POTENTIAL SALE

Department: Legal Services and Finance

REASONS FOR CONFIDENTIALITY

Grounds:	S48(1)(a) - The public conduct of the part of the meeting would be likely to result in the disclosure of information for which good reason for withholding exists under section 7.
Reason:	S7(2)(b)(ii) - The withholding of the information is necessary to protect information where the making available of the information would be likely unreasonably to prejudice the commercial position of the person who supplied or who is the subject of the information.
	S7(2)(g) - The withholding of the information is necessary to maintain legal professional privilege.
	S7(2)(h) - The withholding of the information is necessary to enable the local authority to carry out, without prejudice or disadvantage, commercial activities.

EXECUTIVE SUMMARY

1 The purpose of this report is to provide information so that Council can decide:

a) Whether it wants to proceed to public consultation on the potential sale of Aurora Energy Limited (Aurora); and

b) If so, whether its preferred option for consultation is the divestment of Aurora.

2 Dunedin City Holdings Limited (DCHL) has prepared a formal recommendation to Council, which is to divest Aurora, repay Aurora's debt and reinvest in a diversified investment fund.

3 Any consultation would be on the basis that Council would use the proceeds to repay Aurora's debt and the remainder would be used to generate income through a diversified investment fund.

4 Under the Companies Act 1993 and DCHL's Statement of Intent, DCHL can only sell Aurora and reinvest in a diversified portfolio if it obtains Council's prior approval.

5 Based on recent sales of infrastructure companies, DCHL expects that Aurora could sell for approximately $[redacted] billion to $[redacted] billion.

6 Aurora's debt is forecast to be approximately $576 million around the proposed time of sale.

7 After paying Aurora's debt and the transaction costs, the balance of the gross sale proceeds (expected to be approximately $[redacted]) would be used to create a

diversified investment fund. For the purposes of this report, the diversified investment fund is called the “Aurora Fund”.

8 The Aurora Fund would include protections to ensure that it is an intergenerational asset for the ratepayers of Dunedin. The capital would be protected, and inflation adjusted so that it is not eroded over time. The income would be available for Council to use as it chooses, including for example to offset rates or repay debt.

9 If the Aurora Fund has a long-run total return of 8% per annum and there is a distribution policy of 5% per annum, then DCHL expects that the Aurora Fund would deliver a cash distribution to Council of approximately $[redacted] in year one. The residual 3% expected return would be used to protect the capital base (i.e. to offset inflation).

10 DCHL notes that:

a) Council and Aurora both have significant capital expenditure requirements.

b) A sale of Aurora would:

i) Increase income to Council through a higher and more consistent income stream.

ii) Reduce DCC’s Group debt through the repayment of Aurora’s debt (forecast to be approximately $576 million as at the middle of next year).

iii) Reduce risk through having a more diversified portfolio.

c) Given the current market, a sale of Aurora has the potential to realise a price premium.

d) If Aurora is retained, DCC’s Group debt in 2033 is forecast to be $[redacted] billion (including forecast debt in Aurora).

e) If Aurora is sold, DCC’s Group debt in 2033 is forecast to be $[redacted] million lower, at $[redacted] billion. This reflects repayment of $576 million of debt following sale and the avoidance of further forecast increases in Aurora debt. If Council applied the income from the Aurora Fund towards interest and debt, then DCC’s Group debt would be further reduced.

f) DCHL’s modelling assumes that Council would receive approximately $[redacted] million of distributions from the Aurora Fund over an eight-year period, compared to approximately $[redacted] million of dividends from Aurora over the same period. This is a $[redacted] million difference. Under either scenario, there are inherent uncertainties. However, income from the Aurora Fund would be cash whereas income from an Aurora dividend would likely be a result of balance sheet borrowing based on the increased capital value of Aurora (i.e. it would likely be debt funded).

g) A sale of Aurora would assist compliance with the DCC Group’s Local Government Funding Agency (LGFA) debt covenants.

h) Lower group debt, following a sale of Aurora, would reduce risk to Council’s future credit ratings.

11 Council’s Finance Team has compared Council’s finances with and without the sale of Aurora. Based on 10-year modelling forecasts, a sale of Aurora would have significant benefits to Council’s finances, including:

a) [redacted]

b) [redacted]

c) [redacted]

d) [redacted]

12 Note that the numbers have been reviewed and analysed by multiple parties. There are slight differences in some numbers because of rounding.

13 Council's legal advice is that [redacted]

a) [redacted]

b) [redacted]

i) [redacted]

ii) [redacted]

14 If Council decides that it wants to proceed to consultation and its preferred option for consultation is a sale of Aurora, then a statement of proposal and communications plan would be prepared and brought to Council on 20 March 2024 for Council approval.

15 The decision on how the Aurora Fund would be held and by whom would be made following consultation on Council's Investment Plan through the 9 Year Plan.

16 Council staff recommend that Council proceed to consultation on the basis that Council's preferred option for consultation is the sale of Aurora. This is for many reasons, including:

a) The reasons outlined in the DCHL recommendation report and in a letter from Deloitte which supports the DCHL recommendation.

b) This approach gives Council the opportunity to hear the community's views on the proposal.

c) The sale of Aurora has a significant effect on Council's finances through a higher and more consistent cash return from the Aurora Fund.

d) If Council decides to approve a sale of Aurora, a sale would only proceed if the price was at or above a price set by Council. If Council decides to proceed with the sale (following completion of the consultation process), a price would be set ahead of Aurora going on the market.

