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Clear skies

Having spent the last couple of years in a politics-driven limbo, Australia's renewable energy sector is seeing renewed investor interest. Nevertheless, the market still presents various challenges

FOR MUCH OF THEIR NEARLY FOUR-YEAR history, the two agencies tasked with driving the growth of renewable energy in Australia have lived under threat of closure. They were victims of political circumstance: introduced in 2012 under legislation passed by a Labor government but spending their early days as moving targets for a Liberal administration.

"In the first year, we didn't really understand what the makeup of the senate was going to be, and once we did understand it we didn't know which way the fringe parties would lean. We recognized that either we get very big or we quietly go into the night; no one wanted to go quietly into the night," says Ted Dow, managing director of DIF Capital Partners who until earlier this year served as CIO of the Clean Energy Finance Corporation (CEFC), which works to bring capital into the sector.

As prime minister, Tony Abbott may have been unique among his 21st century developed market counterparts in presiding over the opening of a coal mine and having to clarify – ahead of his 2013 election victory – that he believes climate change is real. Abbott had previously questioned the science behind the concept and his administration's stance on mitigation would not be described as hardline.

Attempts to close CEFC and the Australian Renewable Energy Agency (ARENA) failed to win senate backing, but the government did seek to restrict remits and budgets. This policy paralysis, including a dispute over revisions to Australia's renewable energy target (RET), suffocated investment in clean energy. Capital deployed topped $5 billion in each of the four years from 2010, according to Bloomberg New Energy Finance. In 2014 and 2015, it came to $2.56 billion and $2.96 billion, respectively.

"Abbott was the highest profile critic of the industry and it was government policy that led to there being less support for the sector," says Michael Hanna, head of infrastructure for Australia at IFM Investors. "Investment markets like certainty and if you don't know what the regulatory outlook is going to be like that affects sentiment and price."

A new prime minister has brought new confidence and there is expected to be substantial investment in the space over the next few years. Several renewables-focused PE funds are in the works and infrastructure investors are showing renewed interest in the sector, but it remains to be seen who will provide most of the capital and exactly how it will be deployed.

Positive steps

While Abbott wanted to shutter CEFC and ARENA, his successor Malcolm Turnbull intends to put them in charge of the A$1 billion ($770 million) Clean Energy Innovation Fund. Another significant breakthrough came a few months prior to Turnbull's election as party leader in September when an agreement was reached on the RET. The large-scale RET was revised downwards from 41,000 gigawatt hours by 2020 to 33,000, while the small-scale RET – which covers rooftop solar power and solar hot water – is unchanged. They also agreed to remove the biennial review of these targets.

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>
> – Scott Gardiner

The Clean Energy Council says that 17,000 GWh of large-scale renewable energy was produced in 2015, while achieving the full target means building 12,600 MW of new capacity. Projects equating to 6,600 MW have already been approved, although some will not reach construction. It estimates that more than A$10 billion will be invested in 30-50 major projects, as well as hundreds of medium-scale solar facilities.

CEFC, which has a A$10 billion investment mandate, has seeded several funds to help specialist managers take advantage of the anticipated ramp up in supply. Earlier this month, it committed A$100 million to a partnership with Palisade Investment Partners that will invest in projects valued at A$1 billion. Palisade's LPs are putting in A$400 million. The GP already owns two wind farms and CEO Roger Lloyd expects most of the capital to be deployed in this segment. A stand-alone pooled renewable energy fund is planned for the second half of this year.

Others preparing to enter the market include Lighthouse Infrastructure, set up by ex-Hastings Fund Management executive Mitch King, which will launch a dedicated solar fund, while Quinbrook Infrastructure Partners – run by a team that spun out from Capital Dynamics – will seek capital for a vehicle targeting Australia, the UK and North America.

In addition, several of the global and regional infrastructure players, ranging from Morgan Stanley to Morrison & Co., are said to be showing more interest in the market. Asia-focused Equis Funds Group, for example, has opened an office in Brisbane, hired a team of renewables specialists, and acquired or gained options over 1,000 hectares of land with a view to developing a 1,000 MW multi-stage pipeline. "We expect the first projects to be available for construction commencement later this year," says David Russell, CEO of Equis.

For those seeking new capital, it is unclear where it will come from. Palisade is bringing several of its direct investment mandate clients – including VicSuper, LGIAsuper and Qantas Super – into the CEFC partnership. LGIAsuper and Qantas Super have been with the GP for several years and already have exposure to renewables as backers of Palisade's 111 MW Waterloo Wind Farm. But they are the exceptions to the rule in the superannuation fund community.

"The Australian market was probably the first that really dominated infrastructure here and took its expertise offshore," says Oliver Yates, CEO of CEFC. "But given the size of our pension funds, when you are looking at smaller classes of investment, it's difficult to get them to focus unless you somehow amalgamate or pool it."

