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Standing Committee on Economics
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Hepburn Wind is a community owned co-operative of commercial scale designed to accommodate the energy needs of the local community based in Daylesford Victoria, about 110 kilometres north west of Melbourne. The Co-operative has about 1900 members with over half those members being local to the project. It has taken six years from inception to completion and is now generating and dispatching energy to the electricity network. Hepburn Wind embraces both social and economic objectives with a focus on community engagement and the delivery of economic benefits to its members and the local community in general through economic multipliers.

The project has an approximate capital cost of $13.50 million dollars provided by members' equity (shares issued in the Co-operative) Victorian Government grants and bank debt (provided by Bendigo Bank). Members' equity is the equivalent of share capital in the Co-operative and comes from approximately 1900 members. The members of the co-operative can be characterised in general, as "retail investors" that is; individuals, self-managed superannuation funds and philanthropic investors. This broad-base support from local community members, over half the investors are "local", demonstrates the ability of these projects to tap into local capital. Hepburn, like most regional areas, does not have enough capital to develop this project alone and is supported with funding from like-minded investors who do not live in the local community but share the co-operatives objectives.

Some of the challenges facing community developments are detailed below followed by some suggested solutions to those challenges.

These observations are neither comprehensive nor exhaustive but rather represent the observations of the author and the successful experience of financing a community owned and operated renewable energy generator. There are many obstacles inhibiting the development and construction of projects of this size. There are numerous reasons to encourage this scale of project which include social licence, community engagement and ownership, retention of economic benefits, developing skills, increased opportunities in regional Australia, improved grid security and increased generation of renewable energy. Community scale generation projects represent a real opportunity to create business opportunities in regional Australia; the provision of finance is one of the most obvious obstacles. It is also an obstacle that can be overcome with little risk and expense.

Challenges:

Capital availability as a constraint, issues of timing

Before any project can get started it requires capital, and initially this capital will come from the group who initiated it. From this initial capital develops a capital-raising programme to take the project through to completion. There is an inevitable lag between the capital available and the need for capital to progress the project. The need to enter into binding contracts (a legal agreement between the community and the developer to commence design work, ordering plant and equipment) with suppliers and distributors and the financial ability to support those contracts requires funds. The availability of capital therefore determines the pace at which the project can proceed and acts as a major factor in the time it takes to bring a project to completion. A deficiency of capital constrains the rate of progress of the project.

The developer will demand proof that the community has the financial capability to complete the project and honour it's contractual obligations. Because of the single asset nature of the project counter parties have no mechanism to offset their risk apart from excess capital from the project. Consequently the project is often required to have an excess of capital and the demand for funds can outstrip their availability from time to time, this in turns slows down the rate of progress and pushes out the completion date for the project. Another example of the timing problem is the demand for securities, guarantees to ensure performance of the contract, from counter-parties, often months in advance of the actual payment, or in some cases the requirement that a large percentage of the contract value is paid in advance.

Collectively these are examples of the need for the community to have funds available from an early stage of the project, often well in advance of their actual demand to demonstrate their capacity to honour their contracts and deliver the project in a meaningful time frame.

Debt funding availability

Another plank of the capital structure of the project typically comes from a bank and represents "senior" debt secured by a mortgage over the assets of the project. This debt has priority over members' equity and the provider has the right, in the case of default, to dispose of the assets to recoup their funds. Debt funding is available on prescriptive terms as the lender tries to protect itself from what is viewed as an inexperienced management team and single asset risk. There are two criteria that borrowers rely on to reduce their risk exposure; income from the project and the percentage of debt to the total cost of the project.

There are two types of debt funding- construction and operation. Typically construction funding is expensive as the lender is at risk that the developer/project manager will not complete the project in time and on budget, leaving the debt provider with an incomplete project requiring additional capital before it becomes operational. These risks are mitigated by a higher interest rate and the preparedness of the financier, in the case of default, to take over and complete the project, or their confidence that they can find a willing and competent buyer to complete and operate. Subsequently the banks are reluctant to participate unless the community can demonstrate significant levels of equity or demonstrate that it has access to additional sources of funding, as an example, government grants or third party guarantees. Furthermore typically the bank will only provide finance once and after all equity has been committed, this results, when the project finds itself drawing down debt, in a lack of funds for working capital such as daily expenses for staff and rent. Development funding is usually contingent on the approval of operation debt funding.