RECOMMENDATIONS

That the Council:

a) **Decides:**

   i) To proceed to public consultation on the potential sale of Aurora Energy Limited;

   ii) To use the special consultative procedure for the consulation; and

   iii) Its preferred option for consultation is to divest Aurora Energy Limited.

b) If Council decides that it wants to proceed to public consultation in accordance with resolution (a) then Council:

   i) **Identifies** in accordance with section 80 of the Local Government Act 2002 that:

   - A sale of Aurora would be inconsistent with the current Long Term Plan 2021-31 because a proposed sale of Aurora Energy Limited is not contemplated by the current Long Term Plan 2021-31; and

   - The 9 Year Plan would be updated to reflect any Council decisions regarding Aurora.

   ii) **Notes** that:

   - The proceeds of any sale of Aurora Energy Limited would be used to repay Aurora's debt, and the remainder would be used to generate income through a diversified investment portfolio;

   - The diversified investment portfolio would have mechanisms to protect the capital in the portfolio; and

   - The decision on how the diversified investment portfolio would be held and by whom would be made following consultation on Council's Investment Plan through the 9 Year Plan process.

   iii) **Notes** that:

   - A statement of proposal and communications plan will be prepared and brought to Council on 20 March 2024 for Council approval; and

- Council's decision in relation to the proposed sale of Aurora is to remain confidential until the Council agenda for the 20 March 2024 meeting is released. At that time, a media release will be issued by Council.

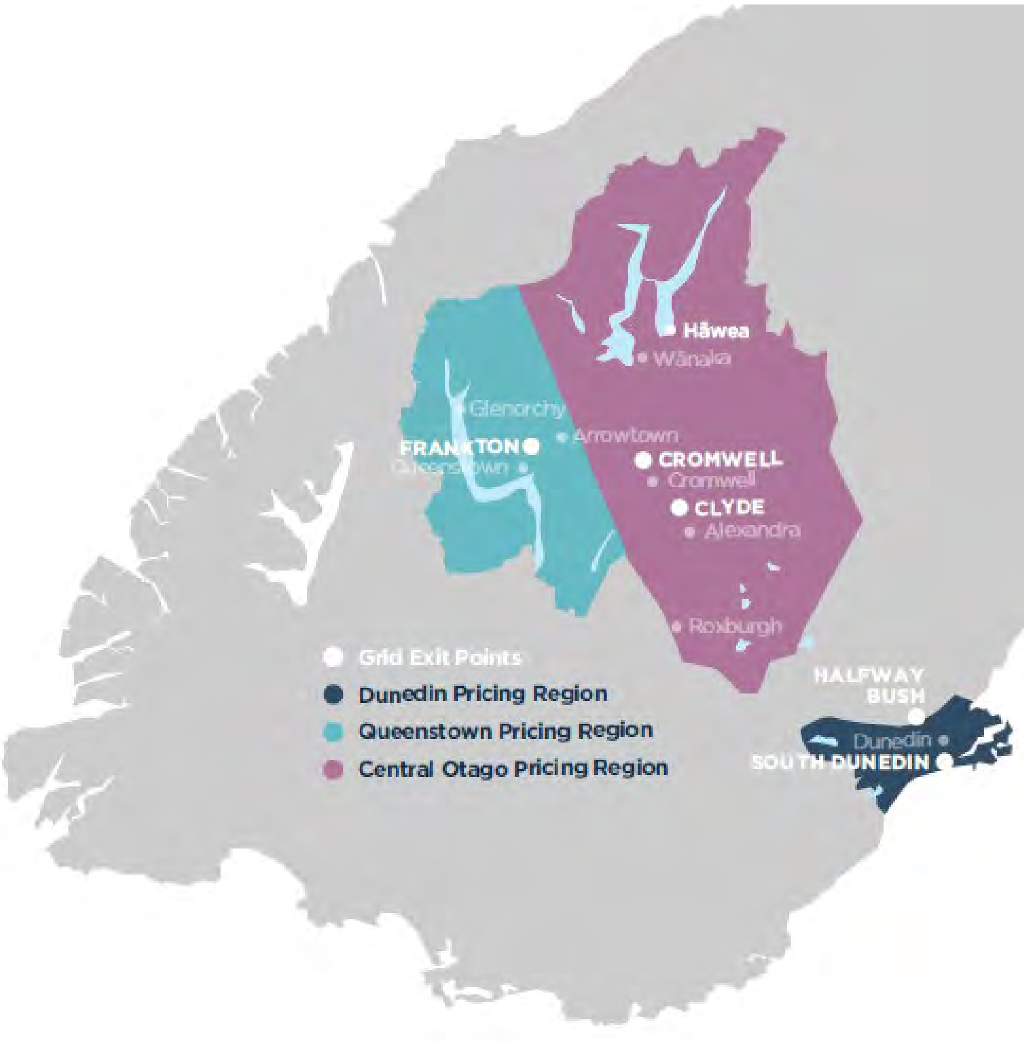
BACKGROUND

Ownership of Aurora

17 Aurora is 100% owned by DCHL and DCHL is 100% owned by Council.

About Aurora

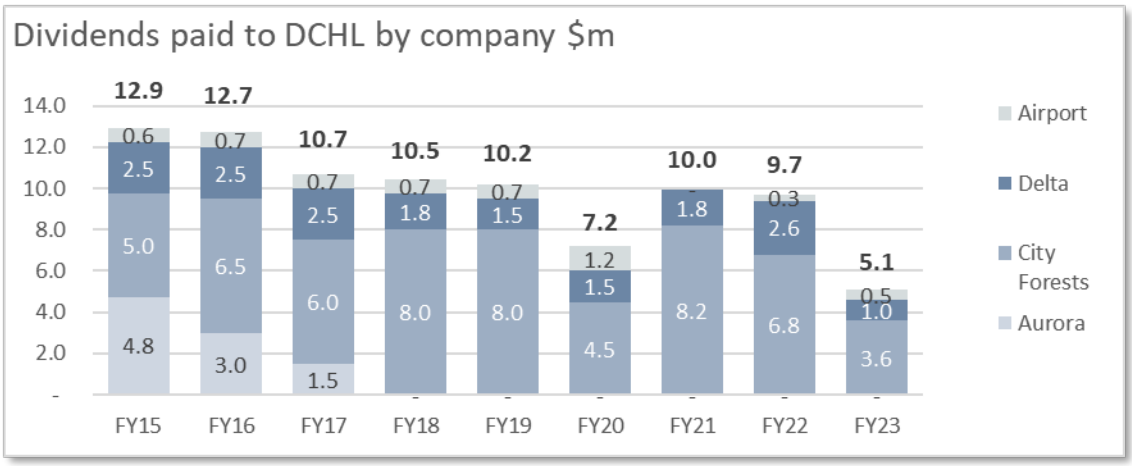
18 Aurora owns and operates the regulated electricity distribution networks for Dunedin, Central Otago (including Wānaka) and Queenstown Lakes.