Expansion obstacles

The key challenges are certainty, scale and the depth of the local GP community. The

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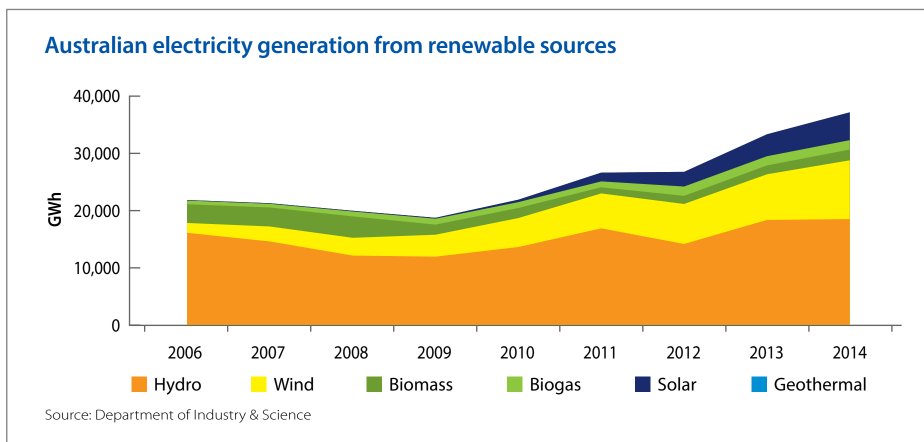
certainty question is whether anyone will buy the electricity once a facility is up and running. In other developed markets, an off-take arrangement – in the form of a power purchasing agreement (PPA) – is usually in place from the outset, equity providers come forward and then financing is secured, creating a smooth path to construction. Policy uncertainty in Australia made buyers wary of offering these guarantees.

Industry participants say the situation is improving with PPAs more readily available, but it is still difficult to obtain the 15-year contracts awarded in markets like the UK. "The predominant tenor offered by the retailers is five years and the debt tenor is 5-7 years. Rather than a well-buttoned-down project financing structure, here you see much more refinancing risk and merchant risk beyond that 5-7 year period," says David Scaysbrook, managing partner at Quinbrook.



Source: Department of Industry & Science

Some blame this dynamic on a dysfunctional electricity retail market, with PPA issuance dominated by AGL Energy, Origin Energy and EnergyAustralia. There are three pressure points. First, these retailers operate the country's coal-fired power plants, which may arguably means they have a vested interest in controlling the pace of renewables adoption because they want to get as much value as possible from the existing infrastructure.

Second, the retailers are wary of entering into long-term contracts to buy energy when large industrial customers often switch providers after less than five years. In the absence of a substantial feed-in tariff regime that would incentivize them to lock down renewable energy supply, they tend to ask for discounts on pricing in return for taking on this additional risk. Third, they have intimate knowledge of how to run power station projects, which means pricing and terms are tight.

"If you don't have a bucket-load of capital then you need project finance, which means a reasonably long-term PPA – and that leaves you at the beck and call of the energy retailers," says Scott Gardiner, a partner at King & Wood Mallesons (KWM). "Having done these projects themselves they understand down to the cent how much return an efficient developer needs to stay viable."

Aware that local projects are not getting done due to a lack of workable PPAs, state governments have stepped into the breach. The New South Wales and Victoria authorities are among those to initiate their own power procurement schemes for renewables, although they have yet to achieve significant size.

Risk factors

The scale issue exists due to the high level of fragmentation in the market. For example, while a number of wind energy facilities are available in the A$200-300 million range, the vast majority of projects are marketed on a single-asset basis with equity checks of A$30-75 million. This is fine for investors already present in Australia and looking for bolt-on acquisitions, but insufficient to attract new entrants to the market.

This is not necessarily a disincentive for managers, with most middle market GPs pursing some kind of aggregation strategy. In a solar market where rooftop installations of less than 100 kilowatts delivered 40 times more electricity than large-scale facilities in 2014, Lighthouse wants to leverage falling photovoltaic panel costs and greater uptake in the industrial and commercial segments. There are only a handful of facilities above 1 MW in Australia, but Lighthouse's King says he is seeing projects of in excess of 20-40 MW.

"The solar market is still fairly fragmented so we felt there would be opportunities at scale to be delivered over the next couple of decades," he adds. "You see more project finance principles applied for the mobilization of capital with larger sites and the green shoots in the utility part of the market with longer-term contracts."

For LPs, concerns about scale go hand-in-hand with concerns about risk. Last year, AGL sold a 50% stake in the 420 MW Macarthur Wind Farm to a consortium led by Morrison & Co. for A$532 million. Not only did AGL provide a 20-year PPA for Macarthur but it also makes a fixed monthly off-take payment, which means it takes on most of the risk. AGL compared the structure to a bond, based on the low risk-return profile.

