

CEFC COMMENT ON DRAFT REVISED INVESTMENT MANDATE

General Summary

The CEFC currently earns an average *lifetime* investment portfolio yield of approximately 7% **before operating costs**. As the portfolio is below a target size of about 2.5 billion, operating costs are proportionally higher than market. This 7% figure represents what the CEFC writes loans and does not include cash holdings drawn as part of prefunding.

The draft proposed mandate seeks to increase the CEFC's benchmark performance rate to CPI + 4.5-5.5% **net of operating costs** (i.e. about 9-10%), measured annually while not increasing the risk profile of the portfolio from its current level (i.e. that which is proportionate to a return of 7% before costs).

For the CEFC to achieve a 2% higher benchmark rate of return than the current benchmark, it would ordinarily have to move from its current 90% debt-based portfolio towards equities and hence take a higher-risk profile. The CEFC Board shares the objective of protecting and minimizing risk exposure in the investment of public funds. The CEFC Board has taken a conservative risk approach and significantly limited the CEFC's current equity exposure. This is consistent with ensuring private sector participation in investments.

The analysis of Dr Bishop and Professor Officer that accompanies this brief contains an examination of the historical spread of listed Australian equity returns and Corporate Bond yields over the CPI by rating, and indicates that to achieve the new benchmark rate of return, the CEFC would be forced to increasingly move to sub-investment grade debt if its portfolio was restricted to debt securities.

Alternatively, it would need to lever up a portfolio of investment grade debt to earn the required yield to meet the benchmark. The *Clean Energy Finance Corporation Act 2012* ('CEFC Act' or 'the Act') effectively prevents the CEFC from borrowing other than for bridging, so leverage is not possible. Greater sub-investment grade debt in the CEFC portfolio will increase credit risk which the new Investment Mandate seeks to limit. In order to have a chance of meeting this proposed benchmark, the Corporation will need to fulfil its statutory obligations to find additional investment opportunities that:

1. produce out-of-market credit investment returns; and
2. involve additional equity risk and returns.

Under its existing Investment Policies the Corporation has sought to maintain a balanced portfolio approach. In order for the CEFC to continue to do this and fulfil its Investment function to service the eligible market under the CEFC Act the Corporation will need to continue providing:

- Low-risk low-return investment facilities that service manufacturing, SME, not-for-profit and government/local government sectors for energy

- efficiency and on-site renewables to catalyse investment activity in areas underserved by the traditional banking sector;
- Corporate facilities of longer tenor for energy efficiency and on-site renewables; and
 - Funding for vehicles co-financed with banks and energy utilities designed to incentivise SMEs and other businesses to invest in building efficiency upgrades, top performing efficiency equipment and vehicles.

The returns targeted under the draft proposed mandate parallel those in the Future Fund mandate. However:

- The return required of the Future Fund is 'per annum over the long term', whereas that proposed for the CEFC is strictly 'per annum'.
- The Future Fund Mandate included a 'ramp up' grace period to achieve benchmark, whereas the proposed CEFC benchmark denies the CEFC such a ramp up period, and does not recognise that the CEFC portfolio currently remains sub-scale.
- The Future Fund is permitted to develop a portfolio with substantial investments in classes with higher-risk, particularly Australian and Global equities. The CEFC is restricted to Australia only investments.
- Under the CEFC Act, the CEFC's investment universe is much more restricted than the Future Fund, and hence the CEFC has more limited opportunity to find 'out-of-market' returns or additional equity risk exposure than is available to the Future Fund.
- Reflecting their different purpose, the Future Fund's portfolio is based on listed equities which are liquid, while the CEFC, in facilitating increased flows of finance into the clean energy sector, has an illiquid portfolio which is primarily debt focused.

The CEFC will meet its obligations under the Act in respect of the draft proposed mandate even though it seeks a higher return without additional credit risk. The Board notes the mandate must be consistent with the statutory object under section 3 of the Act in that it must allow the Corporation to continue to 'facilitate increased flows of finance into the clean energy sector'. Any mandate that had the effect of imposing a severe impediment on CEFC's ability to perform the functions given to it under the Act is unlikely to be considered consistent with the CEFC Act or the object of the Act.

