Lighthouse Community Energy Project
Potential Value Adding Measures Feasibility Study
Environmental Upgrade Agreements

August 2016

CLEANaS is a not-for-profit association dedicated to driving the uptake of clean energy in Newcastle and surrounds through community owned projects and activities. http://cleanas.org.au/

INTRODUCTION

The Clean Energy Association of Newcastle and Surrounds (CLEANaS) aims to increase the uptake of renewable energy and energy efficiency installations in the Newcastle and surrounding region. We seek to do this by supporting current energy users to reduce their energy consumption as well as transitioning to renewable energy sources.

This report details the Feasibility study on the potential value adding measure of Environmental Upgrade Agreements as part of Output Three of the Lighthouse Community Energy: A critical mass of viable and appropriate project sites identified and prepared for implementation.

CLEANaS is considering possible mechanisms which could add value to the portfolio of prospective projects by improving financial viability. This includes Virtual Net Metering, which enables aggregation and peer to peer trading of electricity; and Environmental Upgrade Agreements, which remove barriers for financing mechanisms for commercial buildings.

ENVIRONMENTAL UPGRADE AGREEMENTS

Environmental Upgrade Agreements (EUAs) are a council-based financing mechanism enabling businesses to better access finance for environmental upgrades to existing non-residential buildings or multi-residential buildings of more than 20 lots.

Local government legislation on Environmental Upgrade Agreements (EUAs) enables upgrading or retrofitting of these buildings. As a way of funding improvements to the resource efficiency or environmental sustainability of certain buildings, the legislation allows councils to enter into EUAs with owners and finance providers.[i]

Under an EUA, a lender provides finance to a building owner and the local council collects repayments through the rates system. The council then passes the property charge onto the lender.

Use of the council rates system means that a EUA loan is prioritised over other debts attached to the land if there is a loan default. This gives lenders more security, allowing them to offer long-term loans at competitive interest rates.[ii]

A EUA is secured finance so it can be locked in for a longer term, up to 15 years. This increases the likelihood that the savings generated will be greater than the EUA repayments and better match the life of the upgraded equipment. Furthermore, EUA finance is attached to the land. If the land is sold, the EUA may be transferred to the new owners or discharged on settlement.

Eligible works include those that focus on:

- energy and water efficiency;
- renewable energy;
- reducing greenhouse gas emissions;
- preventing or reducing pollution;
- reducing the use of materials;
- recovery or recycling of materials;
- monitoring environmental performance; and
- encouraging alternatives to car travel, such as walking and cycling[iii]

The EUA finance is for improvement projects from $250,000 and above that reduce energy use, lower carbon emissions and save water.[iv]

EUAs have been available in New South Wales since 2012. Only six EUAs have been signed in New South Wales so far.

BENEFITS OF USING A EUA

Financing an upgrade using an EUA delivers multiple benefits to building owners and tenants not generally achievable through traditional commercial finance including:

- 100% finance;
- competitive fixed rate interest rates and long loan terms; and
- tenant contributions towards upgrade costs.

For the building owner, no mortgage security is required on the loan or financial covenant[v], with energy savings used to fund the repayments.[vi]

Upgrading using self-finance or traditional commercial finance usually results in the tenant receiving the majority of utility savings benefits, not the building owner. The building owner has no means of recovering these benefits outside of lease negotiations.

The EUA mechanism overcomes this by allowing building owners to share the costs of the environmental upgrade with their tenants through existing lease provisions or by specific agreement. This was made possible by changes to the Local Government Act 1993 to encourage building upgrades.[vii]

PITFALLS:

Council involvement

Without active Council interest, enthusiasm and commitment, EUAs simply will not work. Councils have been slow to get behind EUAs. This is partly because the work required from Council has been reasonably heavy. Councils generally did not have staff or processes in place to deal with this, and the role and responsibility of Councils was not well understood. That said, City of Sydney, Parramatta, North Sydney, Lake Macquarie and Newcastle City Councils are participating in EUAs and have processes in place to deal with EUA applications.

Financier participation

While there has been definite interest from financiers in the EUA space, there has been little active participation.

Documentation barriers

Historically, the documentation required for an EUA was long and complicated. OEH called for an overhaul of that documentation to simplify the process.

