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Electricity Network Recapitalisation Strategy

Gearing and Dividend Benchmarking Analysis - Summary

Queensland Treasury Corporation

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Disclaimer

IMPORTANT NOTICE

- This report is delivered subject to the agreed written terms of KPMG's engagement with Queensland Treasury Corporation (QTC) as set out in our engagement letter dated 20 April 2015
- This report provides a summary of KPMG's work and findings in respect of *Gearing and Dividend Benchmarking Analysis* of Ergon, Energex and Powerlink relative to their private and public sector peers both before and after the implementation of the recapitalisation strategy proposed by QTC
- In preparing this report, we have had access to information provided by QTC, including on behalf of Energex, Ergon Energy and Powerlink. In the preparation of this report, we have relied upon and assumed, without independent verification, the accuracy, reliability and completeness of the information made available to us in the course of our work to date, and have not sought to establish the reliability of the information by reference to other evidence
- The benchmarking analysis in this report is based on publicly available financial statements, company announcements and rating agencies' reports. Unless noted, no adjustments have been made to ensure comparability of the financial information
- We do not make any statement in this report as to whether any forecasts or projections included in this report will be achieved, or whether the assumptions and data underlying any prospective financial information are accurate, complete or reasonable. We do not warrant or guarantee the achievement of any such forecasts or projections. There will usually be differences between forecast or projected and actual results, because events and circumstances frequently do not occur as expected or predicted, and those differences may be material
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Background

- Queensland Treasury Corporation (QTC) is currently undertaking analysis of a potential recapitalisation strategy in connection with the Queensland Government (State) owned electricity businesses – Energex, Ergon Energy and Powerlink (the GOC's)
- QTC has requested that KPMG:
  - undertake peer benchmarking of gearing levels to illustrate and analyse how Energex, Ergon Energy and Powerlink are positioned relative to their private and public sector peers both before and after the implementation of this recapitalisation strategy to assist QTC in setting the final parameters for the strategy
  - undertake peer benchmarking of dividend payout ratios in light of the proposed change in dividend policy for these GOCs to payout 100% of NPAT
- This presentation summarises the findings of this analysis
- It is important to note that the analysis presented herein is based on draft Corporate Plans provided by QTC to KPMG

Key Findings

Forecast gearing levels following the implementation of the QTC proposed recapitalisation strategy are comparable to market benchmarks measured by Net Debt / Fixed Assets and fall within Moody's investment grade rating band

It is important to look at different gearing measures and benchmarks to develop an overall appreciation of where the forecast debt levels of Energex, Ergon Energy and Powerlink sit relative to their peers in the market:

- **Net Debt / RAB targets:** To determine the level of upfront regearing, the financial modelling targeted 70%/70%/75% for Energex, Ergon Energy and Powerlink respectively based on the proportion of Net Debt to the Regulated Asset Base (RAB)
- **Debt / Total Assets outcomes:** The AER provides for gearing of 60% based on the proportion of Debt to Total Assets. On this alternative definition, the proposed regearing sees Energex, Ergon Energy and Powerlink initially geared at 59%/61%/67%.
- **Net Debt / Fixed Assets benchmarks:** Moody's ratings agency proposes an investment grade rating band of 60%-75% based on the proportion of Net Debt to Fixed Assets with market benchmarks based on this definition being a median of 65% and an average of 77% over the period from FY08 to FY14
- **Net Debt / Fixed Assets outcomes:** Compared with a market median of 65% and an average of 77%, the proposed regearing is expected to result in an initial gearing of Energex, Ergon Energy and Powerlink of 64%/68%/66% respectively

From a credit ratings perspective, gearing is only one important consideration and other credit metrics together with qualitative factors are taken into account to determine an entity's credit rating

- Accordingly, the rigorous continuation of QTC's Debt Credit Review process in respect of these GOCs will be important

Higher gearing levels in the market, compared with the AER provision of 60%, are partly explained by the AER target being based on a different definition but also reflect regulated entities taking the opportunity to maximise their return on equity

- With a Moody's investment grade gearing range of 60-75%, it is feasible for a regulated entity to maintain an investment grade credit rating at gearing levels greater than the 60% provided for by the AER.

