November 2024

Kyushu Electric Power Co.

Questions and Answers at the Business Overview Meeting (Nov 12)

1. Date and Time: Tuesday, November 12, 2024, 1:00 p.m. - 2:10 p.m.
2. Respondent:
   - Kazuhiro Ikebe, Member of the Board of Directors, President and Chief Executive Officer
   - Takashi Nakano, Senior Managing Executive Officer, Director of Operation Division within Business Solutions Headquarters
   - Hiroto Kido, Executive Director of Corporate Strategy Division

3. Questions and answers

Q Securities Analyst A

- In his explanation, President Ikebe mentioned raising the ROIC target. Your company is making steady progress on the medium-term KPI targets, but compared to peer companies, I feel that the target level is a little insufficient. Kyushu Electric has been steadily operating nuclear power and its electricity rates are competitive, however, from an investor's perspective, the rate levels seem a bit too low. I understand that the current electricity rates reflect the specific supply and demand conditions in the Kyushu region, but regarding the realization of non-fossil value, how does President Ikebe view the need to adjust the electricity rate levels and improve profitability?
- I imagine the announcement of the next management vision will be around next spring. Including a review of the organizational structure, what kind of management steering do you think will enable the Kyuden Group to reward stakeholders more than ever before? I would like an explanation of the management strategies and management controls that President Ikebe expects to realize through the organizational review, such as making it easier to decide on portfolio adjustments through autonomous management of each business and facilitating autonomous fundraising within each business.

A Mr. Kido

- Regarding the ROIC target, we announced it in fiscal year 2023 ahead of other companies in the industry. We have introduced a perspective on capital efficiency in management, in addition to the traditional view of operating profit, and have set ROIC targets that align with the WACC. Although it has not been publicly announced, we have also set ROIC levels for each of our growth businesses internally.
- I am aware that other companies are now also setting targets such as ROIC. We recognize the need to review our WACC levels as well, and as we formulate a new management vision, we are discussing the

reconsideration of ROIC targets while observing movements in other power companies. However, I will refrain from specifying any concrete levels at this time.

A Mr. Ikebe

- Regarding electricity rates, we recognize that we have been able to set them at a low price, which has led to TSMC and other semiconductor-related plants moving into Kyushu. We fear that in the future, costs will be pushed up. As the economy improves and investments in fossil fuels decline due to the trend toward decarbonization, I believe fuel costs will rise. Even if fuel costs are recovered through the fuel cost adjustment system, we expect that material prices and labor costs will also increase. Therefore, it is necessary to improve labor productivity through initiatives like DX (digital transformation) to keep these costs from rising as much as possible.
- In the short term, I am worried about the imbalance in electricity pricing. Currently, while there is a large amount of solar power generation during the day, the traditional notion that "the peak of electricity supply and demand is during the day and there is excess electricity at night" is still reflected in electricity prices, and I believe this rebalancing is necessary.
- In the longer term, I think it is important to properly reflect environmental value in electricity pricing. Many companies are implementing internal carbon pricing, but when I hear about the specific carbon prices from those companies, I sometimes feel that there is still a lack of understanding regarding environmental value.
- Furthermore, since Kyushu has strong electricity demand, to sustainably procure power in relation to this demand, we need to recover fixed costs through basic charges. Although we currently lack sufficient data to implement this immediately, I believe rebalancing basic charges and usage charges is also necessary.
- We hope to announce our next management vision around next spring. The transition to a pure holding company structure is a matter within our group, so I think it is fine to proceed with the transition once we are confident in the systems and governance structures post-transition, and I am not considering a specific deadline for implementation. The benefit of this transition is that each business will be able to manage autonomously, leading to quicker management decisions. I believe this is a significant advantage. Regarding fundraising, it is currently more cost-effective to conduct it at the group level, so we fundamentally implement it at the group level, but in the future, it may vary by business.
- Our current organizational structure has been developed around the electricity business, and I feel that maintaining it as is going forward seems out of place. With the targets set for operating profit by 2030 of ¥75 billion for the Domestic Electricity Business and ¥75 billion for Growth Businesses, I believe it is a natural progression to shift to a pure holding company structure rather than maintaining a management structure centered on the domestic electricity business.