Recovery of costs from tenants

This Funding can also overcome the 'split incentive' that can arise when you pay for an energy efficiency upgrade, but your tenants see the most benefit from the resulting energy cost savings.[viii]

Landlords can recover the cost of building upgrades from tenants if they are done under an EUA. This is because the "loan repayments" are made by way of rates payable to Council, and rates and taxes can be recovered from tenants under a net lease. Landlord is only allowed to charge back the amount of which the Tenant has saved in energy costs via the upgrade.[ix]

This applies to the extent that tenants can be shown to be saving money by the building upgrades, and where the lease allows recovery for these rates. Note this will not be possible under leases with gross rent provisions (i.e. where outgoings are not payable by tenants).

Onerous administration

As the NSW Government wanted to monitor the success of its EUA initiative, it mandated quite weighty reporting requirements about how the EUA projects are tracking. However, there is little value in trying to track success when it is the tracking mechanism itself that is off-putting. It is understood that the OEH is conscious of this difficulty, and it is expected that the reporting requirements may soon be reduced and standardised (and may only apply where there is recovery from tenants).

Substantial fees may be levied by the Local Councils, for example City of Sydney and City of Parramatta Council[x] both have a significant upfront fee dependent on the term of the loan.[xi]

BUSINESS CASE

123 Queen St Melbourne, The building was upgraded in 2014 with a 380 kW tri-generation gas-fired energy system, occupancy sensors and double glazing, taking it from a 2 star NABERS energy rating to 4 stars.[xii] The return on Investment was 11.7%, with a payback of 8.5 years, at a cost of borrowing of 7.7%. Although literature on EUA's indicates that they would attract competitive interest rates. The cost of borrowing here does not appear to differ markedly from commercial lending rates at the time.[xiii]

It has been difficult to ascertain the business financial benefits of a EUA as most case studies documented do not provide sufficient detail or clarity, particularly in NSW.

At this stage EUA's do not appear to be an effective way of adding value to Community Energy investments due to:

- the high investment threshold ($250,000) that would exceed in size a number of Community Energy projects;
- a lack of clarity currently on financial benefit and the subsequent perceived limited financial benefit compared with commercial loans; and
- setup and ongoing administration costs and effort that a voluntary organisation would have to muster on an ongoing basis.

For a Community Energy project associated with a commercial building with a capital build of over $250,000 it may be possible for a EUA to be utilised. However, a detailed business case would need to be developed to assess the feasibility of the project and the financial cost benefit to the building owner.

[i] EUA legislation

http://www.environment.nsw.gov.au/business/legislation.htm

[ii] What is an Environmental Upgrade Agreement?

http://www.energyandresources.vic.gov.au/energy/environment-and-community/energy-efficiency/environmental-upgrade-agreements/environmental-upgrade-agreements-frequently-asked-questions

[iii] Environmental Upgrade Agreements

http://www.environment.nsw.gov.au/business/upgrade-agreements.htm

[iv] CEFC Finance for Environmental Upgrade Agreements

https://www.cleanenergyfinancecorp.com.au/media/76243/cefc-factsheet-nab-cefc-ef_eua_lr.pdf

[v] Environmental Upgrade Agreements - A Banking Perspective: Get More for Less

https://www.youtube.com/watch?v=6YmMMrCbmN8

[vi] Eureka Upgrade Finance - Benefits

http://www.eurekaeuf.com.au/benefits/

[vii] Environmental upgrade finance

http://www.cityofsydney.nsw.gov.au/business/business-support/greening-your-business/environmental-upgrade-finance

[viii] Environmental Upgrade Funding

https://www.nab.com.au/business/industry/corporate-and-institutional/environmental-upgrade-funding

[ix] Environmental Upgrade Agreements

http://lpc.com.au/index.php/sustainability/environmental-upgrade-agreements/

[x] Environmental Upgrade Finance: Business Model & Business Case Final report, South Australian Department of Environment, Water & Natural Resources, February 2013

https://www.lga.sa.gov.au/webdata/resources/files/BUF%20Business%20Model.pdf

[xi] Spotlight on 'Environmental Upgrade Agreements' in New South Wales

http://www.dibbsbarker.com/publication/Spotlight_on_Environmental_Upgrade_Agreements_in_New_South_Wales.aspx

[xii] The Fifth Estate, EUA - Your guide to Australia's finance innovation for building retrofits, Environmental Upgrade Agreements By Lynne Blundell

http://sustainablemelbournefund.com.au/wp-content/uploads/2014/03/TFE_eBOOK_FINAL1.pdf

[xiii] Bank lending to business – fixed-interest rate loans outstanding by size and by interest rate

http://www.rba.gov.au/statistics/tables/