Moving to a dividend policy of 100% of NPAT, subject to cash flow considerations, is broadly consistent with observed market practice

- The total average payout ratio of all peers is 95% (including 122% for private peers and 54% for public peers)
- Peers have regard not only to current earnings and cash flow, but also to future capital expenditure commitments and the need to maintain sufficient financial flexibility to meet ongoing commitments (i.e. the ability to raise both debt and equity)

Actual gearing and dividend policy does not impact on electricity prices charged to end users

- Prices charged to end users reflect the costs provided for by the AER i.e. including cost of capital

Gearing Benchmarking – Peers

Peer selection

- A total of 19 entities were analysed as part of the benchmarking analysis. This included 11 entities with reference to the analysis of gearing, focussing on electricity transmission and distribution entities, and 18 entities in respect of dividend policy including additional listed infrastructure entities
- We included both government and non-government owned peers, and separated government and non-government in our analysis. We consider that the non-government entities are more relevant to benchmark given that they are subject to external debt and equity capital markets. Further, the majority of these entities maintain a public credit rating with S&P and / or Moody's and therefore provide a highly relevant reference point
- It is important to note that dividend metrics and policies are heavily influenced by the profile of the shareholders, i.e. government, private or publicly listed. As above, we consider the dividend metrics and policies of privately owned entities to be more relevant

Gearing metric(s)

- Our gearing benchmark analysis focusses on a Net Debt to Fixed Assets definition, a key element of Moody's credit rating agency methodology

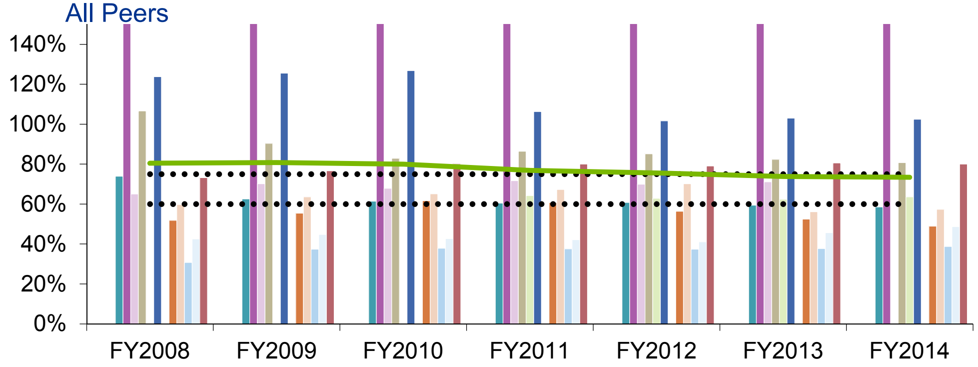
Peer benchmarking

- The adjacent chart to the top right illustrates historical gearing for all the selected peers over the FY2008 to FY2014 period, demonstrating the variability from entity to entity and showing an average gearing of 77% across all peers.

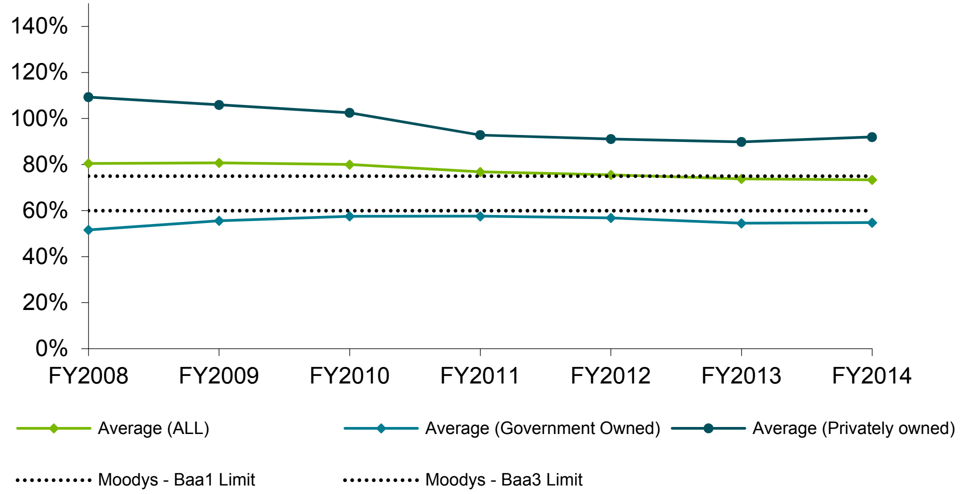
Private versus Public Peers

- The adjacent chart to the bottom right shows the difference in average gearing levels between six private and five public peers:
  - Private peers, 98%
  - Public peers, 55%
- The overall higher level of gearing in the private sector is at least in part explained by their focus on managing the cost of capital and enabling shareholders to ration their equity across a wider range of investments

