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Victorian Renewable Energy Auction Scheme - Submission

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1 Overview

Herbert Smith Freehills welcomes the opportunity to provide feedback in response to the Victorian Government's consultation paper on its proposed renewable energy auction scheme.

Establishing an appropriate legal framework for the auction scheme will be critical to ensure that the scheme is able to meet its objectives. In particular the scheme will need to appropriately address the requirements of project financiers and proponents in order to attract sufficient market interest, at lowest cost, in order to drive development and jobs in Victoria.

This submission is based on our experience of having been legal advisors (to both project developers and financiers) on over 85% of the project financed wind farm projects in Australia to date and over 90% of the large scale solar projects in Australia to date including all but one of the wind and solar projects supported by the ACT's Large Scale Feed-in Tariff renewable energy auction scheme.

2 Scheme Structure

2.1 Interaction with Federal Policies

The scheme structure proposed by the State involves an 'offtake' contract (**Contract**) under which the State would make payments in respect of generated electricity and purchase large-scale generation certificates (**LGCs**) created under the RET scheme from successful proponents (**Proponents**) and either surrender those LGCs itself or, in the lead up to 2020, potentially resell those LGCs into the market.

The greater the certainty that the State can provide project proponents in relation to project revenue the more competitive the project finance offerings and accordingly the lower the price proponents will be able to offer the State. A key focus for financiers in the Australian market is "RET repeal risk", that is, the risk of project revenues deteriorating in the event that the RET scheme is repealed prematurely or materially amended.

To best support project financing and attract market interest the scheme would be structured such that payments to proponents are wholly preserved notwithstanding the expiry (where supply terms extend beyond 2030), or any early repeal or material amendment, of the RET scheme. This would involve ongoing payments on account of LGCs based on the project's energy output even where LGCs could no longer be delivered. There can be an obligation on the Proponent to continue to deliver environmental products that might replace LGCs under an amended or replacement RET

Scheme but any price or volume reduction by the State under the Contract in such circumstances will diminish bankability of the proposed Contract because financiers will bank the downside volume case as their 'base case'.

Such allocation of "RET repeal risk" is consistent with the approach adopted under the ACT reverse auction process and is a typical approach for whole of meter renewable power purchase agreements in Australia.

3 Payment Structure

3.1 Contract for Difference

We agree that a contract for difference structure should be adopted for the scheme.

Contracts for difference are very commonly used in the energy industry and allow maximum flexibility in terms of quantity, operational control and offtake structuring. They are well known to project financiers and proponents and can maximise revenue certainty for the project.

While a fixed payment structure as described in the consultation paper may be sufficient to support the project financing of an otherwise 'merchant' project, we expect that the payments would need to be relatively high in order to do so.

3.2 Monthly or half hourly pricing

Typically payments under a contract for difference for a renewables project would be calculated based on the difference between the fixed contract price (**fixed price**) and the relevant regional NEM price during each NEM trading interval (i.e. 30 minutes) (**floating price**) and the quantity of electricity sent out into the NEM by the generator during each of those trading intervals during the term.

The State is considering whether the contract for difference should be settled based on a floating price that is referable to the average (presumably a volume weighted average) of the relevant NEM prices during the relevant month as opposed to settling on a trading interval by trading interval basis.

Taking a monthly averaging approach to floating prices would be unusual and has the following effects:

- **Revenue uncertainty:** as renewable generation is intermittent proponents would be exposed to market prices if monthly average pricing is used and will, in the absence of a technological solution, not be in a position to physically respond to limit such exposure.

For example, if the average price for a month is high due to a short period of particularly high prices during that month, but the project was not able to generate during that period, it will bear the cost of a higher 'floating payment' under the contract without having received the NEM receipts associated with the peak pricing that drove the higher 'floating payment'.

Any revenue uncertainty (and potentially uncapped costs) to which the project is exposed is likely to increase finance costs and potentially a project's bankability. Exposure to extreme market events may also encourage bidders to include a risk premium in their reverse auction bid price.

- **Payment timing:** participants in the NEM receive wholesale market payments from AEMO in respect of past billing periods on a weekly basis and contracts for

difference typically align with this timetable. AEMO adjustments are also made on a weekly basis. Monthly average pricing under the contract would impose on the proponent a second payment timetable together with associated administrative and 'carry' costs of delayed payments from the offtake counterparty.

4 Contracting elements

In the consultation paper the State requested feedback on a set of high level concepts that would be included in the Contract with proponents under the scheme.