Q Securities Analyst B

- I would like to understand whether the awareness of the need for rebalancing electricity rates stems from the sales strategy of the power generation sector or the pricing strategy of the retail sector. In a world where there is indiscriminate competition, if the supply and demand in Kyushu tightens, wholesale prices will rise, leading to an increase in retail prices as well. Could you clarify the starting point of your awareness of the rebalancing issue and how you plan to implement this rebalancing?

- Regarding shareholder returns, the projected annual dividend for this period is 50 yen, which is double the previous year's 25 yen. This means achieving the goal of "50 yen dividend by FY2025" one year ahead of schedule. I believe discussions on future dividend policy are ongoing as part of the next management vision, but what discussions are currently taking place? Other companies have introduced quantitative indicators such as DOE (Dividend on Equity) and payout ratios. Could you share what you are currently considering, including the adoption of such indicators?

A Mr. Ikebe

- There are two types of rebalancing: one based on the current usage of electricity during the day and night, and the other regarding the rebalancing of basic and usage rates. The former is primarily driven by the retail sector, while the latter involves both the retail and generation sectors. Although the issue of ensuring that the power generation sector can recover fixed costs and become sustainable may suggest it is primarily a generation sector problem, if the pricing structures of both the generation and retail sectors do not align, customers will not accept it. Therefore, both should engage in rebalancing. This will enable the recovery of fixed costs through the basic rate and allow us to deliver sustainable electricity to customers.

A Mr. Kido

- Regarding dividends, as stated in the materials, we are currently focusing on ensuring stable dividends of 50 yen after FY2025. For the mid- to long-term approach to shareholder returns, we will consider growth and profit expansion not only in the domestic electricity business but also in other businesses. We need to review aspects such as financial buffers and evaluations from rating agencies, as well as the need for predictability in dividends through the introduction of metrics like DOE. We are now thinking about how to communicate this, taking into account various perspectives as well as the existing concept of stable dividends. We would like to communicate our new dividend policy together with the announcement of the next management vision.

Q Securities Analyst C

- Regarding the distribution of FCF (Free Cash Flow), we are in a situation where we are likely to achieve our target equity ratio of around 20%. Until now, the priority has been on enhancing the equity ratio, and I understand that the idea was to aim for a 50 yen dividend once that target was broadly achieved. When the equity ratio exceeds about 20%, how do you prioritize the reduction of interest-bearing debt, the enhancement of the equity ratio, and shareholder returns in the distribution of FCF?

- Concerning pricing policy, I recall that you have mentioned rebalancing for some time. That makes me think it may be a challenging issue to resolve. While low electricity rates are a strength, there is also a perspective that potential profits are not being realized. Could you share your thoughts on whether the current electricity rates are at an appropriate level?

A Mr. Kido

- As you recognized, we have been working towards an equity ratio of around 20% and stable dividends by FY2025. We are finally in a position where we expect to achieve that target. Regarding the use of FCF, we are considering priorities such as shareholder returns, reducing interest-bearing debt, and growth investments while discussing these within the context of formulating a new management vision.
- If you ask me about our current thinking, I can only say that we will distribute the dividends while considering the balance between each, but once we reach the stage of indicating how we will handle dividends in the vision, I will be able to share more.

A Mr. Ikebe

- Lately I have been concerned about rising interest rates. Currently, even though we have a lot of interest-bearing debt, we are not paying that much interest because of low interest rates. Since we primarily secure long-term fixed rates, even if interest rates rise in the future, we will not be immediately affected, but I am still concerned about the potential impact.
- In terms of our efforts regarding electricity rates over the past two to three years, rather than focusing on rebalancing, we have made efforts to normalize discounts that had been used for sales promotions in a competitive environment, as they had become significant in amount.
- The rebalancing we are currently considering involves adjusting for electricity usage during the day and night, as well as rebalancing the basic and usage rates. I acknowledge the opinion that "electricity rates are too low, and we are not realizing the potential profits," which can be said for any business, but determining the right pricing is a complex issue. If we had set prices slightly higher than the current levels, semiconductor-related companies like TSMC might not have entered Kyushu. I have heard that one semiconductor-related company cited our low-carbon and competitively priced electricity as a reason for their entry into Kyushu. Furthermore, as types of energy converge towards electricity, I believe there is a need for rebalancing the basic and usage rates. I do not believe that we have lost profits because our electricity rates are low, and looking at our previous performance and this period's outlook, I believe we are generating profits.

