Aurora Energy Limited

Mafic Partners response to public consultation

July 2024

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Partners in infrastructure

Contents

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Introduction

Mafic scope

This presentation provides an independent view on the financial aspects raised by respondents to the public consultation process for the potential sale of Aurora Energy Limited (**Aurora Energy**)

- Mafic Partners Limited (**Mafic**) has been appointed by Dunedin City Holdings Limited (**DCHL**) to provide an independent view on the financial aspects of the public consultation in relation to the potential sale of Aurora Energy
- This presentation covers the following key categories:

Capital requirements	• Summary of Aurora Energy's capex forecast and key drivers over the next 10 years • Benchmarking of capex against electricity distribution business (**EDB**) peers
Profitability and cashflow generation	• Overview of the regulatory framework and its impact on Aurora Energy returns • Explanation of the link / delink between Aurora Energy's profitability and shareholder cashflows
Debt levels and capacity	• Summary of the key credit metrics driving Aurora Energy's / Dunedin City Council's (**DCC**) ability to borrow • Summary of Aurora Energy financial risk, including benchmarking against EDB peers • Implications of forecast capital requirements on leverage / credit metrics going forward
Sale considerations	• Key financial considerations of sale versus retain • Evaluation of sale options

Base case forecast

This presentation utilises forecasts supplied by Aurora Energy and utilises the latest estimates of council debt requirements

Aurora Energy's base case

- Mafic was supplied a financial model from Aurora Energy in June 2024
- This reflects the latest opex and capex metrics disclosed by Aurora Energy in its 2024 asset management plan (**AMP**)
- A regulatory weighted average cost of capital (**WACC**) of 7.37% is applied for default price path four (**DPP4**)
  - This is in line with the latest estimate (May 2024) disclosed by the Commerce Commission (**ComCom**)
- We've assumed dividends are paid from FY27 onwards
  - Dividends are set at 40% of net profit after tax (**NPAT**)
  - Note: This has been included to understand the financial metrics under a modest resumption to dividends. Aurora Energy has not made a formal statement on resumption to dividends
- Whilst the numbers presented are based on the most up to date published expenditure forecasts, Aurora Energy has signalled further upward pressure on expenditure, which would flow through to greater capital needs

DCC financials

- DCC level debt and revenue has been estimated based on the latest public information
- DCC group debt (other than Aurora) is determined as follows:
  - FY24 - FY27: sourced from the Dunedin City Treasury 2025 Statement of Intent
  - Thereafter: debt movements are based on the increases set out in the 2021-31 Long Term Plan (**LTP**)
- DCC group revenues (other than Aurora) are determined as follows:
  - FY24 – 25: DCC's most recent Annual Plan
  - Thereafter: DCC group revenues increase at the revenue growth rate set out in the 2021-31 LTP

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Capital requirements

Capital requirements
Key observations

Capital expenditure drivers

- Aurora Energy has experienced a period of significant capex to address past issues
- While these issues have been addressed, Aurora Energy is expected to remain in an environment of elevated capex driven by:
  - Capex inflation
  - High growth Central Otago/Queenstown catchments
  - Capex required to replace ageing assets
  - Decarbonisation and climate change resilience

Benchmarking

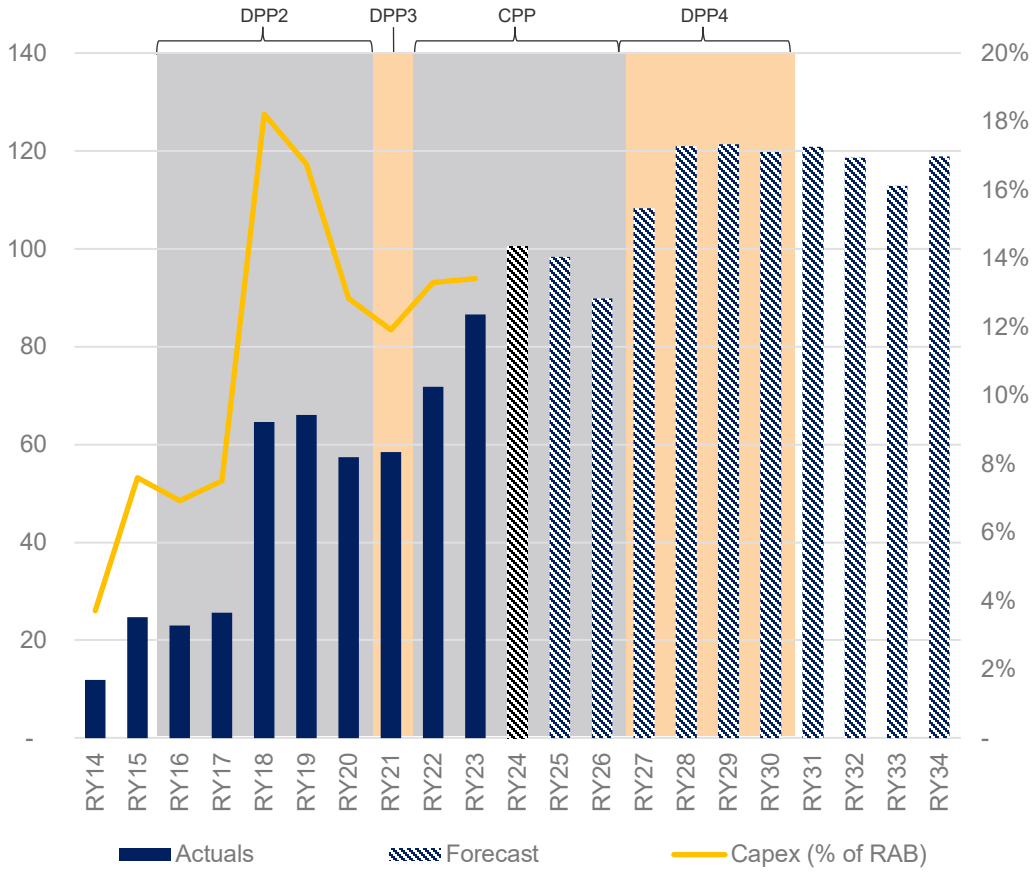
- Aurora Energy is forecasting capex of $1.1b over FY25 – FY34
  - **This is in line with peers, normalised for size**
- We note there is upside risk to the base case in relation to decarbonisation capex, as flagged in the Aurora Energy AMP, and ongoing capex inflation pressures

