Clean Energy Investor Group
50 Camberwell Road Hawthorn East VIC 3123

20 August 2024

Hon. Dr Jim Chalmers MP
Treasurer of Australia
Commonwealth Government
Lodged via email to MNETaxIntegrity@treasury.gov.au

Dear Minister,

Response to Commonwealth Government's consultation paper on foreign resident capital gains tax regime reforms

The Clean Energy Investor Group (CEIG) welcomes the opportunity to provide feedback on the Commonwealth Government's consultation paper on foreign resident capital gains tax (CGT) regime reforms published in July 2024.

CEIG represents domestic and global renewable energy developers and investors, with more than 16GW of installed renewable energy capacity across more than 76 power stations and a combined portfolio value of around $38 billion. CEIG members' project pipeline is estimated to be more than 46GW across Australia. CEIG strongly advocates for an efficient transition to a clean energy future on behalf of the investors who will provide the low-cost capital required for this transition.

Key Points

- **CEIG supports the justification and rationale for clarifying and expanding the foreign CGT regime.**
- However, **CEIG does not believe that the current design of the reforms will achieve their objective** of aligning foreign residents' CGT outcomes more closely with the tax treatment for Australian residents.
- **Australia needs more private investment, particularly from foreign sources, to meet its emissions reduction and renewable energy targets.**
- CEIG is highly concerned that **if this proposed policy becomes legislation, it is very likely that a significant amount of foreign capital will no longer support Australia's clean energy transition.**

- CEIG fears that **these changes will hinder the growth of emerging industries such as renewable hydrogen and offshore wind,** deter the investors who are most active in de-risking the local investment pipeline, **and jeopardise Australia's obligations to its long-term trading partners**.
- **The proposed 30% foreign CGT would make it the highest foreign CGT in the OECD.**
- **Medium-term investors, who are crucial for the energy transition and often early adopters of new technology – a role not typically filled by domestic investors – will be disproportionately affected** as the new reforms could make their returns unviable.
- **The reforms could lead to a 5-15% increase in PPA prices, affecting consumers,** as investors adapt to the higher CGT rates.
- **CEIG questions the need for a level playing field in sectors with limited domestic investor presence** and suggests **further analysis is needed to understand the roles of different investor types** in the clean energy transition.
- CEIG emphasises that any assessment of equity in CGT **must consider the impact of franking credits and the 50% CGT discount and their benefits to Australian investors.**
- Given the **complex nature of tax reform** and the **potential for unintended damaging consequences**, such as impacting Australia's emission reduction objectives, CEIG recommends the Commonwealth Government **defer any decisions until the next Financial Year** and undertake a more **targeted consultation approach.**

GENERAL COMMENTS

CEIG supports the justification and rationale for clarifying and expanding the foreign CGT regime. This includes the reasons outlined in the consultation paper, such as aligning foreign residents' CGT outcomes more closely with the tax treatment for Australian residents and adhering to international best practices.

However, CEIG does not believe that the current design of the reforms will meet their objectives and has significant concerns about the potential negative impact this may have on foreign investment sentiment towards renewable energy assets in Australia. In addition, the Treasury Budget Papers, which discuss aligning CGT with domestic arrangements, do not specifically mention the inclusion of clean energy[1].

Need for foreign investment in renewable energy

Historically, a significant portion of the capital for the energy transition has come from foreign investors. These investors were the pioneers in Australia and continue to lead in innovation by bringing their international knowledge, expertise and technologies to Australia.

[1] Commonwealth of Australia (May-24) Budget 2024-25

To achieve our legally binding target of 43 percent emissions reduction and 82 percent renewable energy generation by 2030, Australia's federal and state treasuries require greater private investment, especially from foreign sources. These CGT reforms contradict other initiatives announced in the 2024-25 Budget, particular those aligned with the Future Made in Australia plan.

Globally, competition to attract international capital into the energy transition is intensifying. There is also growing investor interest in infrastructure assets, demonstrated by the over 40 percent increase in FDI in renewable energy since 2019[2].

Other comparable investment destinations have not sought to impose CGT on foreign investments in energy transition assets, including Canada, Germany, the Netherlands, the United States and the United Kingdom. For example:

- United States: Energy transition assets are generally not "Foreign Investment Real Property" for foreign CGT purposes because the valuable assets are not permanently affixed.
- United Kingdom: Infrastructure assets that constitute a trading business are not treated as land for foreign CGT purposes.

While new initiatives from the Commonwealth and State governments are streamlining the path to final investment decisions for international and domestic investors, international investors face barriers in finalising energy transition deals in Australia that domestic investors do not experience.

Likely impact on government targets

A holistic government policy approach is crucial for the success of Australia's energy transition. All policies must be aligned to accelerate clean energy projects and avoid measures that could hinder progress. Australia's foreign investment policy, released on 1 May 2024, underscores the need to attract investment to achieve the net zero transformation[3]. Yet, these proposed tax reforms appear counter to this objective, potentially undermining the focus on net zero investments that the Government aims to prioritise.