Q Securities Analyst D

- Regarding the idea of a stable annual dividend of 50 yen. Given that the concept of a stable 50 yen dividend is well established within the company, what is the management's view on paying a 50 yen dividend from the current earnings, especially considering the expected rise in interest rates? Do they consider it to be insufficient, adequate, or excessive?

- As the formulation of the next Energy Basic Plan progresses, it is expected to include new nuclear power installations and replacements. If these are explicitly stated in the next energy plan, will Kyuden be able to move forward with new installations and replacements? Or, even if it is mentioned, are there hurdles that would prevent action on new installations and replacements?

A Mr. Ikebe

- I believe the current level of dividends is reasonable compared to our current profit levels. Moving forward, we aim to focus on Growth Businesses, and rather than having a single manager overseeing all Domestic Electricity Businesses and Growth Businesses, we plan to appoint managers for each business, which will allow for greater growth within those sectors. Therefore, I don't think we will set a lower target than the current ordinary profit target. While we might not set a specific point like 50 yen as we do now, though I believe it to be at a level that meets expectations.
- Regarding the second point on nuclear energy, I do not think there is a divergence in the direction of the upcoming energy plan and other systems. I believe the next energy plan will state the need to "promote the development and construction of nuclear power." The consensus is that energy demand will increase due to the spread of AI and other factors, and both the ruling and opposition parties recognize the necessity of nuclear energy. If there is a need to replace old nuclear facilities with new ones, I expect that development will be promoted in the plan. This is a role for the Ministry of Energy, and the development will not proceed solely through private sector efforts. National advisory committee members also consider financial aspects and understand the risks of financing nuclear development, so I believe better national systems will be established for power companies going forward. However, I do not think the national systems will be ready immediately after the plan states the promotion of nuclear development and use as a primary energy source. For us to advance development, we need the government to establish financing systems that allow us to secure the necessary funds for nuclear development. The government needs time to create better systems while we seek local understanding and find ways to advance nuclear development.

Q Securities Analyst E

- I feel that information disclosure from Kyuden has halted, perhaps due to the upcoming announcement of the new management vision. Looking at publicly available financial information websites, Kyuden's PBR is 0.8 times, which does not round up to 1. Considering that PBR is below 1, the 2025 targets are approximately a ROE of 8%, a capital ratio of 20%, and recurring profit of about ¥125 billion, which seem achievable. However, the 8% ROE is merely a minimum line. Currently, Kyuden's ROE is based on leveraging, creating an impression of lower earning power compared to other companies. Therefore, I think the question from another participant about "whether electricity rates are too low" is valid. In the next management vision, I would appreciate it if you could provide ROE levels for a time frame closer to three years out rather than setting a target of "8-10% ROE by 2030," along with explanations of ROI and capital ratios based on those levels. The rise in demand in the Kyushu area is exciting, but I would like to see how much Kyuden can earn from it.

・ When it comes to pricing policy, considering non-discrimination between internal and external retailers, I believe the retail and generation sectors operate under different principles. Therefore, I would appreciate a disclosure that separates the situations of these two sectors and, if possible, compares them to other companies. Given the notion og neutrality, the retail and generation sectors should have different operational principles, so it would be helpful to have clear information disclosure.

A Secretariat (Mr.Yokoyama)

・ The PBR of around 1 in the materials is calculated excluding preferred stocks. The financial information sites you are looking at likely include preferred stocks, leading to a different level.

A Mr. Ikebe

・ Regarding ROE. I believe that in the future, as demand increases, the utilization rate of existing power plants will increase, and if other conditions remain the same, ROE will increase as well.

・ We also think that we should give more thought about how we view demand, and I hope this will be reflected in our targets.

・ Regarding the second point, non-discrimination between internal and external retailers. I feel that the current understanding is somewhat vague.

・ Our retail division bears significant risks from the generation business. For instance, if our nuclear plants are offline, our retail division will have to purchase electricity generated from thermal sources. In this sense, we need to reconsider whether our retail division shares the same risks as others. The suggestion to separate the retail and generation divisions for information disclosure means that if the retail division is bearing the risks of the generation division, the numbers disclosed will not reflect an accurate management decision. Chubu Electric Power distinguishes between its generation and retail divisions, but I do not believe there is such a significant performance difference compared to ours, so we are not considering that distinction at this time.