19 Aurora's electricity network was largely built in the 1950s and 1960s. It now requires significant capital investment to renew aged assets, build resilience in its network, meet population growth in Central Otago and meet greater demand for electricity due to decarbonisation.

20 Aurora agreed a Customised Price Path (CPP) with the Commerce Commission in 2021 to enable higher prices to be charged to customers than under the default price path (DPP), allowing funding of Aurora's capex programme to improve the network. However, even with that funding, it is expected that significant capital expenditure requirements will consume operating cash flows and require more debt.

21 As shown in the table below, Aurora has not generated any dividends since 2017 (i.e. for 6 years).



22 DCHL is modelling Aurora to resume dividends from 2027. At that point, Aurora may be able to deliver dividends in the order of $[redacted] million to $[redacted] million, but there is high uncertainty around the quantum of the dividends due to inherent uncertainties in Aurora's capital reinvestment requirements, regulatory settings and ordinary business risks.

23 Any dividends from Aurora over the next 10 years would be funded by debt, placing pressure on the DCC's Group debt position.

Request by Council

24 Council's Letter of Expectation to DCHL in the year ending 30 June 2024 included an expectation *"to provide the DCC with strategic options for consideration (including consideration as to the future composition and direction of the portfolio) that allows the DCC to consider the implications for the DCC as shareholder with a particular focus on dividends/return on investment from DCHL."*

DCHL Recommendation to Sell Aurora, Repay Aurora's Debt and Reinvest in Diversified Fund.

25 Council has appointed highly experienced professional directors to the Board of DCHL, including the appointment on 1 July 2023 of Greg Anderson and Chris Milne who both specialise in investment and corporate finance.

26 DCHL has considered Council's Letter of Expectation and has drawn on analysis and insights from various advisors to develop strategic options. [redacted].

27 [redacted] has also (on behalf of the board of Aurora) undertaken a strategic review of Aurora including an assessment of its forecast capital structure and identification / evaluation of strategic options, considering a range of issues, including asset management planning and strategic planning.

28 As a result of this work and specialist advice, DCHL has sent a recommendation report to Council, attached as Attachment A.

29 DCHL's recommendation is to sell Aurora, repay Aurora's debt (estimated to be $576 million around the time of a sale) and reinvest in a diversified fund.

30 The DCHL recommendation is discussed more fully later in this report, but elected members will need to read DCHL's report in full (Attachment A).

Need for Council's consent

31 DCHL can only sell Aurora and reinvest in a diversified portfolio with Council's prior approval. This is because a sale of Aurora would constitute a major transaction for DCHL under the Companies Act 1993, which requires shareholder approval (by a Special Resolution). The sale also requires Council's approval under DCHL's Statement of Intent, which requires DCHL to obtain Council approval before disposing of any shares exceeding $5 million in value.

Investment Plan

32 Around the same time as DCHL's work on the proposed sale of Aurora, Council and DCHL have been working on an investment plan and considering how to structure the ownership and structure of Council's subsidiaries.

33 Council has not made any decisions on the ownership and structure of Council's subsidiaries:

a) This is something that would need to be consulted on through the 9 Year Plan; and

b) Council resolved at its meeting of 27 February 2024:

[redacted]

34 [redacted]

a) [redacted]

b) [redacted]

i) [redacted]

ii) [redacted]

35 [redacted]

36 [redacted]

DISCUSSION

37 This part of the report is structured as follows:

a) Summary of DCHL's recommendation (i.e., to sell Aurora, repay Aurora's debt and reinvest in a diversified fund).

b) Council's finances- status quo vs divestment of Aurora.

c) Reasons to retain Aurora.

d) Use of sale proceeds.

e) Potential protection mechanisms for a diversified investment fund.

f) Consultation requirements.

g) Consultation document.

h) Staff Recommendation.

i) Proposed process.

Summary of DCHL's Recommendation

38 DCHL's recommendation to Council is attached as Attachment A. Elected members will need to read DCHL's recommendation in full, but this part of the report provides a high-level summary. Staff have taken some tables from the DCHL recommendation report as they are helpful in explaining some points.

DCHL Recommendation

39 DCHL recommends a 100% divestment of Aurora, with the proceeds being used to repay Aurora's debt and reinvest in a diversified investment portfolio (nominally called the Aurora Fund).

40 DCHL has verbally advised that it recommends putting Aurora on the market as soon as possible, which could be in the second half of 2024. In that case, the intention would be to complete a sale on or around 1 July 2025.

