Research and Insights

Ausbil's Energy Transition Series

September 2021

Regulated Utilities: The epicentre of the global energy transition

Renewable energy companies are the typical 'go-to' exposure for the multi-generational thematic of energy transition. However, some renewable energy investments can carry higher risk. An alternative way to play this transition, and one we argue with less risk, is through the regulated utilities sector. Utilities have a critical role in the energy transition, with attractive investment characteristics for long-term infrastructure and ESG focused investors. The opportunity lies in the fact that utilities have been overlooked by markets, so far, as an essential part of the transition to renewable energy. We believe that is about to change.

Key points

- The opportunity to participate in the secular energy transition is rich with options.
- We have seen governments increasingly focused on accelerating the pace of the energy transition, and specifically infrastructure investment.
- The current and emerging policy backdrop will continue to create more and more investment opportunities in utility and renewable energy companies.
- Despite improving fundamentals, the share prices of many renewable energy companies globally have been under pressure, creating attractive opportunities for long-term investors.
- While regulated utilities are largely overlooked by the equity markets, there is huge potential for long-term, low-risk secular investment across major thematics such as the energy transition and climate change.
- Global renewable leaders Ørsted and NextEra, together with regulated utilities like Elia and Ameren, are prime examples offering a chance to participate in this once in a generation transition to a cleaner world.

Q: What is the energy transition, and why does it matter?

A: The world has long relied upon fossil fuels, fuels that are typically mined (coal) or drilled (oil and gas), then burned for energy conversion either through combustion engines for propulsion, or in furnaces for the powering of electricity generators. The carbon intensive nature of fossil fuels has contributed to climate change, and other detrimental environmental and health consequences.

Now, organisations like the United Nations have set targets for the transition to new types of cleaner and renewable energies, including wind, solar, geothermal, hydro-electric, hydrogen gas, and carbon capture utilisation and storage (CCUS), amongst the many examples. The Paris Agreement seeks net zero carbon emissions by 2050. The capital-intensive nature of energy development and conversion along the entire value chain means that the transition to full renewable energy may take several decades. More and more governments are signing up to a 'net zero by 2050' target. For investors, this means we are still at an early stage in the development of renewables, and in the transition towards renewable energy dominated economies, and thus the opportunity to participate is rich with options.

Tim Humphreys
Head of Global Listed Infrastructure

Phone: +61 2 9259 0281
Email: tim.humphreys@ausbil.com.au

Jonathan Reyes
Co-Head of Global Listed Infrastructure

Phone: +61 2 9259 0286
Email: jon.reyes@ausbil.com.au

Natasha Thomas
Portfolio Manager - Energy and Communications

Phone: +61 2 9259 0283
Email: natasha.thomas@ausbil.com.au

Paul Johnston
Portfolio Manager - Utilities

Phone: +61 2 9259 0284
Email: paul.johnston@ausbil.com.au

Q: Can you provide an update on net-zero momentum with regard to the energy transition?

A: In June 2019, the UK became the first major economy to enshrine a net zero by 2050 commitment into law. Since then, more and more countries have quickly followed suit. Currently, around 53% of the global economy (as measured by GDP) has set or are intending to set a net zero by 2050 target. This is a fundamental shift in the driving forces behind the energy transition, moving from an economic motivation to a normative ESG-focused motivation with clearly defined legal requirements.

We have also seen governments increasingly focused on accelerating the pace of the energy transition, and infrastructure investment more generally. In most instances, this forms part of a nation's recovery plan from the COVID-19 pandemic. For example, the EU has agreed to a €670bn COVID recovery fund, with around €265bn to be made available for the green transition in the form of grants and loans. Additionally, in July 2021 the EU proposed 'Fit for 55', an ambitious undertaking of measures for cutting greenhouse gas emissions by 55% by 2030 (compared with 1990 levels). 'Fit for 55' proposes some significant policy measures, including a carbon border adjustment mechanism (CBAM), a major overhaul of the emission trading system to apply to shipping, aviation, and transport, and acceleration in the development of renewable energy while banning the sale of new fossil-fuel based cars from 2035.