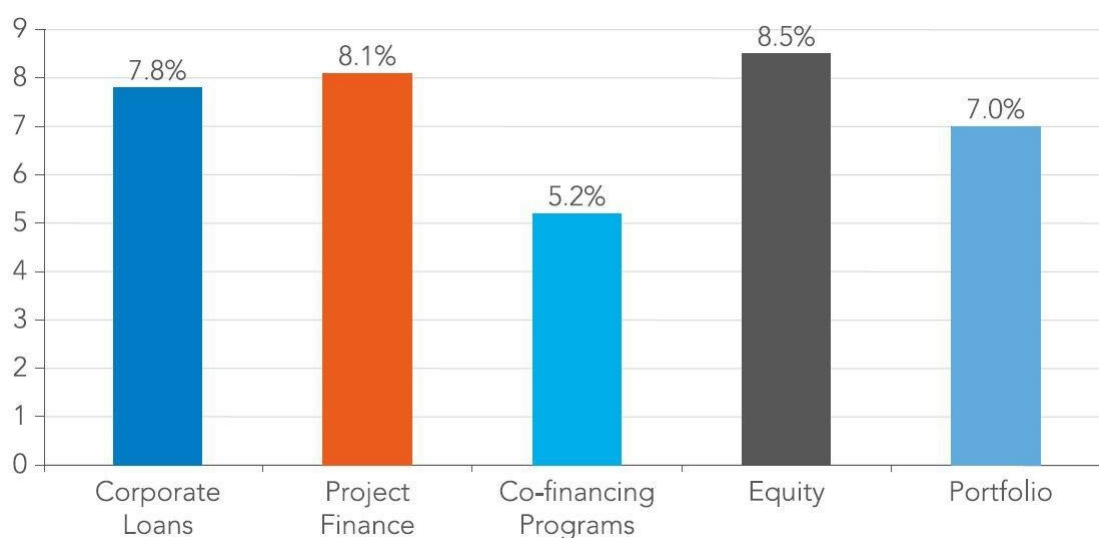
The analysis of both the CEFC and that of Dr Bishop & Professor Officer indicate the CEFC is unlikely to be able to increase returns to the level specified in the draft proposed mandate under the above constraints. To that extent, they believe the draft proposed mandate sets a benchmark return under conditions that make it highly likely to be unachievable.

Issue 1: The proposed target return of CPI +4.5-5.5 is unlikely to be achievable without increased risk and/or out-of-market investments.

The CEFC balances lower-risk, lower-return co-financing programs (i.e. sell through finance with major banks and utilities) with higher-risk, higher-return Project Financing activity to produce an average investment portfolio life time yield of about 7%. The sell-thru co-finance activity earns an average investment portfolio

lifetime return of 5.2%, corporate lending earns an average investment portfolio yield of 7.8%, while the project finance activity earns an average investment portfolio lifetime yield of 8.1%. This is illustrated in the table and graph below (all figures to 30 June 2014):

Segment	\$m CEFC total	\$m Total Project	Yield	Private Sector Leverage
Corporate Loans	\$116.1	\$331.8	7.8%	1.7
Project Finance	\$387.2	\$1,946.7	8.1%	3.7
Co-financing Programs	\$347.5	\$684.9	5.2%	1.0
Equity	\$80.3	\$240.6	8.5%	2.0
Total	\$931.1m	\$3,204.0m	7.0%	2.2



However the draft proposed mandate requires an investment portfolio lifetime return before operating expenses of about 9-10%, or a 2% premium over the CEFC's investment portfolio as written so far.

Our investment experience would indicate that it is generally not possible to increase return without increasing risk (unless there is some information the investor holds that the market is unaware of and hasn't correctly priced). This level of benchmark as proposed is commonly expected to generate negative returns approximately 4 out of every 20 years.