CEIG is highly concerned that if this proposed policy becomes legislation, it is very likely that a significant amount of foreign capital will no longer support Australia's clean energy transition. While the proposed CGT changes may not directly affect all CEIG Members, the broader implications for clean energy investment in Australia will be substantial.

CEIG's internal analysis shows that this proposed change would significantly depress investor returns across all asset classes in Australia by 300 to 600 basis points, depending on divestment timing and other factors like the equity-debt balance. This may

[2] Infrastructure Investor (Jun-24) Clearing the pathway for foreign investment in Australia's energy transition
[3] Australian Government (May-24) Australia's Foreign Investment Policy

render many projects uninvestible. New asset classes, such as offshore wind and renewable hydrogen, which require substantial risk and development capital, will be particularly vulnerable.

CEIG is concerned that these changes will hinder the growth of emerging industries such as renewable hydrogen and offshore wind and deter the investors who are most active in de-risking the local investment pipeline. This not only jeopardises the Government's ability to meet its 2030 renewable energy target but also undermines Australia's obligations to its long-term trading partners, such as Japan and Korea. These partners rely on Australia to develop a renewable fuel industry that will assist them in their own clean energy transitions.

As Australia faces declining exports of LNG, coal and iron ore, this is a critical opportunity to maintain and strengthen its export market by becoming a leader in renewable energy production. Failure to capture this opportunity may require state governments to continue underwriting life extensions of coal-fired capacity, contradicting the Government's stated objectives and risking Australia's future economic and trade prospects.

Sovereign risk

By implementing these reforms, Australia will have the highest CGT rate on foreign investors in energy transition assets throughout the OECD.

In addition to the proposed 30% foreign investor CGT, state-imposed stamp duties must also be included when calculating the total tax burden of transacting Australian energy transition assets. Stamp duty, calculated on the gross value of constructed assets, is a globally unique impost.

While the purchaser is responsible for paying these costs, the economic burden often falls on the seller because taxes affect the asset's market value. An increase in the total tax burden reduces the asset's appeal to buyers, leading to a lower sale price. Consequently, these changes will make Australia a less appealing destination for investment.

CEIG is concerned about the sovereign risk that these reforms create. Changing the foreign CGT over such a short period of time introduces tax risks, as foreign investors have invested in assets and calculated returns based on existing foreign CGT rates. CEIG anticipates that the sovereign risk introduced by these reforms will cause investors to focus their investments elsewhere.

Foreign medium-term investors will be most affected

CEIG notes that there are three categories of investors relevant to the foreign CGT changes:

1. Domestic investors: Australian residents.
2. Medium-term foreign investors: Foreign investors deploying money over a 5–10-year period.
3. Long-term foreign investors: Larger, strategic multi-nationals that own and operate

energy storage and generation over the long term (10+ years).

All three categories of investors are crucial for the energy transition. However, these changes will disproportionately impact medium-term foreign investors. Long-term investors may not feel the effects immediately, but this is likely to change as renewable energy superpower scale projects increase in number.

Medium-term foreign investors will be the most affected by these reforms. This encompasses 'greenfield investors' who carry capital risk throughout the stages of development, construction and early operations before transferring long-term ownership to more efficient sources of capital, such as superannuation funds and other institutional investors. These investors deploy capital over a 5–10-year period and have already made commitments prior to the introduction of these reforms. By assuming the exit of a de-risked asset, medium-term investors can benefit from a lower cost of capital and ultimately provide better value to consumers. Capital gains form a significant component of the investment rationale for greenfield investors, and as a result, the new reforms will make returns uneconomic for medium-term investors.

Medium-term foreign investors play a particularly crucial role in the energy transition, providing a significant amount of capital for renewable energy assets. They bring valuable experience from other markets and have less conservative risk tolerances, which ultimately drive market growth. They are typically the early adopters of new technology, in contrast to domestic investors who have historically shown less interest in developing new energy assets. This has already been evident in the development of the onshore wind, large-scale solar and battery energy storage system landscape, where the early projects were largely funded by medium-term foreign investors. News reports indicate that notable foreign investors have developed significant portfolios in Australia and have partially or fully exited within the medium term.

Australian renewable energy owners and developers have and will continue to seek foreign capital to fund the assets necessary for the energy transition. Consequently, the proposed reforms will result in the loss of a significant source of capital for new technologies critical to the energy transition, which is unlikely to be offset by domestic investors.

Reforms may lead to increases in consumer power prices

Additionally, these reforms could lead to increased consumer power prices. The rising demand for renewable energy power purchase agreements (PPAs) has put pressure on the already limited supply of renewable energy, which is constrained by several factors.

The development of renewable energy projects already face significant challenges, including delays in grid connections, lengthy assessment processes, and financing difficulties. These constraints limit the pace at which new renewable energy capacity can be brought online, exacerbating the supply-demand imbalance in the market.