In the USA, the election of the Biden administration in 2020 also gave renewed impetus to the energy transition. President Biden announced a goal to create a carbon pollution free power sector in the USA by 2035, and a net zero emissions economy by no later than 2050. During a leaders summit convened by the US in April 2021, President Biden announced a new target for the US to achieve a 50-52% reduction from 2005 levels in economy-wide net greenhouse gas pollution by 2030. In doing so, he has challenged the world to increase ambitions with respect to combatting climate change.

The Biden administration has proposed a 10-year extension to the production tax credit (PTC) and investment tax credit (ITC) for renewable energy. Not only are they proposing to extend the tax credit and change it to a cash refund, they also seek to widen the eligibility criteria for the federal investment tax credit (ITC) to include energy storage and green hydrogen projects, and transmission grid investments. While there is an expectation that the eventual policy settings will be watered down somewhat in order to successfully pass Congress, there is no denying the growing momentum to decarbonise the US economy.

Most recently, the Intergovernmental Panel on Climate Change (IPCC) released its sixth assessment report on the physical science basis of climate change. The report was sobering reading, underscoring the need for greater action to combat climate change. The IPCC found that it was an unequivocal fact that human influence has warmed the atmosphere, ocean and land. The IPCC also found that global warming of 1.5C and 2.0C will be exceeded in the 21st century unless deep reductions in CO_2 and other greenhouse gas emissions occur in the coming decades.

Policy measures to tackle climate change are highly likely to strengthen over time, and their objectives made more ambitious. This current and emerging policy backdrop will continue to create more and more investment opportunities for the utility and renewable energy companies, the benefits of which the Ausbil Essential Infrastructure portfolio is positioned to capture.

Q: As infrastructure investors, what are the challenges with investing in renewable energy companies?

A: As infrastructure investors, we are focused on the stability and predictability of a company's cash flows. This is to ensure that the portfolio provides the characteristics investors expect of the infrastructure asset class – downside protection and low correlation to global equities – but at the same time, contributes to meeting our long-term return objective.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly-owned subsidiary of New York Life Insurance Company. As at 30 June 2021, Ausbil manage over $15.8 billion in funds under management.

Ausbil's strict criteria defines Essential Infrastructure as the assets that are essential for the basic functioning of a society, and typically generate stable regulated or contracted cash flows through the economic cycle. One of the challenges in investing in the energy transition is that, in many instances, renewable energy companies do not reach our benchmark for Essential Infrastructure, even if they are positively leveraged to the energy transition. The flipside to this is that focusing on both Essential Infrastructure and leverage to the energy transition is likely to yield a portfolio that generates a superior risk-adjusted return, with less downside risk, and more stable investment cash flows.

While our assessment is done on a case-by-case basis, the key broad factors we consider in terms of whether a renewable energy company meets our Essential Infrastructure criteria includes the following:

- the remaining duration of their power sale contracts (or purchase power agreements 'PPA') and how this is expected to evolve over time;
- the cash-flow certainty associated with the existing PPA, and the term of this certainty;
- the impact of any exposure to merchant electricity pricing (that is, renewable energy output not sold under long-term contracts, and exposed to volatile competitive prices) and how this will evolve over time;
- the renewable energy mix between technologies; and
- fundamental gearing and balance sheet metrics over time.

The most significant risk with investing in renewable energy companies is merchant (or wholesale electricity) pricing risk which also ties back to the contract/PPA tenure, and pricing applicable to each asset and the company overall. Nearly all renewable energy projects or companies carry a level of merchant pricing risk – it depends on what percentage of output is contracted and how this evolves over time. Generally speaking, companies with meaningful merchant price risk (~20% or more of revenue) and with an insufficiently long weighted average contract/PPA duration (less than 10 years) do not display the cash flow certainty to qualify as Essential Infrastructure under our strict definitions.

The challenge with merchant price risk is the difficulty and complexity in forecasting electricity prices – both in the short term and longer term. Long-term electricity prices should converge towards long-run marginal costs and therefore are a function of expectations of future fuel costs (zero for renewables), capital costs, cost of capital, capacity factors and operating costs for different types of electricity generation. Therefore, and by definition, this is influenced by technological trends which are inherently difficult to forecast.

Also, renewable energy assets, particularly solar, can fall victim to their own success. That is, solar plants located in a similar region or even the same country tend to generate electricity in high correlation to each other (that is, when the sun shines it shines for all solar producers at once), impacting realised pricing outcomes. This in turn can mean competitive electricity price outcomes increasingly displaying 'duck curve' characteristics – low prices during daylight hours, and higher prices at other times, meaning realised price outcomes for solar plants can be materially below average market prices, affecting their project returns. Batteries are increasingly being paired with solar to store this energy for use when it is of higher value.

