EXPLANATORY STATEMENT – CLEAN ENERGY FINANCE CORPORATION INVESTMENT MANDATE DIRECTION 2013

Purpose of the Direction

Under the *Clean Energy Finance Corporation Act 2012* (the Act), the Government has established the Clean Energy Finance Corporation (the Corporation) to facilitate increased flows of finance into the clean energy sector.

The Corporation will make individual investment decisions independently of the Government. The purpose of the Investment Mandate is to provide a mechanism for the Government to articulate its broad expectations of how the Corporation invests and is managed by the Board.

Under the Act the Board is responsible for ensuring the proper, efficient and effective performance of the Corporation. This responsibility is subject to any restrictions placed on the Corporation by the Act and to any directions given by the responsible Ministers under subsection 64(1). Directions issued under subsection 64(1) of the Act are known collectively as the Investment Mandate.

Direction

Introduction

The Corporation will supplement existing initiatives, such as the Renewable Energy Target and the carbon price, to catalyse and leverage the flow of funds for commercialisation and deployment of renewable energy, low-emissions and energy efficiency technologies necessary for Australia's transition to a lower carbon economy.

The Government's aim is for the Corporation to invest in financial assets using financial products and structures to address the barriers currently inhibiting investment to help mobilise investment into the clean energy sector. As this is not a grants organisation, these investments must be made with an expectation of being repaid.

It is expected that the Corporation will apply commercial rigour when making its investment decisions, focussing on projects and technologies at the later stages of development. By adopting a commercial approach, it is expected that the Corporation will invest responsibly and manage risk so it is financially self-sufficient and achieves a benchmark rate of return. In achieving this aim the Government has the expectation that the Board will take a long-term outlook when setting the investment strategy for the Corporation.

As a Government entity and a responsible investor the Corporation has a duty to consider its potential impact on other market participants when making investment decisions. However, in line with its public policy intent, the Corporation should also consider positive externalities when making investment decisions and determining the extent of any concessionality.

Portfolio Benchmark Return

For the purpose of this Investment Mandate, the Government has directed the Board to adopt a Portfolio Benchmark Return for the performance of funds invested by the Corporation based on a weighted average of the five-year Australian Government bond rate.

For each investment, an individual reference rate will first be calculated using the average of the five-year Australian Government bond rate as published by the Reserve Bank of Australia for the 15 day period immediately preceding the date a binding investment agreement is executed.

The Portfolio Benchmark Return will then be determined by taking the series of individual reference rates and weighting them for each investment.

The Portfolio Benchmark Return is a long-term target and expected to be earned across the portfolio and over a period of time. Individual investments could be made with expected individual returns above or below the Portfolio Benchmark Return.

Proponents should not expect to be able to access the Corporation's funding at the Portfolio Benchmark Return. The Corporation shall apply commercial rigour in assessing all investments. The actual return the Corporation seeks for any given investment will be a risk-adjusted return reflecting the individual characteristics of specific projects, the need to cover the operating expenses of the Corporation, the requirement to meet the Portfolio Benchmark Return on a portfolio basis and other factors.

Performance against this Portfolio Benchmark Return will be measured net of operating expenses with reports published annually. The Corporation will follow Australian Accounting Standards where applicable in measuring its return and determining any impairment, except in the case of concessional loans, where the measurement should exclude any impairment or mark to market adjustments resulting from any concessional component.

The Government is conscious of the risks inherent in investing in a large portfolio of financial assets. It acknowledges that in practice this will involve some short-term volatility in the Corporation's returns, including the possibility of losses in some years.

The Government is committed to developing the clean energy sector and it has established the Corporation to invest for the long term. Therefore the Investment Mandate establishes long-term portfolio performance measures.

Limits on concessionality

To ensure that the Corporation can facilitate the flow of finance it is expected that it will use a wide range of investment tools. This includes providing commercial and concessional loans where necessary. Concessional loans have a negative impact on the fiscal balance. The Corporation is therefore limited to providing $300 million of concessionality in any one financial year.

A concessional loan is a loan provided on more favourable terms than the borrower could obtain in the market place. The concession provided may be in many forms but typically will be in the form of lower than market interest rates, longer loan maturity or additional/longer or more flexible grace periods before the payment of the principal and/or interest is repayable. Concessionality should be measured as the difference between the present value of a loan provided at the concessional rate and the present value of a loan provided at the appropriate market rate.

The market rate is the prevailing rate of interest the borrowing entity would be subject to in the market for a similar instrument (in terms of currency, term, type of interest rate and other factors) with a similar credit rating. Where the terms are not currently available, an estimation would need to be made of the likely cost. A standard bank lending rate would need to be adjusted to take into consideration the risks associated with the borrower.

As the Corporation will provide loans where there may not be an explicit market rate, this will be a matter of judgement for the Board. The Corporation is expected to develop a robust system to determine the appropriate rate based on looking at loans for similar instruments in terms of tenor and risk.

The Department of Finance and Deregulation Accounting Guidance Note No. 2010/2 provides further information on calculating the amount of concessionality as well as worked examples.

Limits on guarantees

Guarantees are arrangements to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due.

Under the Australian Government reporting framework, guarantees are to be accounted for in accordance with the Australian Accounting Standards.

Guarantees pose a particular risk to the Commonwealth's balance sheet and can have unexpected consequences when called. As such, the Act and the Investment Mandate impose restrictions on their use. To limit any risk the Corporation must ensure that all guarantees are limited in nature and quantifiable.

The Act requires the Corporation to maintain sufficient uncommitted balance in the Clean Energy Finance Corporation Special Account to meet any potential liabilities in issuing a guarantee. In addition the Investment Mandate limits the amount of guarantees the Corporation can issue to 5 per cent of the total amount that has been credited to the Special Account under Section 46 of the Act.

Application of Australian Industry Participation Plans

The Corporation will provide significant support to projects in Australia. The application of Australian Industry Participation (AIP) Plans to investments made by the Corporation is aimed at increasing opportunities for capable and competitive Australian and New Zealand small and medium sized enterprises (SMEs) to participate in major projects.

An AIP Plan details how a project proponent will provide full, fair and reasonable opportunity to Australian industry to participate in a project. This applies to any subcontracting or purchasing opportunities that may be available. AIP Plans do not mandate the use of Australian industry, but rather aim to provide Australian industry with the opportunity to demonstrate their capabilities and capacity.

Corporation must consider impacts from its investment strategy

In establishing the Corporation it is the expectation of the Government that the investments of the Corporation should not disrupt the areas where the market is functioning well. That said, the Corporation has the potential to impact on other market participants and the operation of the Australian financial and energy markets. The Corporation should always consider this potential impact when making investment decisions.

Given half of the Corporation's investments will be in the renewable energy sector, there is a particular risk of impact on the market for Large-Scale Generation Certificates under the Renewable Energy Target. The Corporation should ensure it is cognisant of these risks when investing in projects eligible for these certificates.

As a statutory authority owned by the Commonwealth, the Corporation has a responsibility to act in a way that is not likely to cause damage to the Australian Government's reputation.

Corporate governance

In undertaking its investment function, the Corporation must act consistent with, and establish policies in relation to, Australian best practice corporate governance. In particular, the Government expects the Board's policies to include its approach to environmental, social and governance issues.

Commencement

This direction commences on the day after it is registered.