Operational debt is in place for the medium term, 5 to 10 years and is repaid over time in the form of interest and principal and relies on the project producing enough revenue to cover its operating expenses and loan commitments. Operational debt funding is typically secured by a global debenture charge, in effect another form or mortgage, over the assets of the project. The level of debt funding is determined by the project's anticipated ability to service loan repayments and an acceptable debt to equity ratio. In other words the bank will not lend the community more money that they think they

can afford as determined by their ability to service the loan, the Debt Service Cover ratio (DSCR) and the proportion of debt to the total capital value of the project. The ratio of debt to capital is designed to protect the lender from loss should they be forced to sell the assets to recoup their loan.
In the case of Hepburn Wind the debt to equity ratio is a modest 23%, this is acceptable to the debt funder as they consider they could sell the assets and recover their loan funds in case of default. Typical utility scale wind farms have debt to equity ratios of around 70% - a significantly different financial structure to a community scale project. This partly explains their need for scale and focus on profit at the expense of social licence; they cannot afford to be as focussed on community engagement, as it might result in an uneconomic reduction in scale.

As well as the debt to equity ratio, or in other words how much "skin in the game" the community has, the other factor relevant to the bank is the project's ability to service its interest payments- the so called "Debt Service Cover Ratio" (DSCR). Typically for a project of this size with an unproven track record, providers of debt funding will look for a conservative DSCR, say 1.5 times. This means that the project must generate revenue, after tax, of 1.5 times the annual principal and interest payments. Reliable revenue must be available and ideally should be supported by a reputable counter party to further reduce the associated risk. This usually entails a fixed term contract at a fixed price from a reputable, say listed and large capitalised, business. The sort of business that can and will provide this type of contract- a contract to buy the energy generated by the wind farm and commonly known as a Power Purchase Agreement (PPA) or an 'off-take' agreement, is normally a generator and retailer in their own right.

In effect the community project has to contract with its competitors, the large-scale gentailers, to sell their output and satisfy the project's debt funders. It is obvious that gentailers will only offer to buy the output at a level lower than their own cost of production; otherwise they would simply build the generation capacity themselves.

This challenge is further exacerbated by the need for the community scale generator to deliver at a lower cost than achievable by an operator with a flexible corporate structure. This corporate structure allows them to balance their cash demands against existing revenue. Typically they have a segmented business that facilitates shifting profit between divisions, in effect a cross subsidy, that is not available to a small-scale enterprise. If a large listed corporate has a "development" division and a "generation" division it is quite possible that the generator can agree on a higher PPA with the developer, thus enhancing the developer's profits whilst passing the increased cost onto the consumer. By corporate management such as this the large scale corporate can amplify their reported profits and enhance their market value. This is a competitive advantage a single purpose community generator does not have.

Grid Connection
In the case of Victoria there is no obligation on the distributors to accept the power generated by a community scale wind farm. In addition there is no competition amongst distributors, who have a regional monopoly. Hepburn Wind has often been reminded that our projected annual output, 12,200 MWs is not significant and may in fact be a distraction for those managing the grid. This in turn reduces the certainty of accessing the grid and therefore the revenue needed to finance the project. Without ready access to the grid the project is not economically viable as there is no mechanism to sell the generated power.

The monopoly nature of the distributors in Victoria means, amongst other things, that there is little room for the community generator to negotiate favourable terms for grid access. In effect the generator becomes a "price taker" and the terms may be onerous. For example the demand that the community has to make a substantial part payment in advance, further strains the availability of funds. In addition the community generator may pay more than would be reasonably justified. The last point reflects the fact that the distributor can insist on capital works to improve the network in anticipation of generation and may insist on upgrades that are excessive in scope and expense when compared to the generation capacity being installed

Foreign Exchange Risk Management
Typically with advanced technology a component of the capital expense will be outside Australia. The board of the community generator will need to be wary or mindful of the impact of moving exchange rates. In the example of HW, feasibility was assessed before the GFC and the subsequent collapse in the value of the AUD. This led to the realisation that due to the effect of the GFC on the exchange rate the project's viability was under pressure due to a dramatic increase in cost. Subsequently the AUD regained most of its losses.

The risk embedded in foreign currency denominated contracts is a function of currency volatility, that is, the magnitude that the value of the currency can vary over time, and is high given the speed with which currency markets can move.
Volatility is an important factor in financial markets as it is used as an input in the calculation of the cost of hedging programmes (a programmes designed to mitigate the risk of adverse movements as opposed to speculation which is aimed at profiting from these movement). High volatility and speed of exchange rate movements mean that the cost of protecting (hedging) the project from these risks can be an expensive strategy and at additional, unbudgeted cost, that in its own right adds an extra financial burden on the project. It is possible that the effort and cost of raising capital for a community could be wasted because the effective cost of insuring against an unexpected increase in costs was excessive. This foreign exchange risk is a dilemma, as the board must consider spending large amounts of money to protect the project against an event that might not even occur. In addition, for taxation purposes there are restrictions on what is defined as a "hedge" so if alternative strategy is employed the project might have to realise a "taxable" loss for accounting purposes giving the impression to members that their funds have been invested in trading foreign exchange rather than hedging against unforseen movements in the currency and further pushing out the date at which dividends can be aid to investors.