Net Debt / Fixed Assets
All Peers



Net Debt / Fixed Assets
Ownership Split (Government vs Private)

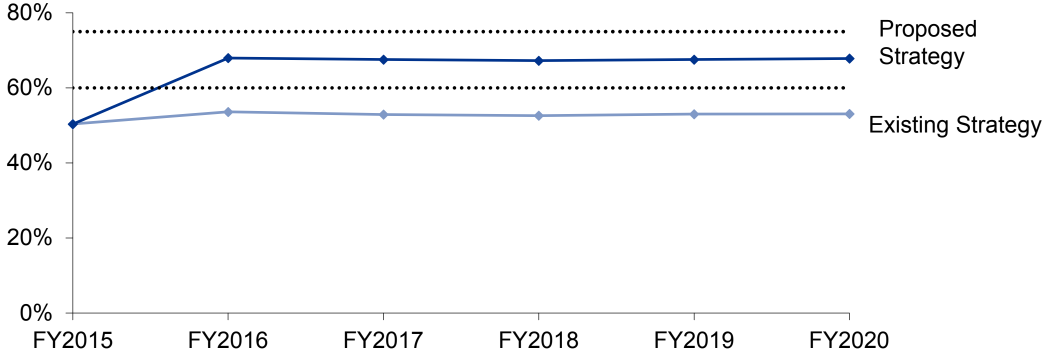


Source: Capital IQ, S&P, Company annual reports, KPMG benchmarking analysis

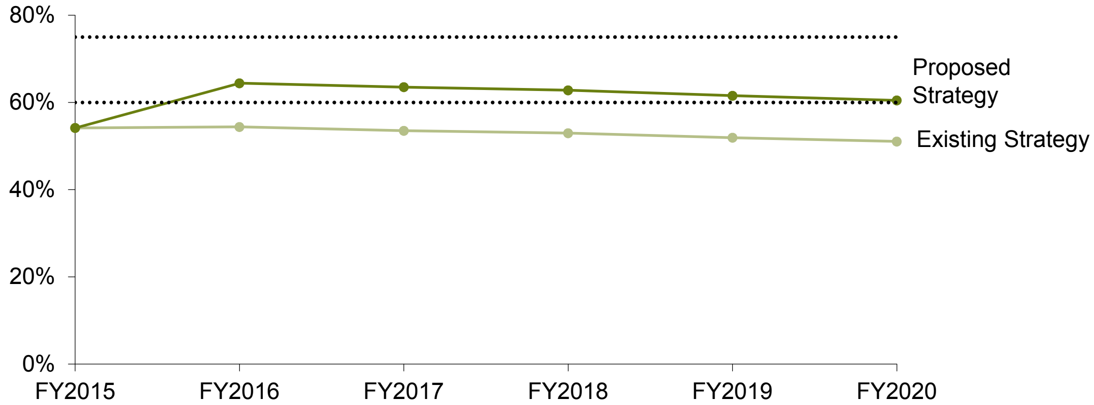
Gearing Benchmarking – Network GOCs

- Based on draft Corporate Plans, the charts below show the forecast level of gearing in each of the three networks GOCs before and after the proposed implementation of the QTC recapitalisation strategy in the context of Moody's investment grade band of 60% to 75% in respect of gearing
- We note that the proposed level of gearing of each of the three entitles remains well within Moody's Baa1 and Baa3 range as measured by Net Debt / Fixed Assets
- However, from a credit ratings perspective, gearing is only one important consideration and other credit metrics together with qualitative factors are taken into account to determine an entity's credit rating. Accordingly, the rigorous continuation of QTC's Debt Credit Review process in respect of these GOCs will be important

Ergon (including EEQ)

