Submission on the Australian Government's National Reconstruction Fund

Australian Sustainable Finance Institute | February 2023

Australian Sustainable Finance Institute

1 Introduction

The Australian Sustainable Finance Institute (ASFI) welcomes this opportunity to make a submission on the design and development of the National Reconstruction Fund (NRF).

ASFI represents Australian financial institutions – including major banks, superannuation funds, insurers, asset managers, and financial services firms – that are working to align the Australian financial system with a sustainable, resilient, and inclusive Australia. ASFI members collectively hold over AU$17 trillion in assets under management and are committed to allocating capital in a way that supports positive social and environmental outcomes. They therefore have an alignment with the NRF's objectives to secure future prosperity and sustainable economic growth for Australia, and an interest in ensuring the NRF can operate as intended to effectively crowd-in private capital for this purpose.

2 NRF Priority Areas and Target Investment Levels

Flexibility v detail; definitions of key terms

ASFI recommends that the Government build in flexibility in the NRF's mandate with respect to the definition of the seven priority areas, as well as with respect to the target investment levels. Excessive rigidity will limit the NRF's ability to capture opportunities in the investment pipeline as they arise, and to respond to evolving market dynamics in Australia and internationally.

The NRF should be empowered through its investment mandate to select projects within the Government's priority areas based on a robust analysis of where the investment gaps and barriers are, and the potential impact of the proposed investment – in particular its potential to contribute to the transformation and diversification of the relevant sector, and anticipated benefits for the competitiveness and long-term strength of the Australian economy.

The approach adopted for the Clean Energy Finance Corporation (CEFC), where the government sets through legislation the high-level investment mandate and the CEFC develops (and periodically updates) the supporting policies and procedures should be adopted for the NRF. The enabling legislation or investment mandate should set out the objectives of the NRF. Except where there is good reason to be more explicit, the NRF should have reasonable flexibility to interpret and define what is meant by the terms 'transformational', 'diversification' and 'value-add' as they apply to each of the priority areas.

As further discussed below, the objective of supporting the Australian economy to transition in line with Australia's climate targets should be mainstreamed across the NRF to ensure it operates as an enabler for the net zero transition.

Regional Development

We support a focus by the NRF on regional development and consider that the investment mandate should require investments to align with state and Commonwealth regional policy and plans wherever possible. The 'Co-Investment Plans' that the Government proposes to develop with industry should consider what supporting infrastructure may be needed alongside NRF investment and how to fund that – for example, housing and services investment to support population growth that may occur in a regional area as a result of NRF investment in a company or project.

Renewables and low-emissions technologies

The CEFC has developed considerable and well-regarded expertise in clean energy investment over its 10 years of operations. It is not clear from the consultation paper why the $3 billion allocated to the NRF for investment in renewable energy and low-emissions technologies would not be more appropriately disbursed through the CEFC. As it stands, there could be situations where the CEFC and the NRF are investing in the same deal. This raises questions about efficient use of Government resources (ie why resource two deal teams to act on behalf of the same public investor?), and the role of the CEFC versus the NRF as the catalytic funder in a transaction. ASFI recommends that strong communications channels be developed between the two funds to ensure appropriate coordination and where possible, alignment of investment processes, due diligence requirement, etc (see further below our suggestions regarding sharing of resources).

ASFI also recommends this priority area should be broadened to include climate-adaptation practices and technologies – which are in high demand world-wide and will play an increasingly critical role in managing and responding to climate change. Climate adaptation investments should be considered across the spectrum of sectors including in transport, agriculture, coastal resilience, and social infrastructure.

Target Investment Levels

It may be that opportunities in some priority areas are more readily available than in others, and that this dynamic changes over time. In light of this, we recommend that the Government's 'target investment levels' (ie the quantitative investment targets set out in the discussion paper) be framed as soft targets with flexibility to undershoot in some areas and overshoot in others. This will help ensure the NRF is able to deploy its capital at a suitable pace and respond to opportunities that arise, which may be difficult to precisely predict in these rapidly evolving markets.