Capital requirements

Key observations

Aurora Energy is forecasting capex to remain elevated over the next ten years, which is underpinned by several long-term capex drivers

Capex profile (nominal $m)[1]



Capex drivers

- ✓ Capex inflation
- ✓ Significant capex required to replace ageing assets
- ✓ High growth Central Otago/Queenstown catchments
- ✓ Decarbonisation and climate change resilience

Key observations

$1.1b — **10Y capex**
Forecast over FY25 – FY34

70% — **5Y capex as % of RAB**
Nominal as % of RY23 RAB

1,400 — **New connections**
Annual forecast per annum

1. Based on regulatory year end (March).

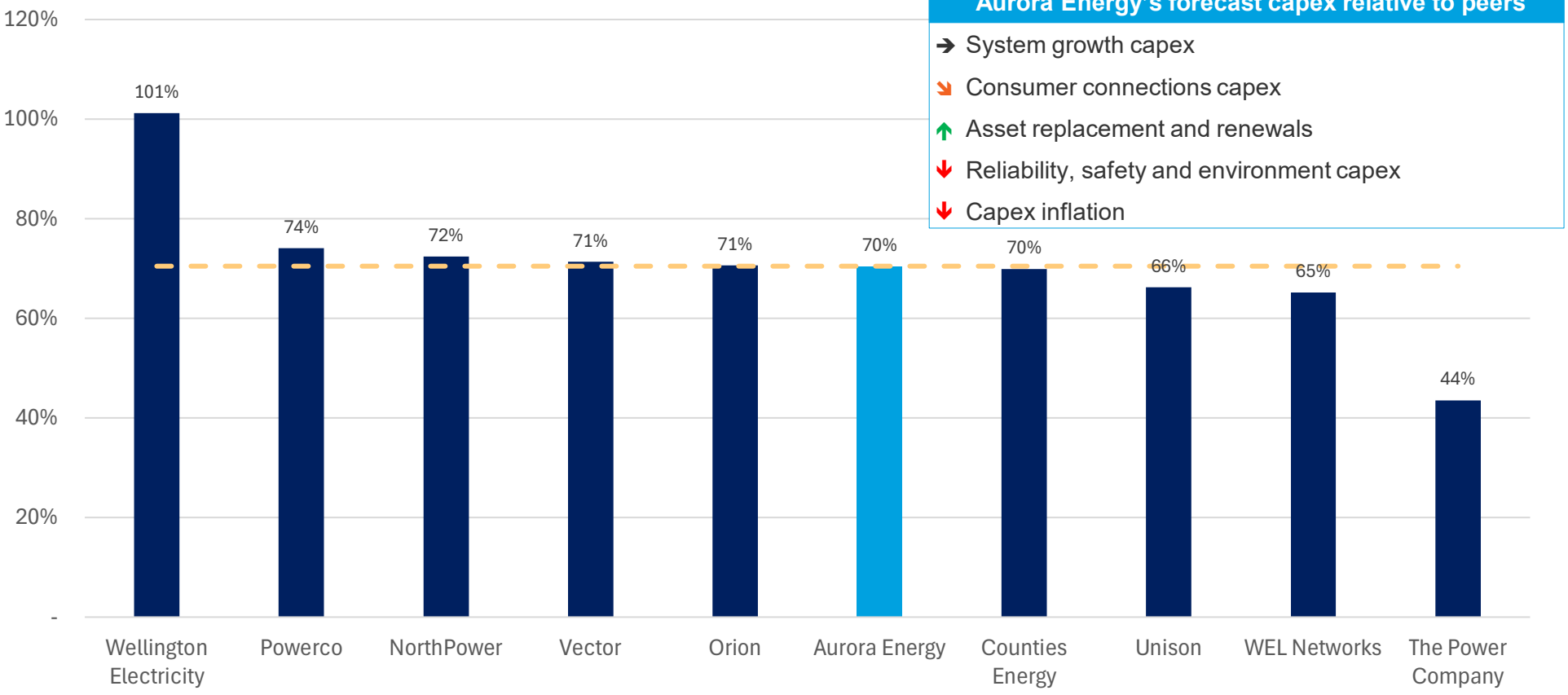
Key: ↓ Below peer average ↘ Slightly below peer average → In line with peer average ↑ Above peer average

Capital requirements

Benchmarking against peers

Aurora Energy's base case capex is not dissimilar to its peers and a reasonable base for assessing cashflow and debt requirements

Five-year forecast capex (nominal) as a % of RY23 RAB[1]



1. Table presents for the ten latest EDBs (based on the RY23 regulated asset base (RAB)), capex sourced from the latest asset management plans (2024). Capex is for the period RY24 – RY28.

