Australian Government

CLEAN ENERGY FINANCE CORPORATION

The Hon. J. B. Hockey MP

Treasurer

Sen. the Hon. Mathias Cormann

Minister for Finance

3 December 2014

Dear Ministers

Thank you for your correspondence of 28 October 2014 (received 6 November 2014) in which you provided a draft *Clean Energy Finance Corporation (Investment Mandate) Direction 2014* ('draft proposed mandate').

Thank you also for the opportunity of our recent meeting with Minister Cormann and officials of 25 November 2014 to discuss the draft proposed mandate and the one week extension of time to provide our response. We note, and as was affirmed in the meeting with Minister Cormann, that you have drafted the proposed mandate with the objective of minimising exposure risk of taxpayers' funds in transition to the realisation of the Australian Government's objective to abolish the CEFC.

The Clean Energy Finance Corporation (CEFC) stands ready to assist in achieving the Australian Government's objectives, in so far as they are consistent with the CEFC Act. The Board shares the objective of protecting and minimizing risk exposure in the investment of public funds.

The stated object of the CEFC Act under Section 3 is "to facilitate increased flows of finance into the clean energy sector". In line with this object, the CEFC has pursued its investment function applying commercial rigour, to invest responsibly and manage risk prudently, utilising a robust, commercial risk management approach. We have sought to minimise risk through a diverse spread of investments in terms of industry, geography and counterparty within the small universe in which the CEFC is permitted to invest.

We have reviewed the draft proposed mandate, and note it requires the CEFC to maintain its existing level of portfolio risk while targeting a significantly higher investment return. This would be challenging to achieve in any financial market. It requires the CEFC to seek out additional investments that are outside market norms, in addition to carrying on its existing investment activities. The Board has a concern that your new proposed investment mandate is likely to prove to be inconsistent with the object of the CEFC Act.

As you will be aware from the *2013-14 Annual Report of the Clean Energy Finance Corporation* the CEFC's current portfolio of investments consists largely of senior debt and has an overall shadow credit rating of BB. The CEFC's portfolio reflects the fact that we are a specialised, sector-focused institution. Our focus to date has been on catalysing private financiers' participation, and as such, the CEFC's investments exhibit a credit profile which matches those held by private sector banks active in providing such facilities.

The average lifetime yield of the CEFC's investment portfolio is presently 7% ***before* operating costs**. The draft proposed mandate would increase the benchmark return to Consumer Price Index (CPI) plus 4.5-5.5 % ***net* of operating costs**. Based on long-term CPI of approximately 2.5%, and assuming operating costs around 2% during portfolio establishment, the proposed mandate would increase the target yield of the overall portfolio to 9.0% - 10.0%. This level of benchmark is commonly expected to generate negative returns approximately 4 out of every 20 years. Given the CEFC's existing investment portfolio has a lifetime yield well below this proposed new benchmark, to achieve the higher targeted rate of return on the overall portfolio, future CEFC investments would need returns significantly higher again, over and above the proposed new benchmark.

We have attached a short paper that highlights why this risk-return target is unlikely to be achieved. This paper is supported by independent analysis from Dr Steve Bishop and Professor Bob Officer which explains the observed correlation between investment risk and return. This independent analysis confirms that, like any other investor, the CEFC would need to increase its risk exposure in order to achieve the increased returns specified under the draft proposed mandate unless it can find a body of investments that demonstrate a risk-return profile inconsistent with traditional market based principles to deliver out-of-market investment returns.

We note the terms of the proposed benchmark return follow those of the *Future Fund Investment Mandate Directions 2006*. Application of a CPI based index may be appropriate for the Future Fund, as it has an unconstrained asset allocation and invests in equities, infrastructure and property, the earnings of which are broadly correlated with the CPI. It is not appropriate for the CEFC, given the object of the CEFC Act, with our constrained investment universe in the clean energy sector, the proposed Mandate's constraints on risk, and our focus primarily on debt instruments.

Other matters

We note that the Board has not been provided with an Explanatory Statement to the draft proposed mandate. It is our understanding that a requirement of registration on the Federal Register of Legislative Instruments is that an Explanatory Statement accompany the revised mandate. As this document is an extrinsic aid to interpretation under the *Acts Interpretation Act 1901*, and provides the detailed means of calculation of portfolio benchmark return we would expect to see a draft of that document to ensure its workability prior to publication and date of effect.

CEFC View

Should the Government's objective in proposing the new mandate be to increase the CEFC's benchmark, a more appropriate and realistic benchmark portfolio return (that would meet the objective of protecting and minimising risk exposure in the investment of public funds) would be the 5 year long term government bond rate (LTGBR) + 1% ***net* of operating costs and provisions,** to apply when the portfolio is fully established. This would represent a significant increase in the benchmark of approximately 30%.

The CEFC view is that the 5 year long term government bond rate (LTGBR) remains the most appropriate measure for portfolio benchmark returns because it directly relates to the Government's cost of funding of the CEFC.

In its first year of operation, the CEFC has been able to make some investments exceeding the current benchmark. Market conditions for the clean energy sector increasingly point to CEFC investments increasingly focused on broad-based funding programs with banks and energy utilities for SMEs, agribusiness, local governments and the not-for-profit sector where returns are lower.

The CEFC notes Australian Government policy remains to abolish the Corporation. That is the prerogative of Government, but so long as the CEFC remains in existence, we again reiterate our utility and ability to work in a complementary way to assist realisation of other Government policy initiatives such as the Emissions Reduction Fund, in energy, environment, regional development, agriculture, industry, innovation and infrastructure.

In summary, our view is that the draft proposed mandate would have a significant negative effect on the activities of the CEFC and will likely prove inconsistent with the object of the CEFC Act.

Next Steps

Given the observations above we request that Ministers reconsider the proposed mandate as currently configured. I again extend the offer of availability of the CEFC to you and your officers to assist in provision of further information and or advice on this matter.

I also want to assure you that the Board will continue to pursue its duties under the CEFC Act. Consistent with our obligations under that Act, we will seek to take all reasonable steps to comply with a revised mandate, even if, as all evidence suggests, it will prove highly challenging to significantly increase the rate of return of the portfolio whilst maintaining the current portfolio credit risk profile.

Should you or your office have any questions in this regard, please do not hesitate to contact Mr Simon Every, Head of Government Affairs, by email at simon.every@cleanenergyfinancecorp.com.au or by telephone on 07 3188 1627.

Yours sincerely

[Signed]

Jillian Broadbent AO

Chair of the Board

Clean Energy Finance Corporation