In the longer term, however, there is an emerging view that green hydrogen could potentially become a significant new source of demand for renewable energy – in effect, powering the electrolysers to produce hydrogen with renewable energy particularly when it is otherwise of low value. The resultant green hydrogen could be used to decarbonise parts of the economy (for example, industrial feedstock and hydrogen powered vehicles), but also act as a source of storage for power markets. We are excited by the potential of green hydrogen but acknowledge its economics are highly uncertain at this early stage of commercialisation.

For infrastructure investors longer term PPA contracts provide a high level of certainty of cash flows such that the tail risk, after the initial contracts expire, is less meaningful to achieving an overall acceptable risk-adjusted return. But for the reasons discussed above, it is challenging for infrastructure investors to invest in these types of assets, which have exposure to competitive price outcomes or shorter term PPAs.

Q. With this backdrop, how are you approaching investing in renewable energy in the Ausbil Essential Infrastructure portfolio, and what opportunities are you seeing?

A: We are excited by a number of investment opportunities in renewable energy companies globally. Our conviction around these opportunities has only increased during 2021. Despite improving fundamentals, the share prices of many renewable energy companies globally have been under pressure, creating attractive opportunities for long-term investors.

Our most favoured renewable energy companies are NextEra (US onshore wind and solar) and Ørsted (global offshore wind), both global leaders in renewables in their fields. Both these companies are in unparalleled competitive positions to grow strongly, successfully execute and deliver attractive risk-adjusted returns for their shareholders. But, as mentioned earlier, there is an additional alternative way to get exposure to this exciting investment opportunity, via regulated utilities, which we explore in detail below.

Ørsted: A global leader in renewable energy and ESG

Ørsted offshore wind farm Borssele in the North Sea, one of the largest offshore wind farms in the world. Orsted is a global leader in offshore wind development.

Ørsted is a Danish-based global leader in renewable energy, but particularly offshore wind, with strong ESG credentials. Ørsted is a remarkable company transformation story. Up until 2017, the company was called Danish Oil and Natural Gas (DONG, for short) reflecting its origins in a Danish state-owned company with a 100% exposure to fossil fuels. Ørsted is progressively exiting all fossil-fuel based operations and has transformed itself into a global renewable energy powerhouse over the last decade. Its growth potential is truly enormous – Ørsted is aiming for a four-fold increase in installed renewable capacity by 2030 and a 12% CAGR in EBITDA to 2027. However, it is Ørsted's longer-term growth potential that really excites us, and its desire to spearhead new initiatives like green hydrogen and lead the global decarbonisation effort.

Note: This is not advice. This is included as a case study example of renewable energy infrastructure.

Q: What is the opportunity in regulated utilities?

A: Put simply, regulated utilities, both electric and gas, are critical to the decarbonisation effort. The specific roles of regulated utilities in decarbonisation can take many forms depending on the nature of the business and its specific objectives and investment plans.

Fundamentally, regulated utilities are critical enablers of decarbonisation with electric utilities likely having a more significant and unambiguous role than their gas counterparts.

The main role of regulated electric utilities is grid investment, both at the distribution (low voltage) and transmission (high voltage) level. These investments are required to:

- support the significant investment in renewable energy and allow that energy to be efficiently delivered to customers;
- ensure grid stability given much higher percentages of intermittent renewable energy;
- facilitate efforts to decarbonise the transport sector and support the increased uptake of electric vehicles;
- encourage more efficient use of electricity, and encouraging energy efficiency, for example through the deployment of advanced metering technology;
- increase grid resiliency to the increasing prevalence of extreme weather events from climate change; and
- increase the efficiency of the network itself and reduce the energy lost in the wires between the point of generation and the point of consumption (which can be over 20% in old electricity grids).

In North America, many regulated electric utilities are integrated by nature, in that they own power generation assets that supply their customer bases, together with the poles and wires. These utilities are, in nearly all instances, undertaking significant investments in renewable energy (onshore wind/offshore wind/solar) and at the same time retiring coal-fired generation with an ultimate objective of reaching net zero by no later than 2050. These investments are being made within a 'regulatory construct', meaning attractive, but relatively low, risk adjusted returns for equity investors, while at the same time allowing infrastructure investors to really participate in the decarbonisation journey.