Investment mandate – crowding in institutional capital

There is an appetite from Australian financial institutions (FIs) – including ASFI members – to finance and invest in nation building activities including by supporting emerging industries and technologies. However, these investments can be relatively high risk for a range of reasons including risks associated with unproven technologies, immature supply chains, and uncertain demand. They require FIs to resource deal teams with appropriate expertise which they may not have in house – adding to the cost of the transaction. Investing in new areas can also take longer because the processes are new and unfamiliar for all parties, again adding to the expense. All of this means the risk-return profile of investment in new industries and technologies can be less attractive than the risk-return profile of opportunities in established sectors, so capital is less likely to flow.

The NRF can help address the barriers outlined above by investing in a way that improves the risk-return profile of a given transaction for private capital – meaning its investments should be designed to be 'catalytic' and to (partially) 'de-risk' the investment for private capital. De-risking does not necessarily require a large financial contribution from the public sector: in many cases it is the sharing of risk, and only an incremental improvement in the risk-return profile is required to crowd-in private capital.

Choice of instruments

As envisaged by the consultation paper, the NRF should be able to use the full range of investment and financial instruments so it can structure transactions in a way that can crowd-in private capital. Examples of ways in which the NRF could de-risk investments to mobilise private capital include:

- Providing **equity** in a transaction so that FIs can co-invest using debt or mezzanine finance. Equity is a particularly flexible and useful tool for crowding in private capital including from commercial banks. It would also give the NRF a 'seat at the table' and the ability to influence aspects of the investee project or company consistent with Government priorities – for example, it could require certain minimum standards are met regarding the environment, climate, and social risk management of investee projects and companies in addition to achieving the primary objectives of the NRF.

- Providing guarantees which offer a range of different ways to de-risk and can be targeted to take on specific risks such as some commercial risks like credit risk or offtake risk. In many cases a guarantee may not be called on but provides the confidence for private investors to step in.
- Offering or encouraging the use of insurance/re-insurance products to provide confidence to investors – for example to free up funds allocated for weather and event related losses, add capacity to guarantees, or at the design stage to assure delivery and returns.
- Helping to provide the scale (i.e. ensure transactions are large enough in dollar terms) that institutional investors seek by aggregating smaller projects or companies in funds or other structures and bearing the costs of establishing these structures.
- Creating deal pipeline by investing in companies or projects at an early stage. Private sector finance can step in once a company is more mature or a project is operational, freeing up public funds to be re-invested elsewhere.
- Government finance vehicles can provide significant in-kind and technical support including through technical due diligence and expertise. This assistance reduces transaction costs for private capital, improving the attractiveness of an opportunity.

Risk and Return Profile

The risk and return profile of the NRF should reflect its objectives to stimulate investment in new and emerging industry and technology. Its catalytic function means it will need to have a higher risk tolerance than commercial investors and be able to accept lower than commercial returns. This should be reflected in the targeted rate of return. The NRF should make investments based on sound commercial due diligence to help ensure capital preservation and avoid supporting unsuccessful prospects. It should also apply a principle of additionality – only intervening and 'de-risking' to the extent required to bring in private capital. This is necessarily a subjective assessment but there are examples that can be followed and learned from including the experience of the CEFC, OECD DAC guidance, and the approach of international development finance mechanisms including those managed by DFAT.

ASFI recommends that the Government consider earmarking a sub-set of the NRF capital as higher risk capital with lower return expectations. This will allow the NRF to take on earlier stage and more experimental opportunities that could have strong dividends in terms of both financial returns and transformational economic impact. This higher risk capital is important to help fill a persistent gap in the innovation landscape. Earmarking a subset (eg 25%) of NRF funds in this way would limit the exposure of the NRF as a whole and help ensure it can be financially self-sustaining through its broader investment portfolio. An example of where this earmarking has been applied is the CEFC's Innovation Fund which successfully supported the emergence of the Australian climate-tech investment ecosystem. We recommend the NRF be able to invest its 'higher risk' capital in a range of areas which could include early stage companies, emerging fund managers, or projects. The ability for the NRF to take on 'first loss' positions would be particularly valuable for this tranche of the NRF as a tool to crowd-in private capital.

Institutional and Governance Arrangements

Just as important as the choice of instruments and rate of return, is ensuring the right institutional and governance arrangements are in place to enable the NRF to carry out its mandate as a catalytic investor. ASFI supports the Government's intention for the NRF be a separate institution to Government, and for investment decisions be made at arm's length to Government. This will help ensure that the NRF can invest according to its mandate and is not subject to political interference in individual transactions.