It is unlikely that the CEFC could push out the yield on its corporate lending portfolio beyond market rates. However it can seek out-of-market returns where available to complement ordinary activity.

In the event that, despite taking 'all reasonable steps', the CEFC is unable to find out-of-market investments achieving the increased benchmark, it is unlikely the CEFC can meet the risk-return conditions set down in the proposed Investment Mandate to:

- 'develop a portfolio across the spectrum of clean energy technologies that in aggregate must have an acceptable but not excessive level of risk relative to the sector', and
- 'not materially increase the level of exposure to credit risk above the level of the existing portfolio as assessed at the date of the direction'.

In summary, it would be a highly challenging proposition for the CEFC (or for anyone else in the market) to both expose the portfolio to higher equity risk and find viable 'out-of-market' investments while continuing to pursue its existing broad-based investment opportunities.

Illustrative Effect of revised Mandate on Portfolio and Activity

The first chart (Chart 1) below shows the current CEFC investment portfolio broken down by finance type and technology (as at 30 June 2014). Simplified for the purposes of illustration, it demonstrates that Project Finance (i.e. loans for primarily utility-scale renewables projects that are secured against the revenue of the projects and the projects themselves) is more profitable but generally comes with higher risk (e.g. higher construction risk, volatility in generated output or volatility in revenues).

Corporate Loans are loans secured against all of the assets of the borrowing entity, not just a project. To date in the CEFC investment portfolio, this has been mainly bioenergy and waste coal mine gas. The returns and risk are lower, mainly because of the whole-of-entity security (with assets other than the project to repay the debt if the project fails) and there can be additional revenue streams apart from energy generation.

Energy Efficiency and Rooftop PV are lower risk/lower return co-financing arrangements where the CEFC loans finance to a bank, utility or service provider who then sells through the finance to the consumer. The CEFC selects only reputable co-financing program partners, and the effect of bundling small loans together like this should be to spread risk and create an asset class with observed low historical rates of default (e.g. on par with or below finance for similar asset classes) which can then be securitised.

The red broken-line circle is in essence the average of all of these sets, plus a single large equity holding. It shows that the CEFC investment portfolio earns an average *lifetime* investment portfolio yield of 7% **before operating costs**, and has an average shadow credit rating (i.e. risk rating for debt securities) of BB.

It should be noted that this investment distribution is in our experience quite typical. The bottom left to higher right is consistent with a normal distribution of investment returns one would expect – that is, the higher the risk, the higher the return demanded.