Critically, much of the electrical infrastructure in developed markets is ageing, requiring a wave of investment. For example, a report by Deloitte for Eurelectric in January 2021 noted that in the EU currently 25-35% of assets are over 40-years old. If assets are not replaced after their useful life, then 40-55% of assets could be over 40-years old by 2030. This would see a further reduction in the resilience of the grid, its reliability and also its efficiency and flexibility – all characteristics that are necessary in an energy system increasingly powered by renewable energy.

Regulated gas utilities are also playing an important role in decarbonisation. One example of this is using renewable natural gas (RNG) as a feed gas into their networks. Many gas utilities are also actively exploring the potential to blend hydrogen into the fuel mix and potentially, longer term, only transporting hydrogen. More immediately, gas utilities are investing heavily, especially in North America, to replace their ageing pipeline assets to reduce harmful gas leaks. Our prior energy transition paper on gas LDCs focuses more specifically on the decarbonisation role of regulated gas utilities and its investment implications, and can be read here.

Q. Why are regulated utilities an attractive way for investors to benefit from the energy transition?

A: For investors seeking to gain exposure to the energy transition, investing in regulated utilities offers an attractive alternative to renewable energy companies as in most instances they display lower risk but comparable, and in some cases superior, return and growth profiles. The attractiveness of these investment opportunities, from an energy transition perspective, is commonly misunderstood or overlooked, however we suspect this will change.

Regulated utilities can take the form of either: transmission and distribution companies (sometimes referred to as 'poles and wires'); or 'vertically integrated' companies, where the utility owns the entire vertical supply chain – including generation, transmission and distribution electrical assets, all of which are fully regulated. 'Poles and wires' regulated utilities exist in Australia, the UK, Europe and also some areas of North America, and own the physical wires that transmit and/or distribute electricity. By contrast, in Ausbil's Essential Infrastructure definition, 'vertically integrated' companies can only be found in North America.

Regulated utilities are critical enablers of the energy transition. Their role is to support the increasing role of renewable energy in the generation stack by investing significantly in the electricity grids. Major transmission investment in the form of high-voltage assets in particular is required to connect new renewable energy assets. Such investment also supports further interconnection between different electricity markets and countries, particularly important given the challenges associated with the intermittent nature of renewable energy. These investments are included in the rate base (or regulated asset base) of the regulated utility for which they are entitled to earn a reasonable return on, and of, capital, while also recovering their associated operating costs.

Deloitte estimate that between €34-39 billion pa of investment in power distribution grids is needed in the EU out to 2030, a 50-70% increase on the average annual spend across the prior decade. IRENA (International Renewable Energy Agency) also has highlighted the enormous investment opportunity in electricity networks that is needed to achieve net zero by 2050. IRENA estimate that an average annual investment over 2021-2050 of USD600bn is needed to achieve this, more than double the 'run rate' of recent history.

It should be also highlighted that investment opportunities for the regulated utilities are not confined to supporting the energy transition. There is a broader investment need to ensure the electrical grids are resilient and able to reliably supply energy as the climate changes. For example, it is well understood that climate change is making extreme weather events more common (such as, hurricanes, wildfires and floods), creating ever-increasing challenges for infrastructure assets to maintain reliable and safe supply. This is driving another significant investment need, further enhancing the growth potential of this sector.

While regulated utilities are largely overlooked by the equity markets, there are huge long-term opportunities for low-risk, secular investment across major thematics such as the energy transition and climate change. Few sectors enjoy such powerful tailwinds, and that is why we believe that regulated utilities currently represent such an attractive opportunity.

Elia: A leading European transmission grid owner playing a critical role in the energy transition

Some of Elia's enormous network of energy transmission grids, servicing dense populations across Belgium and Germany, and essential for the transmission of an increasing share of renewable energy.

