimum to be held consistent with the growth in electricity demand.

i. the appropriateness of the operating environment including:

Ii scheduled end date of 2020

Acknowledging the need for an end date, it is appropriate to observe that for debt and equity 15+ year payback periods are necessary. When the time taken to undertake site evaluation, obtain planning permission etc, this end date becomes a significant issue, including for some projects already in an advanced state. Unless a strong and substantial market for a separate Green Power brand quickly emerges, which we doubt, it will become increasing difficult to support investment periods, as the payback period will exceed 2020.

iv need for future reviews

The risk of further reviews, irrespective of being actual or perceived, is one greatest inhibitors to investment. Any investment in the renewable energy sector requires all parties to make and accept detailed economic assumptions for the full MRET period, with the basis of these assumptions being a high level of confidence that the regulatory framework will not change. Clearly any change to the framework during this period will impact on the financial position of projects, and most likely to a significant degree. As stated earlier the financial profile of renewable projects does not result in meaningful levels of excess cash flow, hence the acute concern among debt and equity providers regarding regulatory change. If the Review Panel allows this position to be unchecked, it is likely to restrict investment. To underline this point, Commonwealth Bank's position is not to accept carte blanche the risk of regulatory change.

At this time, a clear statement by the Review Panel and subsequently the Government that the sector requires a significant period of regulatory support and stability would be a strong impetus for investment.

We trust our comments have constructively added to the Review of the Renewable Energy (Electricity) Act 2000.

Yours sincerely

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