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Profitability and cashflow generation

Profitability and cashflow generation

Key observations

Aurora Energy return on assets

- Return on assets is determined by regulatory WACC – forecast DPP4 WACC is ~7.4%[1]
- The regulatory regime is such that returns should average WACC in the long-run. However certain factors can impact returns
  - There are several adjustments (e.g. capex overspend and financial incentives/penalties[2]) that have a negative value impact to shareholders[3]
  - Historically Aurora Energy has under-performed regulatory WACC (RY13 – 21)
- In the short-term forecast, Aurora Energy's return on assets is above regulatory WACC. By design Aurora should revert to WACC thereafter. Short-term drivers include:
  - A positive financial penalties adjustment[2] (arising from the customised price path)
  - Realisation of deferred revenues (arising from ComCom revenue smoothing)
  - **These are included in the forecast and would be incorporated by acquirers when determining value**

Shareholder cashflows

- Regulatory returns can differ from shareholder cashflows – this is a function of regulatory design and company specific factors
- Over the forecast period, these differences are driving significant negative free cashflows for Aurora Energy
  - Base case free cash flow is **negative $220m** over FY25 – FY34 (before any dividends)
  - Dividends will further increase outflows
- Given DCC does not have access to equity capital, these cash outflows need to be funded by higher debt

1. Based on the ComCom's latest estimate for DPP4. 2. These relate to Incremental Rolling Incentive Scheme and quality incentive adjustments. 3. We note capex overspend is normalized in subsequent default price path periods. However, they have a negative net present value due to the time value of money. By contrast, the Incremental Rolling Incentive Scheme has a permanent and one-off impact to EDB cashflows

Profitability and cashflow generation

Regulatory return

As defined by the ComCom, EDB's generate an asset return in line with the regulatory WACC. This is calculated every five years and is primarily driven by the risk-free interest rate

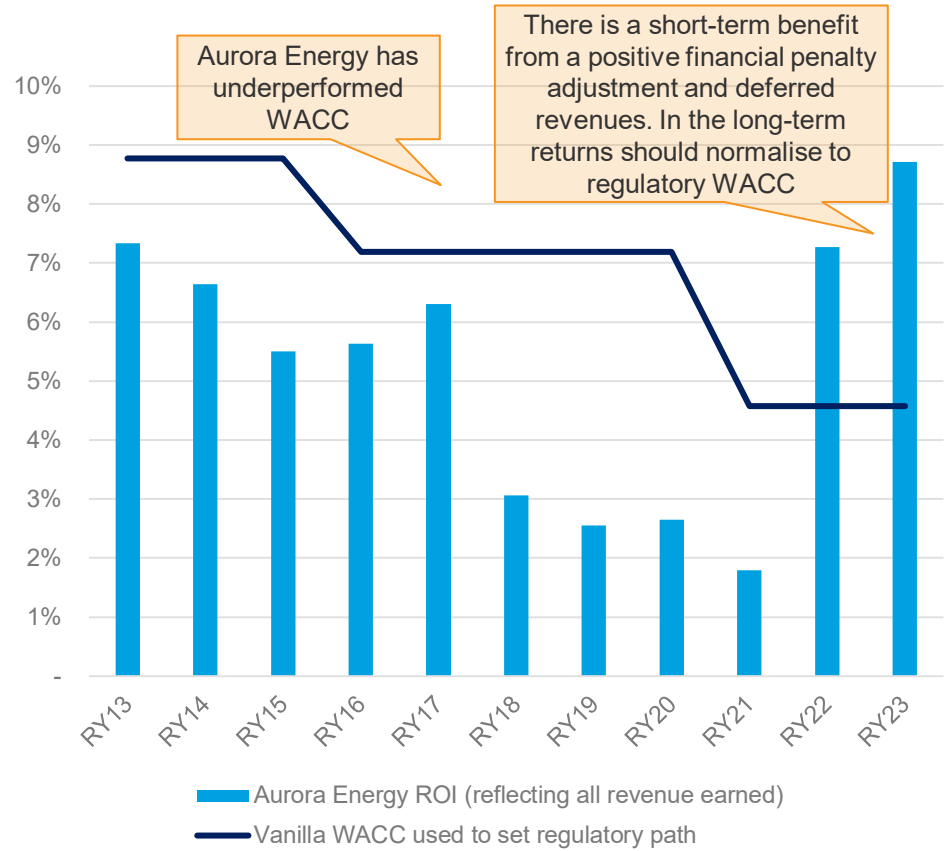
Return on assets is determined by regulatory WACC

- The regulatory regime is designed to enable EDBs to generate returns in line with the regulatory WACC
  - The regulatory WACC is set every five years
  - A key driver is risk-free rate (NZ Government bond rate)
- DPP3 WACC: **4.6%**
- Forecast DPP4 WACC: **~7.4%**[1]

However, EDB returns can differ to regulatory WACC

- Key drivers of deviation include[2]
  - Capex and opex overspend / underspend
  - Financial and quality penalties / incentives[3]
  - Wash ups
- Regulatory changes can also impact returns in the long-term