Elia, listed in Belgium, owns two electricity transmission grids – the transmission grid in Belgium and 50 Hertz which operates the electricity transmission grid in the north and east of Germany. Elia is undertaking significant capital investments in its grids to support the decarbonisation of the energy systems in Belgium and Germany. Across 2021-2025, Elia forecasts it will spend around €7.9bn in capex, generating 8-9% annual growth in its regulated asset base. This capex will be used to reinforce the transmission grid, increase interconnection across Europe, but also to connect significant new renewable energy capacity, particularly from offshore wind in the North and Baltic Seas. In Germany, Elia is undertaking these investments with the objective of having 100% of electricity coming from renewable sources by 2032. Elia is exploring other growth opportunities in Germany and Belgium, such as a potential project with Danish counterparts, the Bornholm Energy Island, to connect Germany and Denmark to an offshore wind hub with around 2GW of wind power on the island of Bornholm.

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Q: How is affordability impacted by the significant capital investment required to support the energy transition?

A: The energy transition is clearly a complex challenge and there is some uncertainty over how it will ultimately be realised. Decarbonising energy systems requires balancing the sometimes competing objectives around the speed of decarbonisation, affordability and reliability of supply.

Companies and regulators need to balance the speed of decarbonisation initiatives with affordability considerations. There will also be different impacts across customer groups, at different points in time, and as large investments are made this can put upward pressure on end customer bills. This creates complex equity considerations that require a detailed understanding and analysis of policy responses and regulatory constructs. Assessing this level of regulatory detail is complex, and one of the reasons that we are confident we can find inefficiencies in how equity markets price these companies, and in so doing, showing outperformance potential in this asset class.

Over the longer term, initiatives to electrify energy and mobility needs are likely to lead to much higher volumes of electricity consumed over time, to support higher residential and commercial use, and electric vehicle charging. This is expected to neutralise the impact of the significant capital investment required on end-customer bills. Analysis by Edison International found that on average a customer's energy bill in California (defined to include electricity, solar, gas and gasoline for internal combustion engine vehicles) will reduce in real terms by around 30% between 2019 and 2045. Nonetheless, this is a critical and complex issue for companies and regulators to navigate.

Ausbil is focused on investing in regulated utilities where the customer impact, in terms of affordability, is contained to increases that closely match inflation, or where bill impacts are well understood and are supported by customer groups, regulators and politicians.

Many North American utilities are outlining significant investment and decarbonisation objectives, but at the same time containing price increases around the level of inflation. This is achieved through substantial reductions in operating costs by reducing or eliminating fuel costs from fossil fuel-based generation, together with other initiatives around modernising the grids and asset management practices. Some states and regions in the US are also experiencing meaningful electricity load growth, uncommon in most developed economies, typically stemming from population growth and growth in commercial demand (for example, data centres) which can serve to mitigate the impact of these investments on customers as a whole.

Q: Why is the North American utility sector so unique and attractive in global comparisons?

A: Regulated utilities in North America present attractive investment propositions for long-term infrastructure investors with a strong focus on the energy transition and achieving aggressive decarbonisation objectives. What sets North America apart are a number of unique investment characteristics that we find particularly attractive, including the following.

Vertical integration. Many utilities are vertically integrated, meaning they own and operate the full supply chain including generation, transmission and distribution assets. This in many instances enables the regulated utility to spearhead the decarbonisation of the supply chain, retiring fossil-fuel based generation typically before the end of their useful lives, investing in renewable energy, with return on investment based on invested capital, or the rate base, posing relatively low risks for investors.

Consumer focused. This industry structure also means the utilities typically take greater 'ownership' of the end user bill impacts and ensure that any investment or decarbonisation plans are structured with a real focus on end-user affordability considerations.

Support from politicians and regulators. State governments and regulators, far more than the US Federal Government, are more influential in determining investment and decarbonisation plans. Many US states have a very supportive approach to investing in renewable energy and decarbonisation. At the Federal level, the Biden administration has proposed stronger incentives for renewables, batteries and grid investments, and has a stated objective to decarbonise the US electricity network by 2035, providing a supportive federal policy backdrop for the sector. It should be noted that the US achieved record levels of renewable energy investment during the Trump administration, suggesting that Federal policies have, at least to date, been less important in driving the decarbonisation efforts in the US.

Policy tools to reduce stranded asset risk. The public policy challenges associated with the early retirement of coal-fired generation has been addressed in many states – these challenges relate to stranded asset risk for investors but also potential affordability impacts from retiring assets before the end of their useful lives. The policy tool of securitisation is increasingly popular in the US and involves low-cost debt financing of the remaining rate base value of coal-fired generation through bonds with a government-backed promise of future payments from the customer base. While utility investors forgo an equity return on this remaining rate base, it can allow the utility to invest more significantly in renewable energy, decarbonise more quickly, and manage the customer affordability impacts.