41 Aurora's debt is forecast to be approximately $576 million if the sale is completed on or around 1 July 2025.

42 DCHL considers that the case for selling Aurora is compelling. In DCHL's view:

a) Council needs different assets if it is to receive higher and more consistent, sustainable cash returns from its investments.

b) Aurora is delivering reasonable capital growth but, as an infrastructure business with growing demand, significant capital expenditure requirements will consume operating cash flows and require more debt. Divestment of Aurora would reduce DCC's Group debt by approximately $576 million, avoid further DCC Group debt and reduce risk to Council's future credit ratings, debt covenants and borrowing costs.

c) Transaction evidence indicates that major infrastructure investors are willing to pay attractive premiums to buy regulated infrastructure businesses. This creates an opportunity to realise additional value that might not be there in the future.

d) Investing the proceeds in a diversified investment portfolio, with risk diversified across many different assets, rather than just one, will enable long-run higher cash returns that are more sustainable.

43 DCHL has drawn on analysis and insights [redacted] to identify strategic options and analyse transaction evidence. They have identified that there is likely to be strong market interest in Aurora and the transaction evidence indicates investors are valuing infrastructure businesses at a premium over their Regulated Asset Base (RAB).

44 RAB is a standardised measure of the value of infrastructure assets, regulated by the Commerce Commission. DCHL's analysis indicates a potential valuation range of [redacted] times to [redacted] times RAB if 100% of DCHL's shares in Aurora are sold to a third-party investor.

45 Using the potential multiples of RAB, this would mean that:

a) The range of the Aurora sale price would likely be between approximately $[redacted] billion and $[redacted] billion.

b) After repaying Aurora's forecast debt of $576 million, net sale proceeds would likely be in the range of $[redacted].

c) A diversified investment portfolio would deliver a cash return of $[redacted] million to $[redacted] million in year one of the fund, assuming an average long-run total return of 8% per annum with a distribution policy of 5% per annum.

46 This is further detailed in the table below:

Range	Low	Mid	High
RAB (at 30 June 2024)	[redacted]	[redacted]	[redacted]
Multiple of RAB	[redacted]	[redacted]	[redacted]
Gross proceeds	[redacted]	[redacted]	[redacted]
Less: Aurora debt	($576m)	($576m)	($576m)
Net proceeds after debt available to invest in the Aurora Fund	[redacted]	[redacted]	[redacted]
Implied premium on sale (gross proceeds less RAB)	[redacted]	[redacted]	[redacted]
Illustrated returns • **8% total return year 1** • **5% distribution year 1**	[redacted]	[redacted]	[redacted]

47 DCHL considered the possibility of selling only part of Aurora, but it does not see this as a good option. DCHL expects a higher premium and a higher probability of a successful outcome, if 100 per cent of Aurora is sold. As shown in the table above, the forecast premium is in the range between [redacted] and [redacted].

Status quo vs divestment - distributions

48 DCHL has compared the dividends that Council is likely to receive if Aurora is not sold (i.e. the status quo) against the income Council is likely to receive if it sells Aurora.

49 In DCHL's analysis, the divestment scenario delivers a higher income for Council.

50 DCHL's modelling assumes that Council would receive approximately [redacted] million from the Aurora Fund over an eight-year period, compared to approximately [redacted] million from Aurora over the same period. This is a [redacted] million difference. Whilst the [redacted] million from the Aurora Fund is an estimate and subject to market fluctuations, the status quo dividends are also uncertain, and it is likely that this would be funded from additional debt borrows against the value of Aurora.

51 The graph below illustrates projected distributions under each scenario. The dividends shown are from Aurora only. Any distributions from other companies and DCHL's finance and operating costs are assumed to be the same under both scenarios.

Sources: DCHL (divestment scenario), Aurora/[redacted] (status quo scenario)

52 DCHL notes that:

a) The full amount of the dividends paid by Aurora under the status quo would be borrowed against the increased value of Aurora.

b) DCHL's analysis is based on Aurora's FY24 10-year asset management plan and assumes a mid-point sale at a multiple of [redacted] times RAB, with proceeds reinvested in a diversified investment fund that delivers an average long-run total return of 8% per annum with a cash distribution policy of 5% per annum.

c) Although dividends from Aurora of [redacted] million to [redacted] million may be possible from 2027, there is significant risk around the forecast due to inherent uncertainties in Aurora's high capital reinvestment requirements, regulatory settings and ordinary business risk.

53 DCHL notes that a key assumption in the status quo scenario is that the premium that can be realised on investment now will no longer be available in 2033.

Status quo vs divestment- group debt

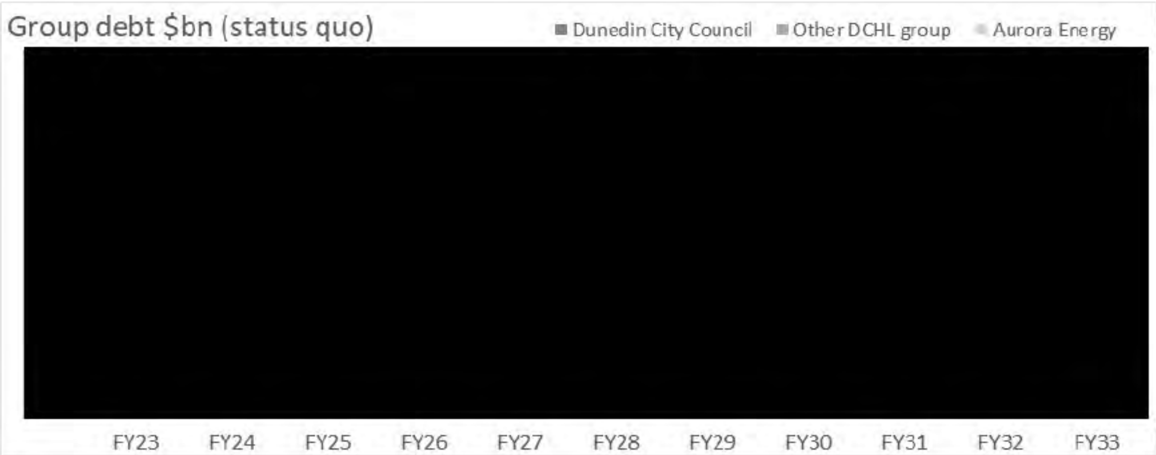
54 DCHL has compared the DCC Group's debt position without a sale of Aurora and with the proposed sale of Aurora. In essence:

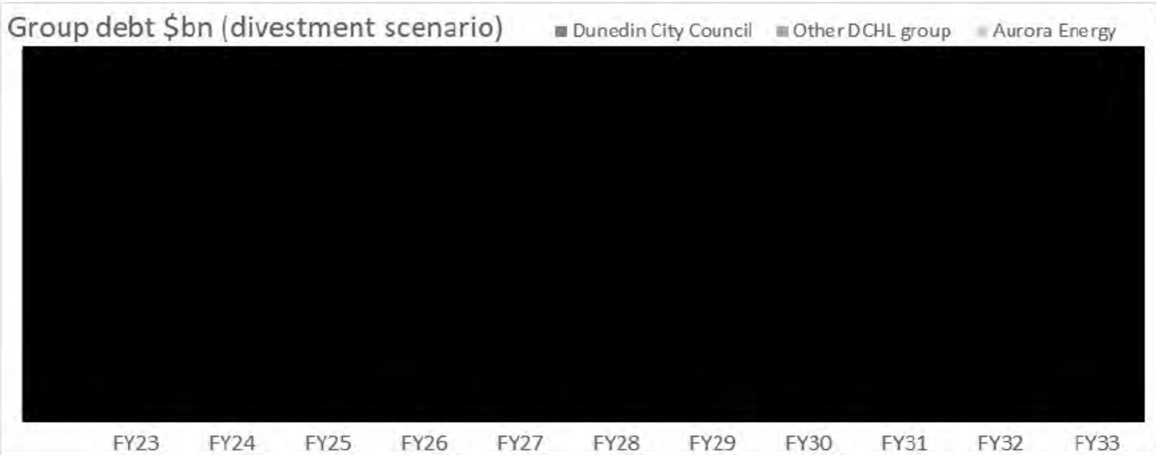
a) There is significant risk around Aurora's capital requirements, which means that its debt could rise higher than the [redacted] million modelled by 2033.

b) At the same time, Council borrowing is also forecast to increase to fund Council's capital programme.

c) Based on the above assumptions (and an assumption that 3 Waters remains a Council function), this would mean that the DCC's Group debt would be $[redacted] million less if DCHL sells Aurora, repays Aurora's debt of $576 million and avoids future increases in Aurora's debt.

55 This is illustrated in the charts below. DCHL's modelling under the divestment scenario, in the second chart, assumes that core Council debt is unchanged. As set out earlier in this report, DCHL expects significantly higher cash flow to Council under the divestment scenario, but Council would have choices around what this is applied to. Council's Finance Team has separately modelled the impact on core debt and expect Council's core debt to be $[redacted] billion if Council uses the income from the Aurora Fund and applies it towards interest costs and the reduction of debt:





56 Under Council's LGFA covenants, the DCC Group is required to maintain interest expense below 30% of total rates revenue. If Aurora is not sold, then the 30% is likely to be pressed in the early

2030s. If Aurora is sold, then this would significantly reduce the ratio of interest expense to rates revenue. This is illustrated in the table below.

[redacted]

(a) Calculation is based on consolidated DCC group accounts. Group interest expense is adjusted for interest income and dividends, noting that interest and dividends from subsidiaries and associates are eliminated on consolidation.

Source: Dunedin City Treasury

Status quo vs divestment – total return

57 DCHL has considered the total shareholder return by evaluating the combined returns of both capital growth and distributions from 30 June 2025 to 30 June 2033 and, based on certain assumptions, found that the divestment scenario delivers a higher total shareholder return. This is set out in the table below:

Range	Status quo scenario	Divestment scenario
Starting equity value 30 June 2025 Ending equity value 30 June 2033	$[redacted] $[redacted] a)	$[redacted] $[redacted]
Total distributions over 8-year period	$[redacted]	$[redacted]
Total shareholder return	$[redacted]	$[redacted] b)
IRR	[redacted]	[redacted] b)

[a] Assumes exit multiple is [redacted] – note sensitivity analysis in Appendix 2 Source: DCHL analysis
[b] Includes one-off $[redacted] premium received upon sale of Aurora
[c] Internal Rate of Return (IRR) is a measure expressing annualised return on investment, in today's terms, noting that returns are realised at different times in the future under each scenario.

58 The Internal Rate of Return (IRR) is a measure expressing annualised return on investment, in today's terms, noting that returns are realised at different times in the future under each scenario.

59 The IRR under the status quo scenario is [redacted]% and under the divestment scenario it is [redacted]%. In making this calculation, DCHL has assumed that for the status quo scenario, Aurora would be valued at [redacted] times RAB in 2033 and that for the divestment scenario Aurora could be sold in 2025 with a one-off premium of $[redacted] (which is based on a mid-point sale at a multiple of [redacted] times RAB).

60 To instead deliver a total IRR of [redacted]%, there would need to be a premium of at least [redacted] times RAB available in the market in 2033.

61 DCHL considers that there is no certainty that a premium would be available in the market in the future but, even if there was, DCHL still recommends selling 100% of Aurora now because of other factors that would flow from a sale of Aurora now (such as an increase in income to Council, reduction of risk and reduction of debt).

Council's finances- status quo vs divestment of Aurora

62 Two sets of forecast financial statements for the 10 year period 2024-34 have been prepared by Council's Finance Team.

63 Scenario 1 is the status quo (i.e. Council's finances without a sale of Aurora). The Scenario 1 financial statements are in draft and were prepared as part of the development of the 10 year plan 2024-34. Scenario 2 assumes the sale of Aurora and the creation of an Aurora Fund (i.e. a diversified investment fund).