Aurora Energy return on assets vs regulatory WACC



1. The regulatory WACC for the next DPP (DPP4) will be determined in September/October 2024. The ComCom's latest estimate for DPP4 is 7.4% which has been applied in the forecast. 2. Note there are other drivers of deviations such as regulatory vs actual gearing, actual versus default price path depreciation, actual inflation and other financial incentives. For simplicity, we've presented the key drivers of temporary deviations to regulatory WACC. 3. These relate to the Incremental Rolling Incentive Scheme and quality incentive adjustments

Profitability and cashflow generation

Regulatory return and shareholder cashflows

<u>However, a regulatory return does not always translate to positive shareholder cashflows</u>

Aurora Energy is expected to incur significant negative free cash flows over the forecast period

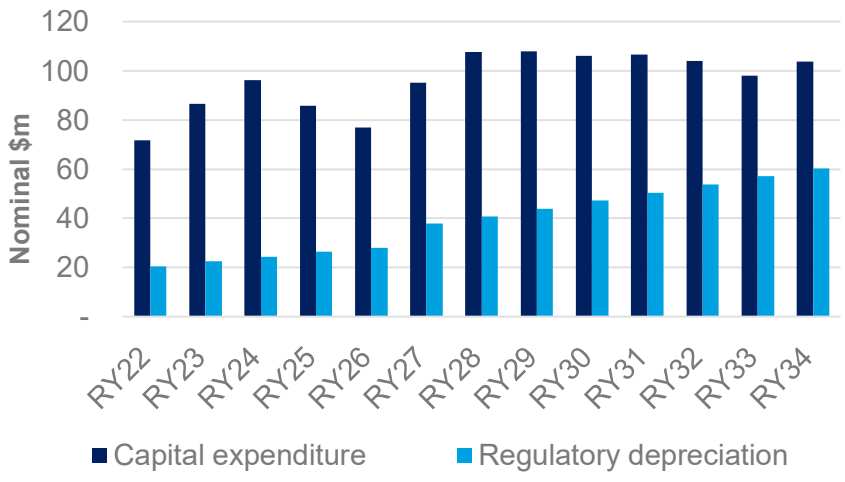
1 Some regulatory returns are non-cash

Regulatory return
Next DPP: ~7.4%[1]

RAB revaluation
(~2%)

Maximum allowable revenue:
(~5.4%)

2 Aurora Energy cash capex is significantly higher than regulatory depreciation allowance



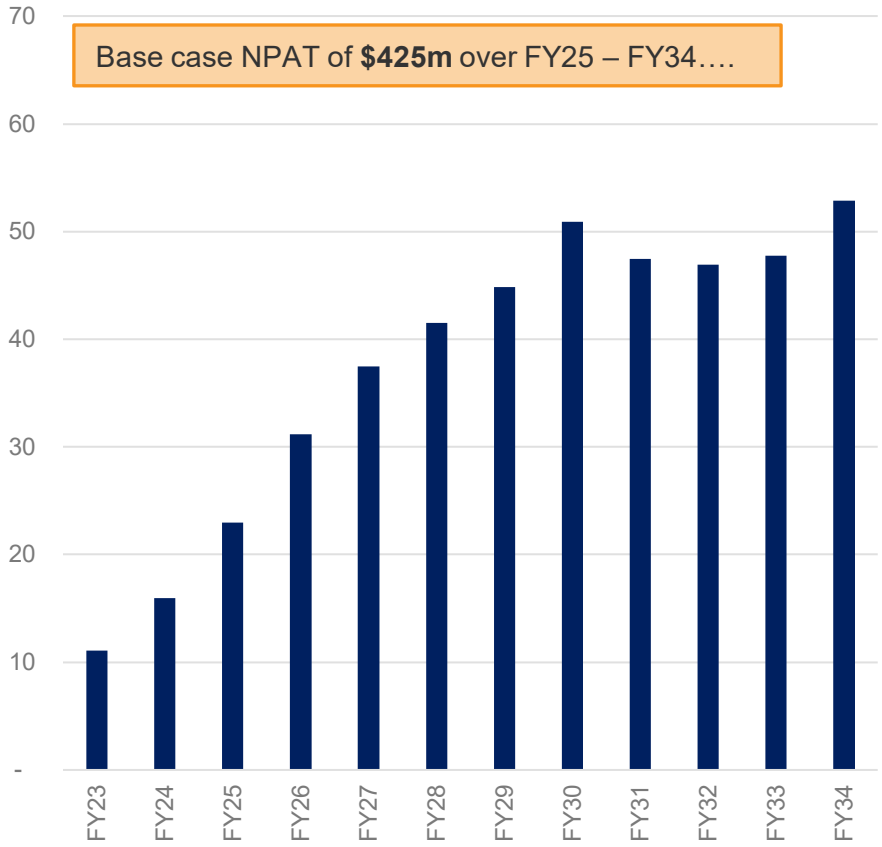
1. Based on ComCom's estimate of the WACC for the regulatory period RY26 – 30