・ The non-discrimination between internal and external retailers is a system that has just been introduced, and we need to determine whether risk sharing is being done appropriately. Additionally, when selling electricity from nuclear power as baseload, we do so under the principle of neutrality, but we need to verify whether we can actually share risks appropriately with the government. We need to work with the government to confirm whether the risk is really being shared on a non-discriminatory basis.

Q Securities Analyst A

- Earlier, there was a comment suggesting that "the company should give more thought about its view on electricity demand." Could you elaborate on what you mean by that? Kyuden's projection is that demand will increase by several billion kWh over the next few years, but supply plans from the OCCTO (Organization for Cross-regional Coordination of Transmission Operators) show a more conservative growth estimate. Are you referring to this gap?
- Regarding the earlier discussion about ROE increasing, if supply and demand tighten, wholesale prices will rise, leading to higher procurement costs for the retail division. Will the retail division be able to pass these costs on to customers? Otherwise, the profit growth from the generation division will not contribute to overall profit growth. Currently, Kyuden's electricity pricing adjustment mechanism has a range, and depending on the market price, adjustments may not be made, meaning that in cases of soaring market prices, the retail division cannot simply pass on those costs. When supply and demand are tight, how do you envision the roles of the retail and generation divisions in generating profits?

A Mr. Ikebe

- Regarding the first point, the demand estimates in the supply plans are conservative, and we need to make them more realistic. I believe the figures provided by our company are also somewhat conservative. Given what I hear from governors about the strength of the Kyushu economy, I feel a disconnect with my own observations.
- On the second point, while the generation division may benefit from higher wholesale prices, it is unacceptable to buy power at high prices from the generation division and sell it at low prices in the retail division. Long-term, I believe the retail division will also need to raise its prices.

Q Securities Analyst D

- Regarding the idea of transitioning to a pure holding company, you mentioned that restructuring would allow each division to make autonomous and swift management decisions. Is the management also approaching the transition with a mindset of making selections among the various businesses? When I asked similar questions to other companies undergoing similar restructuring, they said they were not considering making selections. What is Kyuden's current thinking on this?
- Risk sharing under the policy of non-discrimination is an interesting discussion. Listening to President Ikebe's remarks, it seems there is a concern that we do not yet know which division—generation or retail—is bearing the balancing risks while implementing this policy. Is it possible to separate the business model of the generation and retail divisions through strict adherence to neutrality, or should we consider that ultimately, in terms of electricity supply across Kyushu or the nation, separating these models may not be feasible? In other words, should we view the current policy of neutrality as a transitional system while new entrants gain market share, or do you believe it is ultimately possible to create a business model that separates the generation and retail divisions under this policy?

A Mr. Ikebe

- The advantages of a pure holding company structure are that each division can operate autonomously and the holding company can decide its own business portfolio. The response from the industry peers regarding not considering business selection likely stems from inquiries about whether they would divest the transmission and distribution business. While we will consider each division's efficiency, we also need to think about the synergies between them. Our group has expertise in the transmission and distribution business, which is highly beneficial for overseas operations. This business is less affected by environmental factors and faces relatively few competitors globally. It's essential to consider not just profit margins but also the overall synergies, and I believe transitioning to a pure holding company will allow us to think about our portfolio in that way.
- Regarding the second point on neutrality, while there is no inherent problem in the generation division selling under this principle, I want to enable various selling methods. For instance, I would like to be able to set long-term contracts for periods of 20 years. Currently, the generation division is required to sell under contracts that are only a few years long, which does not allow sufficient time to recover the investment costs incurred over 10 or 20 years. In the past, during the era of regional monopolies, the retail division bore the risks of purchasing electricity from the generation division, which justified their investments. Now, that dynamic has changed. Other arrangements, such as those with Japan Atomic Power, where the retail division pays fixed fees even when power plants are offline, could be considered. We need to expand beyond short-term contracts and offer various contract types to align with the concept of neutrality.
- Regarding your question on balancing risks, I do not fully share the same concerns, so I would appreciate more details on that.

Q Securities Analyst D

- While much attention is focused on price neutrality, as President Ikebe mentioned, there are other aspects, such as the risks associated with plant shutdowns and the flexibility of contract durations, that seem to be overlooked in the current policy of neutrality.
- -Essentially, my question was about who bears the costs associated with the balancing risks currently borne by the Balancing Group, and I feel that I have gained a deeper understanding through President Ikebe's responses.