64 The forecast financial statements for the status quo are attached as Attachment B.

65 The forecast financial statements if Council sold Aurora are attached as Attachment C.

66 Key assumptions for both scenarios include:

a) Rates increases are limited to 17.5% per annum in year one, [redacted]

b) A total Council capital expenditure programme of $2 billion delivered over the 10 year period 2024-34.

c) An interest rate of 5%.

d) [redacted]

e) [redacted]

67 Both scenarios include a high level of uncertainty around NZTA Waka Kotahi funding, [redacted]

Scenario 1- Council's finances without a sale of Aurora

68 The ten-year financial model forecasts the following (based on DCC alone and not on a DCC Group basis):

a) [redacted]

b) [redacted]

c) [redacted]

d) [redacted]

e) [redacted]

f) [redacted]

g) [redacted]

69 In February 2024, S & P Global Ratings revised Council's credit rating outlook from 'stable' to 'negative'.

70 This scenario assumes a dividend of $11.0 million per year from DCHL. At present, DCHL is reasonably confident that it can achieve this in years one and two, but it cannot provide that level of certainty from year three onwards. There is a degree of risk around Aurora's ability to deliver a forecast dividend stream and DCHL's modelling assumes that dividends will be funded by debt.

71 [redacted]

Scenario 2- Council's finances based on a divestment of Aurora

72 This scenario assumes that:

a) The Aurora sale proceeds are realised by year three and held in a diversified investment fund. (Note: the repayment of the Aurora debt would take approximately 12-18 months from the sale date because it would need to match existing debt maturities).

b) The Aurora fund results in increased dividends or income to Council of $[redacted] million over eight years (from year three), being an average of $[redacted] million per year.

73 For the purposes of this scenario, the additional income reduces the amount of debt raised.

74 The ten-year financial model forecasts the following (based on DCC alone and not on a Group basis):

a) [redacted]

b) [redacted]

c) [redacted]

d) [redacted]

e) [redacted]

f) [redacted]

g) [redacted]

h) [redacted]

75 This scenario is likely to have a positive effect on S & P Global Ratings. The benefits include reduced debt, and a significant improvement in liquidity and cashflow.

76 As a result of the Aurora sale, DCTL forecasts show minor changes in forecast interest rates over the 10-year period. The greatest change in one year is a 0.4% reduction. All other years, the change is less than 0.12%.

77 Although the capital in the Aurora Fund would be protected, the income from the Aurora Fund would be available for Council to use as it chooses, including for example to offset rates or repay debt.

Reasons to retain Aurora

Capital Growth in Aurora

78 The main reason to retain Aurora would be to deliver capital growth, noting that Aurora is forecast to have a RAB as at 2033 of $[redacted].

79 This is discussed earlier in this report under the heading "Status quo vs divestment-total return"). As noted earlier, if there was a price premium of more than [redacted] times RAB as at 2033 then, from a pure investment perspective, there would be a financial advantage in retaining Aurora. However:

a) There is no certainty that a price premium would be available in the future

b) Retaining Aurora would mean that DCC's Group debt is likely to increase to approximately $[redacted] billion by 2033

c) The risks associated with an undiversified portfolio would remain

d) There would also be significant risk around dividends from Aurora, and it is likely that any dividends would be funded from additional debt borrowed against the increased value of Aurora

e) DCHL considers that the above factors more than outweigh any potential capital growth.

Potential concerns from members of the public

80 The proposed sale may raise concerns about the risk of Aurora increasing its electricity lines charges, or misusing its market power in some other way, if it is no longer Council owned.

81 Lines charges are regulated by the Commerce Commission. The Commerce Commission ensures that Aurora only receives revenue that reflects its costs of operating and maintaining the network, and the Electricity Authority sets guidelines for how Aurora's prices are structured and what pricing approaches can be used. This price control will continue if Aurora is sold.

82 Aurora will also remain subject to the general provisions in the Commerce Act which prohibit it from misusing its market power.

83 There may be a concern from households, businesses and the wider community who rely on Aurora's network for electricity supply that a sale could result in network safety issues or reliability reducing. However, lines companies are subject to specific additional regulation by the Commerce Commission because they are natural monopolies. That regulation would continue following a sale.

84 Electricity lines businesses are required to report to the Commerce Commission annually on a range of metrics covering asset health, profitability and quality of service. The required reporting includes information about the number of unplanned outages, the average duration of each unplanned outage and the cause of each outage. This information allows electricity providers to be compared with each other and allows changes over time to be tracked.

85 Lines owners also need to comply with the Electricity Industry Participation Code. The Code sets of rules to promotes competition, reliable supply and efficient operation in the electricity sector and is enforced by the Electricity Authority.

86 The proposal to sell may also raise concerns about the risk of Aurora going into foreign ownership. The Overseas Investment Office (**OIO**) provides oversight of foreign investment in New Zealand. Under the Overseas Investment Act 2005, no overseas person or entity will be able to purchase Aurora unless it first obtains OIO consent. The OIO will only grant consent if it is satisfied the overseas investment will, or is likely to, benefit New Zealand and that the proposed purchaser is not unsuitable to own or control Aurora.

Use of sale proceeds

87 DCHL is recommending that the proceeds from any sale of Aurora be used:

a) To repay the Aurora debt (forecast to be approximately $576 million at the time of sale); and

b) To use the balance of the funds to establish a diversified investment portfolio (nominally called the Aurora fund).

88 Staff support this recommendation and note that the decision on how the Aurora Fund will be held and by whom will be made following consultation on Council's Investment Plan through the 9 Year Plan. The Aurora Fund could for example be held by Council or DCHL or an entity specifically established to hold the Aurora Fund.