Profitability and cashflow generation

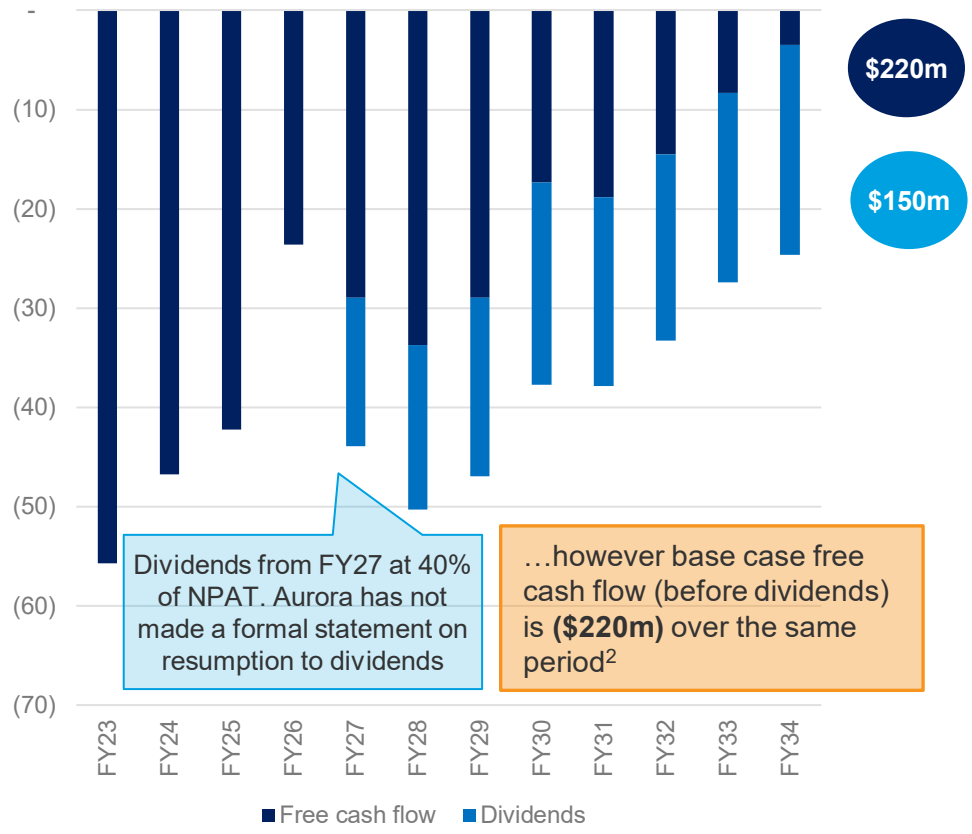
NPAT and free cashflows

Aurora Energy is expected to incur significant negative free cash flows over the forecast period. This will need to be funded via debt or equity

NPAT (nominal $m)



Free cash flows and dividends (nominal $m)[1]



1. Calculated as operating cashflows minus capex. 2. $370m after dividends

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Debt levels and capacity

Debt levels and capacity

Key observations

Aurora Energy's credit metrics

- Aurora Energy's ability to borrow is driven by (i) EDB credit metrics and (ii) DCC group credit metrics
- **EDB metrics:** Aurora Energy's leverage is one of the highest of EDB peers
  - Current FFO / debt ratios are in line with an "aggressive" assessment by S&P
  - Ratios are forecast to remain relatively highly leveraged, albeit they improve over the next 10 years
- **DCC group credit metrics:** DCC ownership means council credit metrics are the key constraint
  - EDB's typically have a high debt to revenue (Aurora Energy: ~370%[1]). As such they can have a drag on council credit quality and ability to borrow
  - DCC group debt / revenue is expected to further increase over the forecast period and there is a risk of a credit rating downgrade
  - This risk is exacerbated by S&P's current "negative outlook" for DCC's credit rating

Aurora Energy capital requirements

- On an absolute basis, Aurora Energy requires significant additional capital from DCC
  - The base case forecast sees Aurora Energy requiring **~$370m** of additional debt over FY25 - FY34 (~$220m excluding any dividends)
  - Combined with DCC's wider debt requirements, this sees total DCC debt increasing to $2.1b by FY31 (from $1.2b as at December 2023)
- Failure to support Aurora Energy's capital requirements will have implications on service quality and the ability of Aurora Energy to meet customer needs
  - It could also result in Aurora Energy incurring quality incentive adjustment penalties

1. As at FY23

Debt levels and capacity

Aurora Energy's financing constraints

Aurora Energy's ability to borrow is driven by typical EDB financing ratios and DCC credit metrics

Aurora Energy's ability to borrow is driven by:

Aurora Energy credit metrics[1]

S&P primary ratios:
FFO / debt
Debt / EBITDA

Moody's primary ratios:
FFO / net debt
Net debt / RAB
Interest cover

Indicative credit rating	FFO / debt	Debt / EBITDA	Net debt / RAB	Interest cover
bbb- / bb+	<6%	>6x	>90%	1.1 - 1.4x
bbb	6 – 9%	5 – 6x	>75%	1.4 – 2.0x
a-	9 – 13%	4 – 5x	60 – 75%	2.0 – 3.5x
a+/a	13 – 23%	3 – 4x	45 – 60%	3.5 – 5.5x

Takeaway: Highly leveraged financial ratios create heightened financial risk for DCC as a shareholder

DCC credit metrics

S&P primary ratio:
Debt to revenue
(group level)

Internal limit:
Gross debt to revenue
(parent level)

LGFA limit:
Net debt to revenue

We've excluded these as internal limit is parent only and LGFA limit has flexibility to exclude subsidiary debt

Debt / revenue	Impact
>240%	**DCC ratings downgrade**
~200% - 240%	**Risk of DCC ratings downgrade** *Weakening financial risk position could trigger a lower "financial management" assessment. Note this is qualitative assessment. As such the range presented is indicative only and will ultimate be determined by S&P*

