

19 April 2024

The Hon Stephen Jones MP
Assistant Treasurer and Minister for Financial Services
The Treasury
Commonwealth Government
Lodged by email to: yfys@treasury.gov.au

Dear Minister,

Response to Commonwealth Government's Annual Superannuation Performance Test - design options

The Clean Energy Investor Group (CEIG) welcomes the opportunity to provide feedback on the Commonwealth Treasury's *Annual Superannuation Performance Test - design options* consultation paper (the consultation paper) published in March 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 clean energy with a focus on the stakeholders who can provide the cost-effective capital required for this transition.

Key Points

- CEIG notes that, **for the purpose of benchmarking unlisted infrastructure assets such as renewable energy assets, the MSCI Index suffers from significant limitations and is not fit-for purpose.**
- **CEIG reiterates the importance of reforming the YFYS framework** and the Commonwealth Treasury's exploration of alternative approaches to benchmarking since **the current approach may be discouraging investment in the clean energy sector.**
- CEIG notes that all of the proposed alternatives to the status quo have distinct benefits over the status quo.

- **CEIG's preference is for option 4 – alternative framework, where unlisted infrastructure assets would be assessed against a more granular, better aligned, 'industry specific' benchmark built and maintained by a regulator** (for example, renewable energy assets would be measured against a 'renewable energy benchmark'). Other possible options include the use of the Sharpe or Sortino ratios.
- **CEIG supports the initial work undertaken by Future Group** with the Clean Energy Finance Corporation (CEFC) and MSCI **to establish a new benchmark class for domestic clean energy infrastructure assets.**
- **CEIG recommends the Government adopts a dynamic framework** that can be alert to **emerging opportunities** for super funds to **invest to help support the decarbonisation of the economy.**

GENERAL REMARKS

The Your Future, Your Super (YFYS) initiative has been a pivotal development in the Australian superannuation landscape, impacting the way funds manage and allocate investments. With a core focus on enhancing member outcomes through improved performance benchmarks and a strengthened duty to act in the best financial interests of members, YFYS has necessitated a reassessment of investment strategies.

Notably, this has had implications for the allocation of capital towards renewable energy projects, as funds must balance the pursuit of sustainable investments with the need to pass an annual test against a benchmark that is presently not fit for purpose. CEIG raised these concerns within our earlier submissions and welcomes the current undertaking to reform the benchmark framework¹. CEIG notes our particular interest in the reform of the unlisted infrastructure asset benchmarks given the challenges associated with the status quo.

MOVING BEYOND THE STATUS QUO

Current benchmark is not fit-for-purpose

As highlighted in our previous submission², the current benchmark used for the performance test for unlisted infrastructure investments (MSCI Index) is not, in the view of the CEIG, accurate for or consistent with the incentives required for the investment in the renewables sector .

The use of the MSCI Index as the benchmark for the performance test is likely to have unintended negative consequences. The high benchmark return and the risk profile associated with the assets measured by the benchmark could deter superannuation funds from investing in clean energy infrastructure assets. By financing clean energy infrastructure assets, investors seek stable cashflows that generate long-term

¹ CEIG (2023) [CEIG-response-YFYS-Draft-Regulations](#)

² CEIG (Oct-22), [CEIG response to Review of Your Future, Your Super Measures](#)

sustainable returns. Feedback from our Members suggests that, for unlisted contracted renewable energy infrastructure assets, seeking long-term financial returns in the order of 7%-8% per annum would be more consistent with historical returns and the risk profile for such assets and would create a more sustainable benchmark.

The high benchmark return and risk profile essentially requires superannuation funds to take on greater risks to meet the benchmark return, resulting in the potential for a more volatile return profile from an asset class that has traditionally been valued by institutional investors for providing long-term, yield-driven, stable returns that are positively correlated to inflation as a result of the long-term, inflation-linked cashflows derived by the underlying assets. Further, the global pool of attractive higher risk/return profile infrastructure investments is not unlimited, hence the need to focus on this segment of the investment universe has the potential to unnecessarily attract capital away from investment in more stable, core style infrastructure assets which are expected to generate sustainable high single-digit, long-term returns.

These disincentives are likely to be to the detriment of superannuation members' long-term interests as the regulations are forcing superannuation funds to take a higher risk bias and to limit portfolio diversification.

Consequences of status quo for the financing of ESG assets

The unintended consequences from the use of the MSCI Index could negatively impact the cost of the Australian energy transition for electricity consumers. Over the next decade, superannuation funds have a significant opportunity to provide low-cost capital to deliver the energy transition at least-cost for electricity consumers. These concerns also apply more broadly to the financing of Environmental, Social, and Governance (ESG) assets.

Investment in sectors like clean energy - which are crucial for sustainable economic growth and environmental sustainability - often require a detailed and quantified understanding of long-term value creation, which may not always align with the immediate and backward-looking performance metrics set out in the current YFYS framework.

The current approach results in an overemphasis on short-term performance. The current framework might incentivise funds to focus excessively on short-term performance to meet or surpass benchmarks, potentially at the expense of long-term strategic goals and member interests. It also lacks holistic assessment. By not assessing the choice of strategy, the test might overlook the overall appropriateness and effectiveness of a fund's investment strategy for its member cohort. It increases the potential for 'benchmark hugging' where there is a risk that funds might manage their portfolios primarily to meet the benchmark criteria.

ANALYSIS OF BENCHMARK DESIGN OPTIONS

CEIG focuses on the treatment of investments in clean energy assets, and therein unlisted infrastructure, as an asset class.

Preferred approach: option 4 – alternative framework

CEIG notes that all of the proposed alternatives to the status quo have distinct benefits over the status quo.