CHART 1: CEFC INVESTMENT PORTFOLIO RISK-RETURN MATRIX AS AT 30 JUNE 2014

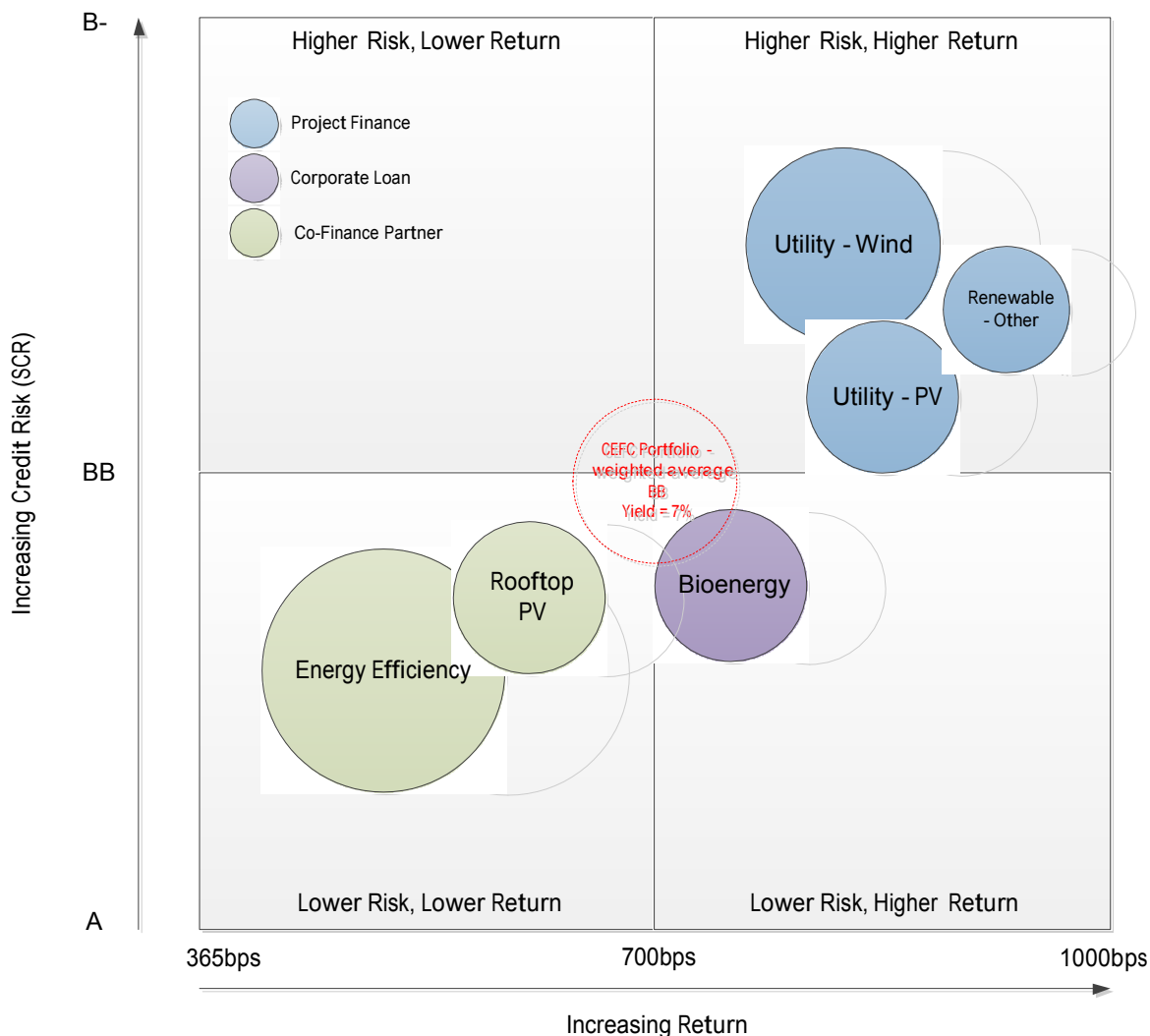


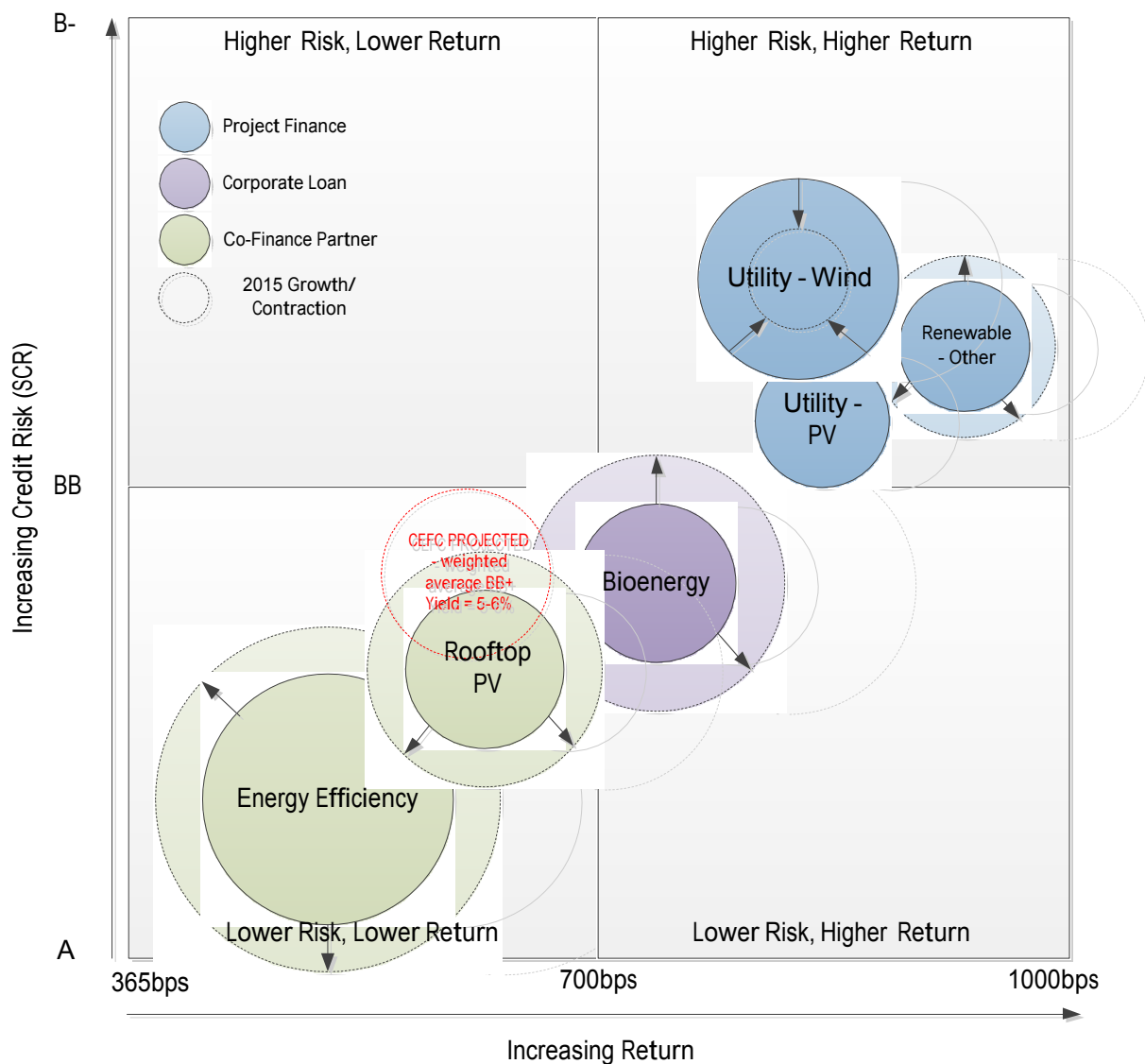
Chart 2 below shows what the CEFC currently expects its investment portfolio to look like as at 30 June 2015 (as opposed to 30 June 2014 above). It reflects market conditions in the energy sector with generation oversupply, uncertainty over both the Renewable Energy Target and long term energy policy settings generally. Many utility scale projects have payback periods of 10 to 20 years or more and the observed market conditions are that investors will not commit to capital funding investments while policy settings remain in flux.

Accordingly, the CEFC expects no growth in the share of its portfolio in Project Finance for Utility scale solar PV by end of financial year, and a contraction in share of portfolio dedicated to Project Finance for Utility scale wind. In Project Finance, we expect this to be partially offset by potential growth in larger-scale Bioenergy.

We also expect Corporate Lending for Bioenergy (and perhaps for some Energy Efficiency and commercial scale Rooftop solar PV) to expand, as well as expansion in co-financing for these purposes.

The overall effect is that, as Project Finance investment opportunities in Utility scale wind and solar PV) renewables contract, we expect the CEFC's lifetime portfolio yield to fall from about 7% to between 5-6% with a commensurate shift in the overall risk profile to BB+.