Power Purchase Agreement Levels
Currently the community generator needs an "offtake" agreement with a credible counter party to support its application for debt funding. We have already discussed the conflict of interest this presents, as the provider of these agreements are typically competitors. In addition the market has over recent years been flooded with Largescale Generation Certificates (LGCs) previously known as Renewable Energy Certificates (RECs) to the extent that they are in surplus and thus cheaper to buy than to create. LGCs are created by generation capacity and accreditation that the power produced is "green" power. Consequently when the community generator seeks finance they find it difficult to get PPA contracts at a price that can support debt, thus increasing the need to find equity. Depressed PPA levels have undermined support for new generation capacity at all scales and it is this, plus uncertainty about future levels of revenue for renewable energy in general, that has restricted commissioning new capacity.

Paying Dividends and rewarding investors
As a start up business with large capital expenditure the community generator is entitled to claim generous depreciation allowances. This is of course a good thing as it effectively provides a tax subsidy to the developer (it is not exclusive to community generators, this is available to all businesses). In the situation where the community generator is structured as a co-operative and produces surplus revenue from its operations it is, for tax purposes, making a loss. It can't pay a dividend to its members, as dividends are only payable from a surplus, investors have to be patient investors prepared to wait until the project is making a surplus in order to get a return on their investment. The availability of patient funds is a constraint to the projects ability to raise capital and is reflected by the timing of membership applications, essentially investors will invest towards the end of the development, after the maximum demand for funds, when completion is in sight.

Investment Scale and Access to Wholesale Funding
Institutional investors often described as "wholesale" as opposed to "retail" (mum and dad) investors have minimum limits on the funds they will invest. Typically wholesale investors are not interested in "direct" investments, where they invest in the operating company, preferring instead to use Investment Managers who undertake due diligence and locate potential investments for a pooled fund. Pooled funds are typically managed by experienced management teams and offer a lower cost

and risk point of entry to the market by having exposure to a wide, diversified, pool of assets. I know from experience that managers will not look at investments less than $25 million in size, this is simply an economy of scale matter as it takes as much effort to analyse a $25 million deal as a $250 million deal and one is of significance to portfolio performance while the other is not as significant. Most social enterprise investing is of a one off in nature and therefore does not reach the right investment size to warrant consideration. Also social enterprise investing is usually of the "direct investment" form, into the entity as opposed to a managed fund, which is of greater risk. The conclusion is that a project like Hepburn Wind at $13.5 million is too small for institutional investors and can't tap into the large pools of superannuation funds.

Recommendations:

1. Feed in Tariffs for community scale generators

An obvious way to increase the availability of funds is to remove the revenue risk from the project by introducing a guaranteed price for the output. A Feed in Tariff would be ideal for this. In Canada they have a community scale Feed in Tariff set at a $0.01 per KW premium to assist in offsetting the cost disadvantages that small scale enterprises have in relation to their larger corporate competitors. Feed in Tariffs have the advantage of giving the generator a guaranteed PPA price and therefore the ability to demonstrate that the project risk is limited to generation capacity rather than the vagaries of the market. The need to reach a PPA with a large-scale competitor is removed and potential lenders can understand with greater clarity what the expected revenue stream will be. Certainty encourages investment and a Feed in Tariffs creates certainty.

2. Special purpose investment vehicle, "Community Renewable Fund"

The establishment of a specialized fund to co-invest, with local communities, in regional renewable energy generation, without restricting the type of generation technology, in other words, a technology agnostic basis. The Fund could be in the form of Managed Investment Scheme falling under the auspices of ASIC requiring a Responsible Entity with an AFSL Licence, experience management in both the funds management and community renewable fields and with funds under management large enough to attract wholesale investors and an offering for "retail" investors. The fund would be a "unit" trust in that investors get units in the trust and the trust itself is not a tax payer, instead the fund simply passes through income, after management fees, to unit holders. The Fund's offering to wholesale investors would be in the form of an Information Memorandum (IM) and a Product Disclosure Statement (PDS) for retail investors.

A PDS has more detail and attempts to highlight the risks of the investment more than an IM. The difference simply reflects the assumption that "wholesale" investors are professional and therefore have a greater understand of the investment process and risks. Retail investors are assumed to be less well informed and therefore need more detailed information on which to base their investment decision. A unit fund is common in Australia, they are typically unlisted and well recognised and supported by financial planners and financial advisors. Such a fund would be popular in major urban centres where there isn't the physical space to build generation capacity, nor necessarily the right environment for generation.

The Fund could provide finance at crucial stages of the project.