We suggest that in order to maximise response to the scheme and ensure the availability of project financing, the following terms should be addressed in the proposed Contract:

- **Counterparty credit:** typically project financiers will require that either the offtake counterparty has at least an investment grade credit rating or that its payment obligations are guaranteed by a party that does. Alternatively obligations to provide bank guarantees or letters of credit typically apply. The State could reduce finance costs by ensuring that the contract counterparty is a government entity (with appropriate restrictions on assignment by the buyer to a non-government entity) or by providing the proponent with a guarantee from a government entity in support of the offtake counterparty's payment obligations. Such support should survive or be replaced upon any transfer of the Contract from the offtake counterparty.
- **Security and tripartite:** the Contract should allow for financiers to take security over the Proponent's rights under the Contract and include provision for tripartite arrangements between the Proponent's financiers and the offtake counterparty as is typical for arrangements of this type. The Contract tripartite arrangements should provide for appropriate cure and step-in rights for the Proponent's financiers.

One of the bankability issues with the ACT auction scheme Deed of Entitlement is the lack of any clear acknowledgement of financiers' security interests in the assignment, change in control and termination provisions.

- **Termination:** the Contract should not include 'hair trigger' events of termination. Given that the Contract will be critical to support the project's viability, the Proponent and its financiers should be allowed reasonable time to prepare and execute cure plans.
- **Termination payments:** it will assist project financing to have a clear regime for compensation to be paid should the Contract be terminated for the offtake counterparty's default or due to a change in Victorian law (e.g. a repeal of the enabling legislation associated with the scheme).

We recommend a formulation based on the "close out amount" concept as utilised in standard form ISDA documentation. The close out amount is intended to calculate the cost to the terminating party of obtaining a replacement contract in the market – effectively keeping them whole for the 'loss of bargain' suffered as a result of the termination. The close out amount would be paid by the State should the termination arise due to a repeal of the relevant legislation and otherwise by the defaulting party only.

Another of the material bankability issues with the ACT auction scheme Deed of Entitlement is the lack of clarity in the wording of the termination compensation

clause which creates some uncertainty as to how the guaranteed termination amount would be calculated in various scenarios.

- **Change in Law:** upon a change in law taking place the Contract should provide the proponent with the right to pass through to the offtake counterparty its increased costs, and potentially recover its lost revenue (in the case of changes to Victorian law). Such changes might include additional taxes imposed on renewables projects, changes in environmental laws that limit project output or changes to the scheme legislation that fall short of repeal.
- **Generation requirements - cap:** it is not uncommon to cap the annual quantity in respect of which difference payments will be made. Exceeding the cap would simply result in difference payments not being made in respect of that excess generation.
- **Generation requirements – minimum:** For this scheme minimum generation targets do not seem necessary (e.g. the State is not depending on a certain number of LGCs to meet a surrender obligation as a retailer might be). Typically a failure to generate a minimum quantity of electricity would trigger a requirement to pay liquidated damages rather than being treated as a default. Those liquidated damages would typically be sized by reference to the offtaker's costs of purchasing (for example) replacement LGCs or paying RET shortfall penalties. Such costs would not be incurred by the State.

Proponents' financiers will focus very closely on any liquidated damages regime imposed on the Proponent because typically the Proponent will be a special purpose company whose revenues will solely be derived from the operation of the renewable generation project. Accordingly project financiers may require cash reserving or contingencies to be made by the Proponent as cover in the event of any potential generation shortfall and this will add costs which Proponents will price into their bids.

If a minimum quantity is required, force majeure relief and an extensive cure regime should apply. Proponents should have the right to 'bid' any required proposed minimum generation quantity as part of the reverse auction process. In addition, the State should closely consider the intermittent and seasonal nature of wind and solar generation in setting any minimum generation targets and the time periods over which they are measured.

- **Payment terms:** as above we recommend weekly settlements to align with the NEM timetable.
- **Contract length:** a supply term of 15 to 20 years is most likely to minimise finance, and anticipated refinancing, costs by improving Proponents' ability to attract long tenor project financing.

5 Scheme administration and cost recovery

The State has requested comment on the administration of the scheme and the recovery of costs under it.

From a Proponent and financier perspective the key issue for scheme administration is that the arrangements are simple, that the Contract counterparty has the capability to administer the contract and that the Contract counterparty is creditworthy (as discussed above).

On that basis the most appropriate option would be the State's suggestion of appointing a government agency to administer the scheme and act as Contract counterparty. The



agency could perhaps appoint a third party service provider to assist with Contract administration including settlement calculations. In addition to having the benefit of simplicity this approach would also go some way to eliminating any perceived counterparty risk.