CHART 2: CEFC INVESTMENT PORTFOLIO RISK-RETURN MATRIX PROJECTED FOR 30 JUNE 2015

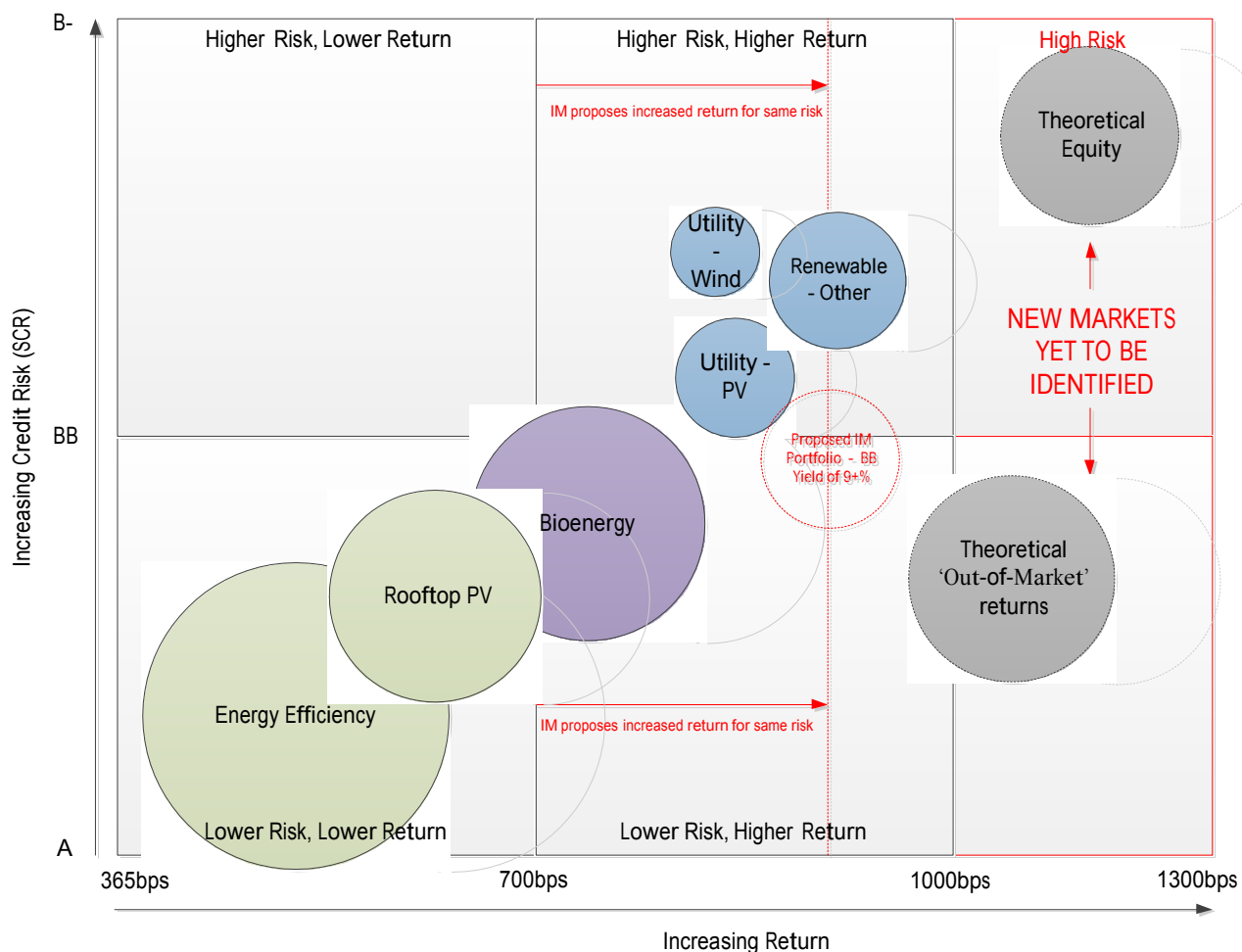


The third and final chart (Chart 3) shows the anticipated impact of the draft proposed mandate showing a hypothetical targeted CEFC portfolio which would be necessary in order to significantly increase the investment rate of return whilst seeking to maintain the current investment portfolio credit risk profile.