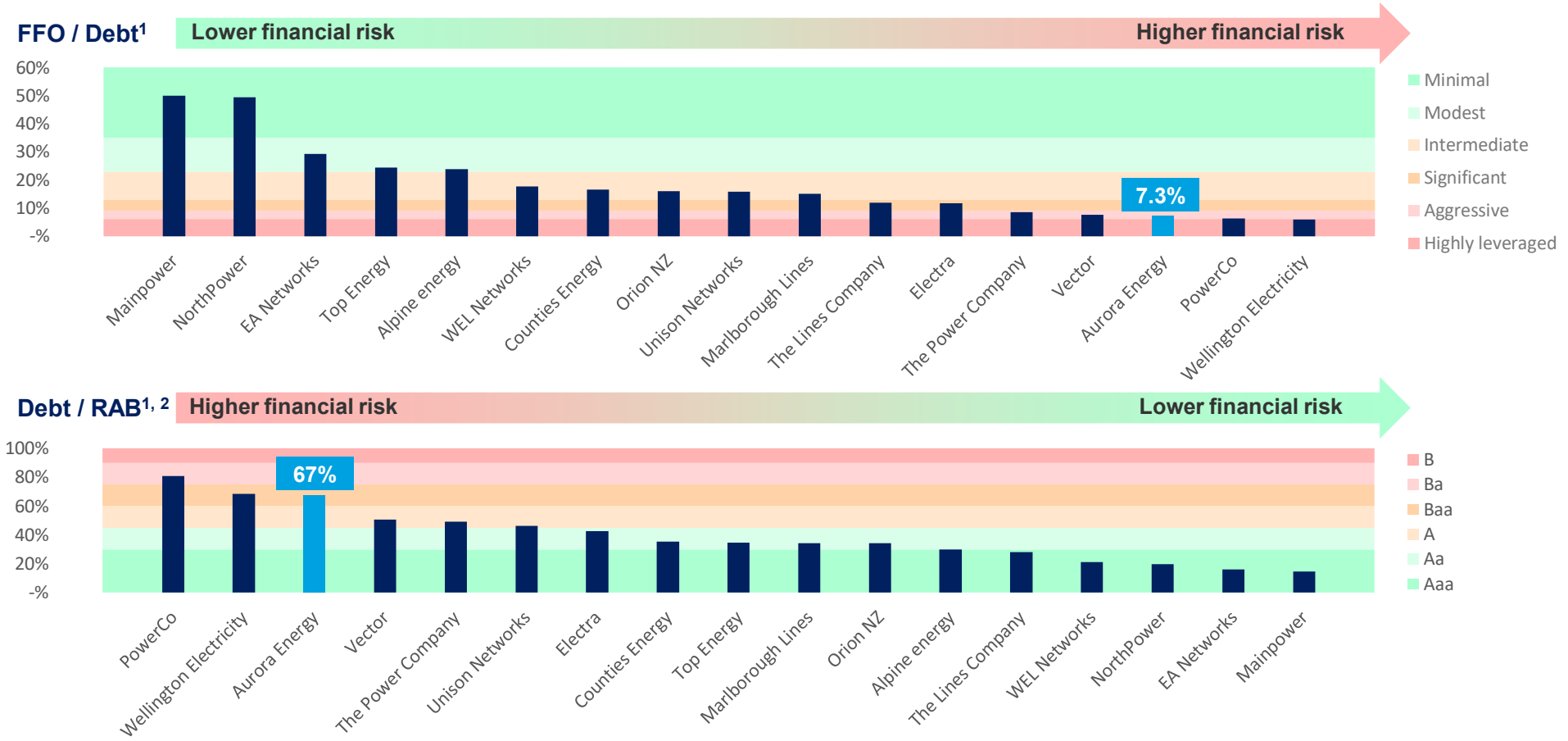
Takeaway: Where DCC's debt to revenue (group) trends towards 200%+, it has wider implications on DCC's borrowing capacity and credit rating

1. S&P and Moody's use other financial risk ratios and qualitative metrics to consider overall credit rating. However, we've presented the key metrics for simplicity.

Debt levels and capacity

Aurora Energy's credit metrics

Aurora Energy is one of the most leveraged EDBs. Only privately held EDBs have higher leverage (which is facilitated by the private sector's ability to access capital)



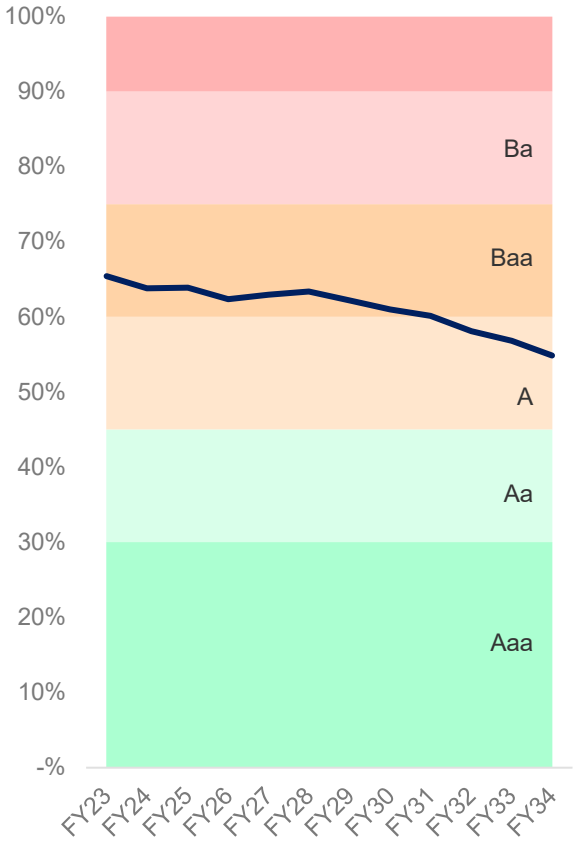
1. The graphs comprise of EDBs with more than $200m of RAB. Metrics are based on the most recently available financial information. FirstLight has been excluded as there is no financial information post acquisition by Igneo. The implied credit rating ranges are indicative only as they don't consider other financial risk and qualitative assessment factors used by S&P / Moodys. 2. Where entities have a material asset base outside of the EDB sector and such information is disclosed (e.g. Vector, PowerCo, Northpower, Top Energy), Mafic has applied debt on a pro-rata basis based on EDB fixed asset and the other segment fixed assets.