CEIG's preference is for *option 4 – alternative framework*, where unlisted infrastructure assets would be assessed against a more renewables sector relevant, better aligned, 'industry specific' benchmark built and maintained by a regulator, using publicly available data (for example, renewable energy assets would be measured against a 'renewable energy benchmark').

This approach aims to directly align investment incentives with the national priority of accelerating clean energy deployment, ensuring that these crucial assets are suitably evaluated for inclusion within fund portfolios.

CEIG notes that its preferred approach could increase the administrative burden for the regulator by needing to create and maintain multiple benchmarks across the unlisted infrastructure asset class. However, this possible increased surveillance is expected to be offset by improved investment outcomes for superannuation fund members.

CEIG supports Future Group's initial work to establish a new benchmark

CEIG supports the initial work undertaken by Future Group with the Clean Energy Finance Corporation (CEFC) and MSCI to establish a new benchmark class for domestic clean energy infrastructure assets, as highlighted within their submission.

Whilst CEIG notes that the work by Future Group is progressing, policy certainty is required from Government including a commitment to progress a new benchmark. This will incentivise more relevant asset owners to share underlying performance data over longer time periods with the benchmark provider to create a more robust index.

Finally, CEIG anticipates that more asset classes will need to be created in the future to help support the decarbonisation of the economy. Therefore, CEIG recommends the Government adopts a dynamic framework that can be alert to emerging opportunities for super funds to invest in, rather than inadvertently shut off such opportunities for superannuation funds to participate.

Other possible options

Option 2a: The Sharpe Ratio

CEIG notes its preference for the use of a risk adjusted measure, over the status quo approach, insofar as the measure accounts for relevant investment terms and volatility more specifically at an asset class level.

Using the Sharpe ratio could be advantageous because it assesses risk-adjusted returns, providing a clearer picture of the fund's performance relative to its investment risk profile. The status quo benchmark approach fails to account for risk/return trade-offs, and consequently may favour more established asset classes notwithstanding their higher volatility, and their higher downside volatility. However, while the Sharpe ratio may offer a more comprehensive view of fund performance; and potentially lead to better member outcomes by emphasising both returns and risk; it could also oversimplify the investment landscape if not properly calibrated, resulting in less investment diversity, potentially having a similar impact on emergent investments to the status quo benchmark framework.

Alternative for option 2a: The Sortino Ratio

If consideration is being given to the Sharpe ratio, consideration should also be given to the plausible benefit of the Sortino ratio which differs from the Sharpe ratio to account for only downside risk.

While the Sharpe ratio incorporates the overall asset standard deviation, the Sortino ratio restricts this variation to the standard deviation of negative returns, excluding upside volatility³. This emphasis is particularly pertinent given the importance of downside volatility in the context of investment risk management. Since it focuses on downside risk, the Sortino ratio can be a better indicator of how consistently an investment avoids losses or negative returns below a certain threshold. It highlights the stability of returns in unfavourable market conditions.

THE UNINTENDED CONSEQUENCES OF THE STATUS QUO

CEIG wishes to note that the current approach may be discouraging investment in the energy sector, not because of the inadequacy of investment opportunities but because of the 'safety' presented by benchmark hugging opportunities. Energy assets may present acceptable longer term returns that do not coincide with the current investment time horizons of the existing framework. Moreover, the current approach may materially impact future energy prices, and bring greater volatility to infrastructure investments.

Investment in infrastructure and costs of energy

The potential negative effects of using the MSCI Index could escalate the expenses associated with Australia's shift to clean energy for electricity users.

³ Where R_p denotes the portfolio return, R_t denotes the targeted return, R_f denotes the risk-free rate and Deviation denotes the standard deviation, either downside or total. $Sortino\ ratio = \frac{R_p - R_t}{Deviation_{downside}}$;

$Sharpe\ ratio = \frac{R_p - R_f}{Deviation_{total}}$.

CEIG expresses concern that reliance on the MSCI Index for performance testing may discourage superannuation funds from contributing to clean energy infrastructure investments. For an economically efficient energy transition in Australia, securing affordable capital is crucial. Superannuation funds are capable, with the appropriate incentives, to play a vital role in providing such capital over the coming decade to ensure the transition is cost-effective for electricity consumers.

In August 2021, CEIG outlined in its *Unlocking low-cost capital for clean energy investment*⁴ report that by tapping into low-cost capital, substantial reductions in the energy transition cost, amounting to as much as \$7 billion, are achievable.

Additional considerations pertaining to regulatory harmonisation

CEIG notes that all the approaches proposed herein (non status quo alternatives) align with the APRA 229 directive pertaining to transition risk, while the status quo approach does not, given that it may dissuade investment in clean energy. Harmonisation necessitates consistency between investment performance assessment methods and broader regulatory frameworks. CEIG asserts that the proposed approaches are more aligned with the APRA 229 directive, which emphasises that super funds should be managing transition risk effectively.

This alignment is crucial as it ensures that investment strategies not only are geared towards immediate performance metrics but also consider the long-term sustainability and transition risks inherent in the shift towards clean energy. In contrast, the status quo approach might fail to adequately address these broader financial and environmental risks, potentially leading to misalignment with regulatory expectations and undermining efforts to transition to a low-carbon economy.

CEIG thanks the Commonwealth Treasury for the opportunity to provide feedback on its Consultation paper and looks forward to continued engagement regarding the issues considered. Our Policy Director can be contacted at marilyne.crestias@ceig.org.au if you would like to further discuss any elements of this submission.

Yours sincerely,



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⁴ CEIG (2021), [Clean Energy Investor Principles](#)