The CEFC would look to continue its important investment work in the energy efficiency space, supporting SMEs, manufacturing and not-for-profits, where availability of finance is a continual challenge.

However, to take 'all reasonable steps' to achieve the proposed benchmark risk-return target, the CEFC will need to maintain balance in its portfolio by additionally investing in higher risk and/or higher return deals than it has to date. These higher risk/return deals might theoretically be equity investments in early stage developments, or opportunities with 'out-of-market returns'. These 'out-of-market returns' remain a hypothetical possibility only, with such opportunities only rarely identified and practically non-existent, given the CEFC's limited investment universe.

CHART 3: IMPACT OF PROPOSED CHANGES TO CEFC INVESTMENT MANDATE



Issue 2: CPI is an inappropriate base rate for the CEFC and the Future Fund benchmark is an inappropriate benchmark for the CEFC

The Consumer Price Index (CPI) as a base rate bears no direct relation to CEFC costs (i.e. cost of government borrowings or 5 year Long Term Government Bond Rate LTGBR), its operating environment or statutory objective. The draft proposed mandate specifies a Portfolio Benchmark Return that is identical to that of the Future Fund, but the CEFC is a very different institution as the table below shows:

Attribute	Future Fund	CEFC
Reason for existence	To meet Commonwealth's unfunded superannuation pension liabilities which are growing at CPI rate through investing	To facilitate increased flows of finance into the renewables, energy efficiency and emissions reduction technologies sector through performing the investment function
Jurisdiction	No limit on where Future Fund can invest	Must invest in projects that are solely or mainly Australian based
Sector	Can invest in any sector	Must only invest in renewables, energy efficiency and emissions reducing technologies (except nuclear and carbon capture and storage)
Means of Investment	Essentially unrestricted.	Can only invest in financial assets (cannot own real property). Must avoid guarantees wherever possible. Cash holdings only to service lending and operations.
Investment Approach	More or less conventional and high volume, low transaction cost.	More or less bespoke, low volume, higher cost in order to meet public objective.
Relevance of CPI to investments	Invests in property, infrastructure and equities, all of which have yields correlated with CPI.	CPI is not a relevant measure in debt markets.
Recipients of Investment	Mainly blue chips and Institutions	Banks and utilities to sell through finance to consumers and SMEs. Private sector from mid-tier to blue chips and Institutions. Public sector from Local Government through to Federal Government and GBEs. Not-for-Profit Sector
Portfolio	70% in liquid instruments. Equities (50%+).	90% Debt focussed (illiquid)
Conclusion	Large investment universe to generate financial returns	Public purpose institution restricted to investing in very limited circumstances in order to drive technological change in energy sector and more efficient energy use

Issue 3: The draft revised mandate gives inconsistent direction on risk and commercial approach

The proposed changes challenge other requirements of the mandate - specifically the requirement to adopt a commercial approach to investment – which would ordinarily require that risk and return be commensurate as is commercial practice.

It follows that the requirement to increase returns without increasing credit risk would not meet the standard of a commercial approach.

Note that under both the existing and revised draft Mandates, the CEFC must:

- a. Apply commercial rigour when making its investment decisions, and
- b. While operating with a commercial approach, develop a portfolio across the spectrum of clean energy technologies that in aggregate must have an acceptable but not excessive level of risk relative to the sector.

Issue 4: No Explanatory Statement and uncertainty over transitional or consequential arrangements

The detail of the actual method of calculation for the current portfolio benchmark is specified in the Explanatory Statement rather than the Mandate itself. The Explanatory Statement is also extrinsic material that may be taken account of in certain circumstances as an aid to interpretation, and hence is itself of some instructional value to the Corporation as the entity charged with administering the law.

During consultation on its existing mandate, the CEFC was supplied with, and contributed to, a draft Explanatory Statement. It is our understanding that it is a requirement of registration on the Federal Register of Legislative Instruments that an Explanatory Statement accompany the revised mandate. The CEFC would expect to be able to view the intended drafting of the Explanatory Statement so it could ensure workability of any arrangements proposed therein.