Government is increasingly interested in opportunities to mobilise private capital to support public policy objectives. There are now a number of Government finance vehicles in operation and more planned – including the NRF. The ability of these vehicles to crowd-in private finance could be undermined by a lack of clarity around what each of them does and how private capital can engage, as well as the challenge for financial institutions of dealing with multiple different institutions each with their own mandates, processes, and contact points. ASFI recommends that the Government consider opportunities to ensure that different financing vehicles work closely together to clearly communicate their mandates and streamline and standardise the ways in which private capital can engage as much as possible.

In the same vein, there are likely opportunities to maximise efficiencies by leveraging (and building on) existing institutional arrangements – such as those established by CEFC – rather than duplicating them. This could include sharing of back office resources and expertise, and should also include sharing information on deal pipelines and approaches where there is a close connection or overlap between the mandates of different vehicles.

Resourcing, leadership and expertise (human capital)

Regardless of how it is constituted, the NRF should be resourced appropriately to allow it to carry out its mandate, with a culture and workforce that combines commercial finance and investment skills, technical research and analytical skills, and industrial development skills.

The NRF's technological and technical expertise in each of the priority areas will be crucial to its ability to crowd-in private capital by reducing technology-risk and lowering transaction costs for private participants. It should be set up to work collaboratively with private capital providers – this has been an important part of the CEFC's role and activities in the clean energy market.

3

Supporting Government Policy Priorities

As a public investment vehicle, the NRF should demonstrate best practice ESG and impact management both in its own operations and through its investment chain. The NRF should:

- Be required to ensure its investments are consistent with supporting and accelerating the transition to a net zero economy – particularly in priority areas that relate closely to the decarbonsiation challenge such as renewable technologies, transport, agriculture, forestry and fisheries, and resources. Apply strong safeguards to operationalise a principle of 'do no harm'
- Incorporate other policy considerations noted in the Consultation Paper (sustainability and circularity principles, regional development, gender equality, opportunities for regional and remote communities and First Nations communities; and creating secure, well-paid jobs) into its investment processes so that investment opportunities that perform highly in those areas are considered favourably, all else being equal.

Across the Australian Government there are examples of investment vehicles that have a well-developed approach to integrating gender equality, impact management, and environmental and social safeguards throughout their operations and investment processes. For example, DFAT aid programs such as the Emerging Markets Impact Investment Fund and Investing in Women have strong gender expertise as well as experience implementing aid program safeguards. Indigenous Business Australia has valuable experience integrating and supporting First Nations' perspectives and opportunities. These should be drawn on to inform the NRF's development and operation.

4 Complementary Reforms

The NRF should operate in conjunction with policies that support the development of priority industries and technologies. These should include policies that stimulate demand – such as procurement standards (for example, setting a target for the use of low carbon products like green steel in Government-funded infrastructure projects) and advanced market commitments (for example, modelled on the First Movers Coalition initiative). They could also include investment incentives through the taxation system at State and Commonwealth levels. There is also a need for grant finance for research and development, and to bridge the gap between innovation to commercial readiness in a range of areas. Relevant grant programs should be well coordinated with the NRF mandate (like the ARENA/CEFC relationship) to provide coordinated support for technologies to reach maturity.

Another opportunity for complementary Government action could be to create a structured avenue for communication and collaboration between private FIs and Government investment vehicles including – but not limited to - the NRF. Options range from establishing a regular industry dialogue, to a permanent 'financial innovation lab' with private and public representation. This could identify barriers and solutions to the flow of capital to help develop innovative investment structures for the NRF (and other vehicles') to use. It could also help inform the evolution of the NRF's mandates over time in response to evolving market dynamics.

As a first step, and a means of testing the value of this initiative, ASFI recommends that the Government convene representatives from the various Government investment vehicles and representatives from the financial institutions that have invested (or sought to invest) alongside them for a forum to seek feedback on what has worked well and what could be improved to more effectively crowd-in private capital to achieve the objectives of the various government vehicles. The findings could feed into the evaluation and ongoing refinement of Government vehicles over time, and support greater collaboration and stronger relationships with the private sector at a more strategic level than on a deal by deal basis. ASFI would be pleased to discuss further how this initiative could work in practice.

Endnotes

[1] Blended finance guidance & principles - OECD

[2] See ASFI's submission to the Government's Development Finance Review