Debt levels and capacity

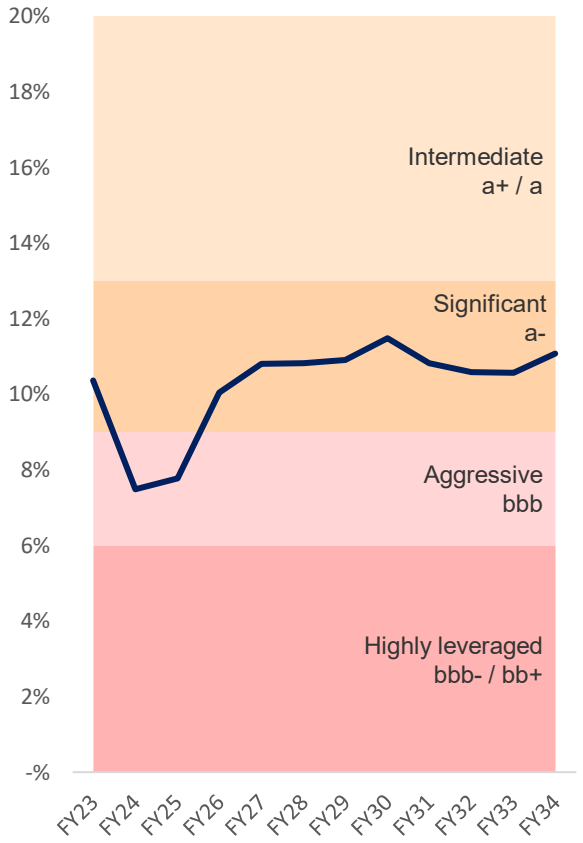
Credit metrics overtime

On a standalone basis, Aurora Energy's credit metrics should improve overtime. However, DCC group leverage is expected to increase overtime and is trending towards 240%. There is limited financial resiliency to respond to unexpected economic factors

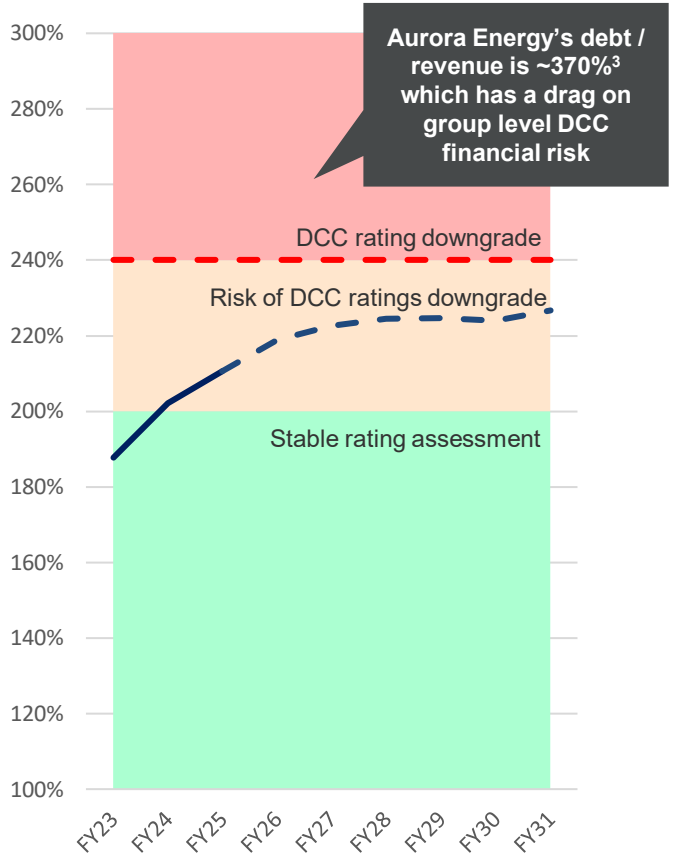
Net debt / RAB



FFO / debt[1]



DCC (group) debt to revenue[2]



1. FFO is calculated as EBITDA less customer contributions less cash interest less cash tax. Credit ratings shown reflect SACP assuming an 'excellent' business risk profile. 2. The debt to revenue metric is based on debt to FY27 from DCTL's Statement of Intent and revenue to FY25 from DCC's annual plan. Thereafter forecast debt and revenue are extrapolated using 2021-31 LTP forecasts. 3. As at FY23

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Sale considerations

Sale versus retain

Below are some key considerations in relation to a retain versus sale of Aurora Energy