89 Decisions will also need to be made around the nature of the fund (eg whether it is a growth fund or a more conservative fund), balancing risk with return, reflecting Council's investment objectives. Such decisions would also be made as part of the Investment Plan.

90 DCHL considers that an average long-run total return of 8% per annum with a cash distribution policy of 5% per annum is reasonable based on a less conservative profile than the Waipori Fund. This would deliver cash income to Council of $[redacted] million to $[redacted] million in year 1. As with any managed fund, there is the potential for a loss in any year, but if held over the long term then historically losses have generally been offset by gains in subsequent years. The risk of losses is mitigated through the diversification of the portfolio so that if one sector has a negative year then this only affects a portion of the fund.

Potential protection mechanisms for a diversified investment fund

91 There are already obligations on Council in respect of its financial management of its assets. For example, Part 6 of the LGA 2002 sets out requirements around financial management (including a requirement to have funding and financing policies) and a general obligation to manage Council's revenues, expenses, assets, liabilities, investments and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

92 There are a wide range of additional protection mechanisms that could be used to protect the capital in the Aurora Fund. Options include:

a) The same protections used for the Waipori Fund, such as Council preparing a Statement of Investment Policy and Objectives and having Council's Standing Orders record that Council may only divest all or any part of the capital of the Aurora Fund by a three quarters majority of the members present and voting.

b) Adding the Aurora Fund to Council's list of Strategic Assets.

c) Seeking a local Act of Parliament, although Council staff would caution against raising this as a possibility this stage as it would need further consideration due to potential unintended consequences.

93 A further discussion on the protection mechanisms would be included in the consultation document for the 9 Year Plan as the protection mechanisms for the Aurora Fund would form part of Council's Investment Plan.

Consultation requirements

94 Anderson Lloyd has provided legal advice [redacted] A copy of Anderson Lloyd's advice is attached as Attachment D.

95 In essence, Anderson Lloyd has advised that:

a) [redacted]

b) [redacted]

c) [redacted]

i) [redacted]

ii) [redacted]

iii) [redacted]

96 [redacted]

97 [redacted]

Consultation Document

98 If Council decides that it wants to proceed to consultation and its preferred option for consultation is that DCHL sells Aurora, then a statement of proposal and communications plan will be prepared and brought to Council on 20 March 2024 for Council approval.

99 Council staff have reviewed consultation documents from other local authorities who have wanted to sell shares in their CCOs. For example, Auckland Council's proposed sale of shares in Auckland Airport and Timaru District Council's proposed shares in Alpine Energy. Council staff have used the examples from other local authorities to identify what has worked well and what has not worked well.

100 It will be important to ensure that there is sufficient information in the consultation document to allow for meaningful consultation. However, it is difficult to provide information on price without disclosing what Council's lowest price might be. Council staff therefore propose saying that the funds will be used:

a) To repay the Aurora debt (forecast to be approximately $576 million at the time of sale); and

b) To use the balance of the funds to establish a diversified investment portfolio containing hundreds of millions of dollars.

101 In this way, confidential information is not being disclosed, but the public has some assurance that Council will not be selling as a "fire sale".

102 Key messages in the consultation document would be:

a) Council is thinking of selling Aurora because:

i) It would reduce DCC Group debt [redacted]

ii) Reduce risk by having a diversified investment portfolio (rather than having a lot of eggs in one basket); and

iii) Increase income to Council by having more consistent and sustainable cash returns (noting that, while Aurora has had reasonable capital growth, it has not returned a dividend to Council since 2017).

b) Council's intention is to use the proceeds to pay down Aurora's debt (forecast to be approximately $576 million by mid next year) and use the balance of the proceeds to create a diversified investment portfolio containing hundreds of millions of dollars.

c) Council wants to consult the public on this proposal.

d) The Aurora Fund will include protections to ensure that it is an intergenerational asset for the ratepayers of Dunedin. The capital would be protected, and inflation adjusted so that the fund is not eroded over time.

e) Council would receive the income from the Aurora Fund (less the inflation amount required to protect the base capital), which would potentially limit future rates increases.

f) There will be further consultation on the Aurora Fund as part of the Investment Plan that is being developed ahead of the 9 Year Plan. This will include details around management of the fund, such as who will manage the fund and whether it is held directly by Council or through DCHL. In any event, the Aurora Fund will be managed in consultation with specialist investment advisors.

Deloitte Recommendation

103 Staff sought the views of Deloitte because Deloitte has been working with Council and DCHL on the Investment Plan.

104 Deloitte has provided a letter, attached as Attachment E.

105 Deloitte has made the following comments:

We agree with DCHL's proposed recommendation. The sale of Aurora Energy Limited is essential in order for DCC to be able to achieve its objectives, primarily:

- *The need to diversify the portfolio and eliminate the concentration of investment risk (that manifested itself in 2016 in relation to the returns to DCHL*

- *The need to diversify the portfolio across many different assets to enable long-run higher cash returns that provide a more sustainable return for DCC.*

In addition, we make comment on other key aspects of the proposal:

- *As outlined on page 24, the historical performance has been mixed with weak dividend flows.*

- *A fund, similar to the Waipori Fund, is a sensible structure for the reinvestment of the proceeds received from the sale.*

- *The range of sale values used in the analysis is supported by actual sales in recent times.*

- *The assumptions in relation to future long-run returns from a diversified portfolio are reasonable.*

- *The proposed distributions under the divest option are $[redacted] million higher across the 8-year period modelled. This is material and would have a positive impact on the DCC's ability to invest in other initiatives and/or manage future rating increases.*

- *The DCC, as part of the investment plan, will have a policy in place to protect the capital from the sale of the Aurora Energy Business. This reduces the risk relating to the loss of capital in the future.*

Staff Recommendation

106 Council staff recommend that Council proceed to consultation on the basis that its preferred option is to sell Aurora. This is for many reasons, including:

a) The reasons outlined in the DCHL recommendation report and in Deloitte's letter.

b) This approach gives Council the opportunity to hear the community's views on the proposal.

c) The sale of Aurora has a significant effect on DCC's finances through a higher and more consistent cash return from the Aurora Fund.