If Macarthur is emblematic of an operational asset that might appeal to a superannuation fund, then a small-scale, merchant-backed, greenfield facility that has yet to secure a PPA represents its opposite. There is the potential of higher returns but taking on that level of construction risk, particularly given the relatively small equity check, would likely not meet the investment criteria. As such, while Quinbrook pursues scale through a combination of buy and build strategies, it has different pools of capital and different investor groups for each one.

Although some superannuation funds have exposure to renewables, DIF's Dow does not expect many of them to back middle market managers. He cites the private debt experience as an example: when superannuation funds started targeting the asset class they were drawn to the more proven US and European markets. "As with other investments, they will recognize that Australia may not be big enough for them and they may not be comfortable with the maturity of the manager set here," he says.

Meanwhile, AGL is working on an alternative. Earlier this year, the company announced the Power Australian Renewables Fund, which will invest in upwards of 1,000 MW of large-scale renewable energy projects with a value of A$2-3 billion. This means AGL can remove assets from its balance sheet – the Nyngan and Broken Hill solar plants, which have combined installed capacity of 155 MW, will be among those sold into the fund – and bring in long-term, low-cost capital. AGL identified infrastructure funds as likely investors in the vehicle, but superannuation funds are also seen as potential targets.

"AGL is trying to create an investment platform to attract capital that writes a much bigger equity check," says KWM's Gardiner. "They are creating an opportunity for the larger investors who may otherwise be looking to invest in port or electricity grid assets."

It is an innovative approach but not without risk. The off-take agreements will only be 5-10 years in duration and investors will have to decide if the presence of AGL as manager, customer and co-investor – it is contributing A$200 million – offers enough certainty that projects can achieve the estimated returns. However, AGL's multiple roles are a source of

concern in itself. Conflicts of interest are likely to arise should the company simultaneously try to observe its fiduciary responsibilities as fund manager, identify projects for the fund to invest in, and serve as a customer of those projects.

"No investor I have marketed to in the last five years would put money into a fund that is so structurally conflicted unless the conflicts are resolved in some way," notes Quinbrook's Scaysbrook.

Plotting the future

Whether or not AGL's fund management gambit pays off, it and the other electricity retailers will have to clarify their positions on renewables. To the CEFC's Yates, mitigating climate change means scaling down fossil fuel generation and so building new coal-fired capacity is impossible. The cost competitiveness of renewable energy must therefore be considered in the context of no coal or a carbon tax, or versus gas or other renewable sources.

Assuming the regulatory environment remains stable, the practice of buying large-scale generation certificates in the open market – electricity companies must submit a certain number to the regulator each year – may no longer be feasible. And if balance sheet pressures means they can't build their own renewable projects, they will have little choice but to rely on third-party providers working under PPAs.

While there appears to be a role for private capital in this process, but it is difficult to plot a trajectory for the market. The independent renewables managers could be successful in their aggregation strategies and build track records, thereby alleviating concerns about scale and the depth of the GP community. With this in mind, it would help if the consultants who advise LPs on allocation strategies became more familiar with renewables.

As for the superannuation funds, it remains to be seen whether they become progressively active investors, as has proved to be the case elsewhere in infrastructure. Yates expects certain groups to establish in house teams for the renewables sector and go direct, but this doesn't make the manager redundant: some of Palisade's commitment to the CEFC partnership will come from direct investment mandates.

"I think in this space they are likely to use some form of a fund structure, but not a normal limited partnership, it will be groups working together through individually managed accounts," Yates explains. "Palisade's LPs are using the manager's expertise but retaining the ultimate decision making power for the individual investments."

What is needed in the interim are success stories. Improving sentiment is evident in listed developer Infigen's stock price, which has yet to recapture its pre-global financial crisis highs but has doubled in the last six months; in the steady climb in the price of large-scale generation certificates; and in the greater availability of PPAs. There are also more exit options for assets of scale, with foreign institutional and strategic capital becoming increasingly aggressive.

Pacific Hydro, which has hydro and wind assets in Australia and Latin America, was not always easy for IFM Investors to handle – there was an asset write-down and ongoing concerns about policy conditions. Yet China-based State Power Investment Corporation (SPIC) agreed to buy the asset in December for an estimated A$2 billion, far more than many had expected. SPIC has since acquired other renewable assets, suggesting its appetite is not yet sated.

"It is increasingly likely that foreign capital will support the sector if it is attractive," says IFM's Hanna. "You might also see partnerships between investors and electricity companies that write contracts – that is how the market should work most rationally. It's evolution not revolution, but there is a fixed and firm renewable target and that implies a lot of projects need to be built over the next five or so years."

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