Consideration	Retain	Sale	Observations
Valuation	**N/A**	**Recent sales suggest a premium to RAB**	• Investors will utilise a long-term discounted cashflow forecast to value (i.e. they will "see through" short-term matters) • Recent transactions have achieved a premium to RAB, reflecting significant interest in the sector (this may not persist[1])
Debt requirements	**~$370m additional debt for Aurora Energy by FY34[2]**	**Lower DCC debt**	• Implied total DCC debt of $2.1b by FY31 (from $1.2b as at December 2023)
DCC access to debt / credit quality	**Weakening DCC group credit metrics**	**DCC capital structure rightsized. Headroom for future risks**	• Aurora Energy debt metrics are expected to remain highly leveraged relative to peers but appear to improve over time • Risk of DCC credit rating downgrade over time
Dividends	**Dividends are debt funded**	**Sale proceeds can be redirected into cashflow generating assets**	• A diversified portfolio is less vulnerable to severe losses or extended periods of low returns because not all investments will react in the same way to market volatility
Control of EDB infrastructure	**Retained**	**Regulatory framework mitigates risk**	• The regulatory framework incentivises investment (via return on RAB) and performance • Revenue already capped by regulation
Portfolio	**Concentrated**	**Diversified, liquid assets**	• Aurora Energy represents ~54% of DCHL subsidiaries asset base[3]

1. Factors such as investor appetite, cost of capital and regulatory changes could impact future valuations. 2. When compared to FY24. 3. Calculated based on 2023 asset book values of all subsidiaries as disclosed in DCHL's annual report (comprising Aurora Energy, City Forests, Delta, Dunedin Railways, Dunedin Stadium, Dunedin Venues Management and Dunedin International Airport

Aurora Energy sale options

We've provided a high-level comparison of various sale options against criteria that may be important for DCC / DCHL

Criteria	Status quo (retain)	Minority sale (<50%)	Majority sale (50.1%+)	Full sale (100%)	Partial network sale
Value maximisation: Maximises sale value		Discount for lack of control	Discount for lack of control	Likely delivers the highest upfront valuation	Smaller scale will likely limit investor set
Execution risk Transaction certainty and investor appetite	N/A	Minority control will be impediment to attracting interest		Widest investor interest and no governance complexities	Complexities of asset separation
DCHL control Governance / voting rights			Reduced control for DCHL (particularly to deliver balance sheet separation)		
DCC credit quality Impact on DCC credit quality and ability to access debt		Limited proceeds			Partially reduces debt but also sees a corresponding reduction to revenue and RAB
Value adding ownership Transaction can deliver operating / oversight value to Aurora Energy			Investor can bring sector experience but will require sufficient control to properly deliver	N/A	Reduces scale of residual business and may present operational challenges (e.g. access to workforce)

Attractiveness to criteria: Low Mid High

Partial network sale

A divestment of part of Aurora's network, such as Central Otago, may enable DCC to retain control of residual assets. However, we believe there are some major disadvantages to a partial sale

Consideration	Key implications
Reduced investor set and relative valuation implications	• A partial sale would involve the sale of a smaller network (e.g. Central Otago and Queenstown have a RAB of ~$388m) • The smaller size would likely reduce the investor pool (as many target investors are seeking a larger scale opportunity in New Zealand, commensurate with the total Aurora asset base). This presents a risk to the sale premium to RAB (versus a full sale of Aurora Energy)
A sub-scale residual business may have operational challenges	• The smaller size may have implications on access to quality staff and contractor negotiating power • It may also limit Aurora Energy's ability to deliver quality services in an environment of change (technology changes arising from a "smart grid", managing increasing intermittent generation, increased resiliency arising from climate change demands)
Residual business would face a higher cost base which could have consumer pricing implications	• Aurora Energy's fixed costs base would be spread over fewer customers • This may necessitate a higher allowable revenue per customer to recover these costs
Complexities in splitting the business	• There will be complexities in splitting the two businesses (e.g. recruitment of new head office, transition of IT / systems) • This likely has timing and deliverability implications with respect to a sale
Less meaningful impact on DCC ratios	• The residual business would continue to put upward pressure on DCC group debt / revenue

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Summary and key takeaways

Summary and key takeaways

Key takeaways are summarised below

Section	Key takeaways
Capital requirements	• Aurora Energy is expected to remain in a period of elevated capex underpinned by several trends • Forecast capital expenditure is in line with peers, normalised for size • Beyond the base case presented, Aurora Energy has signalled further upward pressure on expenditure
Profitability and cashflow generation	• Return on assets for an EDB is determined by the regulatory regime with returns averaging the regulatory WACC • However, this does not always translate to positive shareholder cashflows • Aurora Energy is forecasting $220m of negative free cashflows over FY25 – 34 (excluding dividends) • This reflects regulatory specific matters (e.g. some returns are non-cash) and Aurora specific matters (e.g. forecast cash capex materially exceeds regulatory depreciation allowance)
Debt levels and capacity	• Aurora Energy is one of the most leveraged EDBs • It requires a further ~$370m of debt by FY34 • Aurora Energy credit metrics should improve slightly overtime • However, Aurora is a significant drag on council credit metrics. These are expected to further worsen overtime and risk a credit rating downgrade
Sale considerations	• Recent sales suggest a premium to book value, particularly if a 100% sale was pursued • A retain option comes with material debt requirements, weakening DCC credit metrics and asset concentration risk