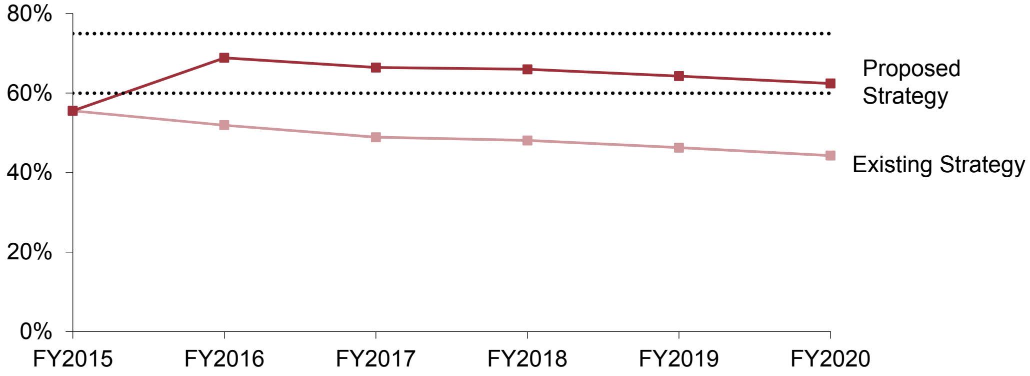


Energex



Source: Capital IQ, S&P, draft Corporate Plans

Powerlink



Dividend Benchmarking

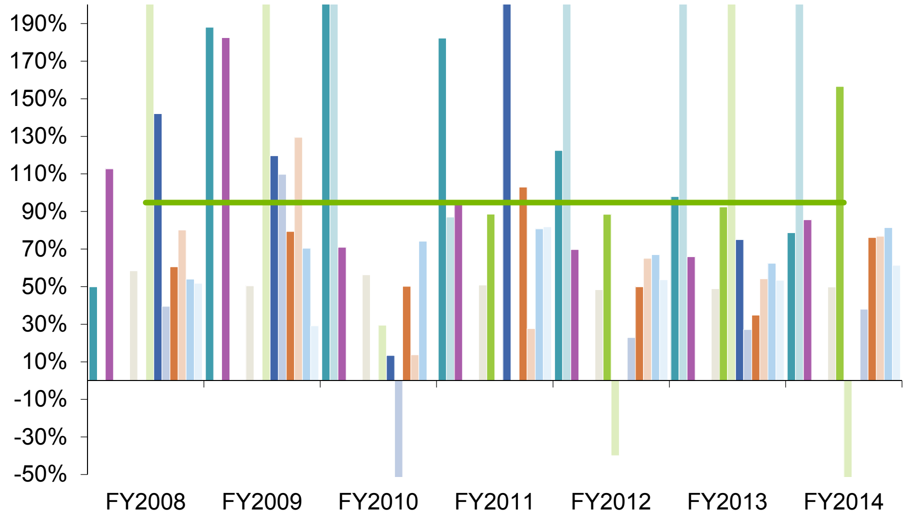
Dividend metric(s)

- In relation to benchmarking dividend payout, there are a range of metrics that are often used. The most widely adopted is Dividend Payout Ratio calculated as DPS / EPS or Dividends Paid / NPAT

Dividend benchmarking

- The adjacent chart shows the historical dividend payout ratios for peers over the FY2008 to FY2014 period.
- The total average Dividend Payments to NPAT across all peers was 95%.
- While the analysis shows a long-run average of close to 100% of NPAT, it demonstrates that dividend payout ratios vary considerably across all peers (both privately owned and government owned), and across all financial years. We conclude from this that there is an inherent mismatch in the underlying basis for the dividend policy / decision and the metrics utilised to observe dividend payment practices
- This volatility in dividend payout ratios could be driven by a variety of factors, including (but not limited to):
  - Shareholder preferences / profile changing over time
  - One-off items included in NPAT / cash flow
  - Timing uncertainties associated with growth and maintenance capital spending
  - Varying liquidity and access to capital markets for funding
- Further analysis has also been undertaken to show the difference in the historical average dividend payout ratios across peers:
  - Private peers, 122%
  - Public peers, 54%
- This analysis suggests that QTC's proposed strategy to move to a dividend policy of 100% of NPAT for these GOCs, subject to cash flow considerations and future capital expenditure requirements, is broadly consistent with observed market practice

Dividend Payments / NPAT



Note: The y-axis bounds have been set to allow for a clearer visual representation – this means that some outliers are not fully shown in these charts.

Source: Capital IQ, S&P, Company annual report KPMG benchmarking analysis cutting through complexity™