PPA prices are currently based on the existing foreign CGT rates. The proposed CGT reforms, which introduce a 30% tax on foreign investor tax on exit, could further strain this situation. As investors adjust to maintain their returns, the cost of financing renewable energy projects is likely to rise. This increase in cost could result in higher PPA prices, leading to a 5-15% increase, as these costs are passed on to consumers.

TRANSITIONARY PERIOD

CEIG recognises that there is a precedent in nearly every tax law for a transitional period before substantial changes take effect. An example of this is the changes to the stapled structures regime, where a 7-year transitionary period was provided for existing arrangements and a 15-year transition period was granted for existing economic infrastructure staples[4].

CEIG recommends that a transitional regime is necessary, recognising that prior investment decisions were made based on the tax code at the time. Without a transitional period, these reforms will exacerbate the sovereign risk associated with foreign investment in Australia.

Consideration should also be given to assets in the development stage. This includes greenfield projects and assets in the pipeline, such as offshore wind proposals and renewable energy zones (REZ), which have formed investment decisions based on the current law.

ESTABLISHING A LEVEL PLAYING FIELD

Testing assumptions

CEIG understands that the purpose of these reforms is to create a level playing field for CGTs between foreign and domestic investors and align with international best practices. Upon review, CEIG believes that the proposed reforms will not achieve the Government's stated objectives of creating a level playing field.

CEIG questions whether it is necessary for Australia to create a level playing field in a sector where domestic investors are notably absent, particularly in the greenfield and medium-term investment sectors. CEIG suggests that further investigation and analysis are needed to understand the distinct roles that various types of investors play in the clean energy transition. We emphasise that these different investor categories should not be treated uniformly. Given the distinct nature of the renewable energy sector and the diverse investor groups within it, the tax system is crucial in shaping investor behaviour. Therefore, maintaining different tax arrangement to incentivise various types of investors is essential to achieving the objectives of Australia's foreign investment policy.

Other considerations

CEIG recognises that:

- domestic superannuation funds are only required to pay 10% on CGT;

[4] Australian Government (Mar-18) Stapled Structures, Details of Integrity Package

- Australian tax residents are eligible for a 50% CGT discount for assets held for at least 12 months[5]; and
- Australian corporations face a 30% CGT rate but benefit from franking credits[6].

Franking credits are generated for shareholders when Australian-resident companies pay income tax on their taxable income and then distribute their after-tax profits as franked dividends[7]. Franking credits have a distorting effect on domestic investment, and Australia remains the only jurisdiction with this system.

Additionally, Australian individual taxpayers are eligible for a 50% discount on capital gains if they hold an asset for more than 12 months. Consequently, CEIG emphasises that any assessment of equity in CGT must consider the impact of franking credits and the 50% CGT discount and their benefit to Australian investors.

CEIG also wishes to highlight that foreign investors in commercial real estate and residential build-to-rent projects are subject to a 15% tax rate under the Managed Investment Trust regime, whereas under the proposed reforms, foreign investors in the energy transition would face a tax rate twice as high[8]. CEIG seeks clarification on why commercial real estate investment is favoured over investment in the energy transition.

Whilst a 10% tax would better align with the taxation of domestic investors and other asset classes, compared with the status-quo, CEIG analysis suggests that at 10% CGT on clean energy investment could depress investor returns in Australia by 100 to 200 basis points making some projects uninvestable.

Presenting this simple example strengthens the critical need for the Government to undertake further analysis to explore the unintended consequences of imposing additional risk to clean energy investments in the already challenging investment environment.

CEIG recommends evidenced based policy development to avoid unintended consequences that risk the energy transition

Given the complex nature of tax reform and the potential for unintended damaging consequences, such as impacting Australia's emission reduction objectives, CEIG strongly urges the Government to engage directly with clean energy investors and undertake further analysis on the unintended consequences of tax reform to prevent detrimental impacts on medium-term foreign investment in Australia's renewable energy sector.

Furthermore, CEIG recommends the Commonwealth Government defer any decisions

[5] Australian Taxation Office (Jun-24) CGT Discount
[6] Parliamentary Budget Office (Apr-23) How is super taxed?
[7] Australian Taxation Office (Jun-24) Franking credits
[8] Australian Taxation Office (Feb-23) Managed investment trusts - overview

until the next Financial Year whilst further analysis is undertaken to determine the impact of this reform on Australia's emission reduction objectives and any alternative proposals that may explored throughout the consultation process. This approach will ensure that foreign investment can continue to support the energy infrastructure pipeline through medium-term investments.

CEIG thanks the Commonwealth Government for the opportunity to provide feedback on its proposed foreign resident capital gains tax regime reforms and looks forward to continued engagement on those issues. Our Acting Policy Director can be contacted at daniel.zelcer@ceig.org.au if you would like to further discuss any elements of this submission.

Yours sincerely,

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