Attractive secular growth. Average compound annual growth rates are 5-7% with some growing closer to 10% pa. Importantly, there is often, for the best-in-class North American utilities, high visibility with these growth rates and the potential for them to extend for decades.

Attractive returns and value creation. Average allowed return on equity (ROE) is currently around 9.5%, with the top-performing utilities able to achieve ROEs in the low teens – an attractive risk-adjusted return given the relatively low-risk nature of these investments. Combining attractive risk-adjusted returns with strong compounding growth is a recipe with significant value creation potential over time. Our key stock holdings in North American regulated utilities include NextEra, Ameren, Sempra, Emera, Eversource, and National Grid in the UK, which also has a meaningful exposure to US regulated utilities.

Ameren: A leading US utility aiming for net zero by 2050, and transforming its generation fleet

Ameren's High Prairie wind farm in Missouri. Ameren is a prime example of a Regulated Utility pivoting to renewable energy to supply its customers.

Ameren is a powerful example of Ausbil's attraction to the North American regulated utilities sector as it carries many of the positive investment attributes noted above. Ameren is Missouri based, with regulated electric and gas utility operations in both Missouri and Illinois. Ameren is a high growth exposure, anticipating 6-8% earnings CAGR between 2021 and 2025, driven by a US$17bn capital investment program. This growth capital opportunity is likely to accelerate after 2025. Ameren has explicit carbon reduction targets including 50% reduction by 2030, 85% by 2040, and net zero by 2050, relative to 2005 levels. It is aggressively retiring its existing coal-fired generation fleet (aiming for zero coal by 2042), and investing heavily in renewable energy. Ameren operates under attractive regulatory frameworks and is keenly focused on disciplined cost management to keep customer energy bills affordable.

Note: This is not advice. This is included as a case study example of renewable energy infrastructure.

Q: How is the Portfolio positioned to benefit from the energy transition? What exciting global investment opportunities do you see in this regard?

A: Ausbil's Global Essential Infrastructure strategy is positioned to benefit from the energy transition in numerous ways. Since inception, we have been gradually pivoting the portfolio to positively increase its leverage to the energy transition through increasing our exposure to renewable energy companies and regulated utilities. More recently, our investment process has identified improved relative value in the renewables sector together with improved growth prospects – providing an opportunity to lift our exposure. As a result, currently around one third of the portfolio has positive exposure to the energy transition. On the flipside, we have also been gradually reducing our exposure to the regulated energy infrastructure and gas distribution sectors, particularly those companies with higher exposure to oil where the long-term stranding impact from the energy transition is likely to be more pronounced versus gas. In summary, the investment opportunities in renewable energy are compelling, and perhaps even more compelling when captured through the regulated utilities that are essential in delivering renewable energy to clients – this is very much misunderstood across the general equity market, and herein lies a significant opportunity for experienced and focused infrastructure investors.

For further information please contact:

Mark Knight
Director, Head of Distribution
Phone 0438 307 841
Email mark.knight@ausbil.com.au

Christine Leonard
Senior Manager, Institutional Business
Phone 0414 372 495
Email christine.leonard@ausbil.com.au

Hik Chadirchi
National Manager, Wholesale Clients
Phone 0424 160 728
Email hik.chadirchi@ausbil.com.au

Fawaz Rashid
Key Account & Research Manager, Wholesale Clients
Phone 0401 830 483
Email fawaz.rashid@ausbil.com.au

Jeremy Sherman
Key Account Manager, VIC, TAS & WA, Wholesale Clients
Phone 0437 773 688
Email jeremy.sherman@ausbil.com.au

Daniel Huxley
Key Account Manager, NSW & ACT, Wholesale Clients
Phone 0421 582 436
Email daniel.huxley@ausbil.com.au

Rebecca Morgan
Key Account Manager, VIC & SA, Wholesale Clients
Phone 0407 917 661
Email rebecca.morgan@ausbil.com.au

Demetri Nikolias
Business Development Manager, NSW
Phone 0425 239 852
Email demetri.nikolias@ausbil.com.au

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