The Fund could finance the development of the project while the community raised capital and in effect eventually "take out" the Fund's part or all of the Fund's equity in the business. This would help alleviate the mismatch of demands for capital during the development and construction phase and allow the community time to catch up commercially. In addition the experience of the Fund's management team coupled with external expert consultants could compliment the resources of the community and reduce the risk of the project during development. The expected cost of the project should also be lower with the input and assistance of expertise in the field and in ensuring that the cost of finance is kept to a minimum. The Fund's objective is to facilitate the development of the projects with local communities on the most efficient basis economically and to ensure the lowest cost delivery for the communities benefit. The Fund itself must be economically sustainable, it must

be able to pay it's own way, but the objective is not to maximise the financial rewards for the management team but to maximise returns for it's investors and deliver flexible low cost finance that reflects the particular needs of community project. Expertise and a flat fee basis, with potential for fees based on the investment performance of the Fund, could ensure the most cost effective model for both investors and communities.

Ultimately the Fund would have retail and wholesale investors, initially though there is the potential for the Government to be a "seed" funder, an investor to get the fund going, allowing it to develop a pipeline of business, management and fee income to support the development of the Fund. On this basis the Government's investment would be that, an investment, not a grant that but funds that act as a catalyst for other investors and which could potentially be redeemed at a later date when the fund is more mature and self supporting, sustainable.

Investment returns could have a benchmark to measure the performance of the fund and distributions, the net of income less fees, could be paid as frequently as monthly to accommodate retail investors. The underlying investment of the fund would be ideally in the form of a hybrid debt and equity instrument. Typically referred to a "convertible notes" these hybrids provide a regular income stream to the fund without requiring the project to repay the principal invested, instead they convert into equity in the future, after the project has matured and well understood, to repay the principal. The idea of the hybrid convertible note is to free up cash flow for the members to facilitate t paying dividends sooner, more frequently and at a higher level and to reduce the cost of finance for the project.

Hepburn Wind's experience has demonstrated the enthusiasm of retail investors to participate and invest in community generation in spite of it not being "local". The fund would require a well-defined understanding of how the sector works, the uneven demand for cash flow in relation to project timing and provide advice on foreign exchange, trade finance and guarantees to secure contracts and reduce any excess demands for capital. In summary a broadly based, a unitised fund, regulated to ASIC, a flat fee basis to maximise unit holder return and the objective of financing regional community scale renewable generation.

3. Special purpose energy retailer

The creation of a retailer specifically for this sector, prepared to operate at financial levels that facilitate a pricing structure for community renewable generators. The retailer would not have profit as its primary objective, although it must be financially sustainable in it's own right, and might be in a position to offer adequate PPA agreements in return for future equity or a share of profits. The target market for the retailer would be both the local market and to the broader market, thus giving depth to the financial strength of the retailer that in turn provide support to the contract and assist with finance. In essence this retailer would be akin to a feed in tariff but more targeted.

4. Guarantees, government or private

Availability of guarantees to secure funding, contracts, hedging of foreign exchange and mitigates counter-party risk. The guarantee could be provided by; Government, The Fund or private enterprise, to de-risk the project during development and for financing purposes. The availability of guarantees would reduce the need to have surplus capital, give comfort to contractors that the community has the financial capability to complete the project and allow the community time to raise capital whilst construction was being undertaken, if necessary. This collectively makes for a better financial outcome for all parties involved and in effect represents pledging funds to the project ahead of schedule.

5. Small scale listing mechanism

The development of a listing platform, the ASX as an example, with short form listing rules, dedicated brokers and low cost trading facilities, all designed to keep the transaction costs to a minimum and to allow access to a pool of capital. Proposed projects could list on this exchange and use it as a means of raising capital in a form that facilitated liquidity, that is the ability for the investor to cash in their investment if they need funds, as opposed to being unlisted where the project will try to assist potential seller find buyers.

6. Changes to co-op rules to allow dividend payments out of free cash flow as opposed to surplus.

During the Global Financial Crisis a change was made to the Corporations Act to facilitate the ability of companies to pay a dividend even though they might be showing a loss. This was developed in response to the situation where a company had good cash flow and a cash surplus to pay a dividend but could not pay a dividend as they were making an accounting loss because, say, market revaluations producing mark to market losses. The consequence, shareholders were being denied income and the company was being denied a mechanism to pay dividends. Changing the Co-operative Act to mirror this would be beneficial, as would aligning nationally the rules for Co-operatives and having a central Regulator. National agreement on rules would allow co-operatives to raise member's funds from a wider, national, market.

Why assist community scale renewable energy project?

These projects create jobs and opportunity regionally, there are local benefits, ownership remains within the community, asset diversity is created for the grid, there's greater competition from diversified generation, and increased skills and economic growth is created at the regional level. In other words the benefits are spread wider and more diversely than when concentrated in large-scale businesses, the economic multipliers are most likely greater for the local communities and support regional sustainable development.

If the Committee would like to discuss this submission further please feel free to contact the author.

Regards.

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