Proposed Process

Proposed process if Council decides not to proceed to consultation

107 If Council decides not to proceed to consultation, then no further work would be done regarding the proposal.

Proposed process if Council decides to proceed to consultation

108 If Council decides to proceed to consultation, staff note that:

a) The process has been developed in a way to provide the community with notice to expect an opportunity to provide feedback.

b) The intention is to keep this report as a confidential report, particularly given that it includes commercially sensitive information and legal advice.

c) Staff propose making the report to Council on 20 March 2024 an open report. That report would seek Council's approval to a draft Statement of Proposal (including a draft consultation document) and a communications plan.

d) This would mean that the proposed sale of Aurora would become public when the agenda is released for the 20 March 2024 meeting. This is likely to be 15 March 2024.

e) When the agenda is released, an appropriate media statement would also be released.

f) By making the report to Council on 20 March 2024 an open report, this gives Council the opportunity to discuss reasons in public why Council's preferred option for consultation is a sale of Aurora. However, a level of caution will be required to ensure that details around price are not disclosed.

109 If Council decides to proceed to consultation on the basis that its preferred option is to sell Aurora, then Council staff expect that the process would be as follows:

a) A report would come back to Council on 20 March 2024 with a draft statement of proposal (including a draft consultation document) and communications plan for Council approval.

b) Public submissions and hearings at approximately the same time as the Annual Plan 2024/25 public submissions and hearings.

c) Deliberations by Council before 30 June 2024, at which time Council would decide whether it approves a sale, and if so, at what price.

d) DCHL would then arrange for Aurora to be put on the market. DCHL would not need to come back to Council before completing the sale if Council's minimum price is met or exceeded. If the minimum price is not met then DCHL would need to report back to Council.

OPTIONS

110 The two key options here are:

a) Proceed to consultation on the basis that Council's preferred option is to sell Aurora; or

b) Not proceed to consultation.

Option One – Recommended Option - Proceed to consultation on the basis that Council's preferred option is to sell Aurora

111 Under this option, Council would:

a) Decide:

i) To proceed to public consultation on the potential sale of Aurora Energy Limited;

ii) To use the special consultative procedure for the consultation; and

iv) Its preferred option for consultation is to divest Aurora Energy Limited.

b) If Council decides that it wants to proceed to public consultation in accordance with resolution (a) then Council would:

i) Identify in accordance with section 80 of the Local Government Act 2002 that:

- A sale of Aurora would be inconsistent with the current Long Term Plan 2021-31 because a proposed sale of Aurora Energy Limited is not contemplated by the current Long Term Plan 2021-31; and
- The 9 Year Plan would be updated to reflect any Council decisions regarding Aurora.

ii) Note that:

- The proceeds of any sale of Aurora Energy Limited would be used to repay Aurora's debt, and the remainder would be used to generate income through a diversified investment portfolio;
- The diversified investment portfolio would have mechanisms to protect the capital in the portfolio; and
- The decision on how the diversified investment portfolio would be held and by whom would be made following consultation on Council's Investment Plan through the 9 Year Plan process.

iii) Note that:

- A statement of proposal and communications plan will be prepared and brought to Council on 20 March 2024 for Council approval; and
- Council's decision in relation to the proposed sale of Aurora is to remain confidential until the Council agenda for the 20 March 2024 meeting is released. At that time, a media release will be issued by Council.

Advantages

- By proceeding to consultation, this would give the public an opportunity to consider the proposal, to make submissions and to be heard.

- A sale of Aurora would be expected to increase income to Council through a higher and more consistent income stream. DCHL forecasts that, over an eight-year period, Council would receive $[redacted] million more from a diversified fund than from Aurora dividends.

- Income from an Aurora Fund would be cash, whereas any dividends from Aurora would likely be funded from additional debt borrowed against the increased value of Aurora (i.e. any dividends from Aurora would probably be debt funded).

- A sale of Aurora would reduce DCC Group debt through the repayment of Aurora's debt (forecast to be approximately $576 million as at the middle of next year). If Aurora is retained, then forecast DCC Group debt in 2033 is $[redacted] billion. If Aurora is sold, then forecast DCC Group debt in 2033 is $[redacted] (and less if Council applies the income from the Aurora Fund towards interest and debt repayment).

- A sale of Aurora would reduce risk through the diversification of assets.

- The Aurora Fund would be protected as an intergenerational asset so that the capital of the fund is protected (including against inflation).

- The income from the Aurora Fund would be available for Council to use as it chooses, including potentially to offset future rates increases.

- [redacted].

- The establishment of an Aurora Fund is forecast (based on assumptions) to have the following effects on Council's finances:

  i) [redacted]

  ii) [redacted]

  iii) [redacted]

  iv) [redacted]

  v) [redacted]

  vi) [redacted]

  vii) [redacted]

  viii) [redacted]

- Council will have the opportunity to consider this further following submissions and hearings. If Council decided to proceed to a sale, Council would need to set a price. A sale of Aurora would only proceed if the price set by Council was achieved.

Disadvantages

- If a sale of Aurora was approved, DCHL would no longer own a regulated asset and get the capital growth from that asset. Aurora is forecast to have a RAB of $[redacted] as at 2033. If there was a price premium available of [redacted] times RAB in 2033 then, from a purely financial perspective, there would be a financial advantage in retaining Aurora. However:

  - there is no certainty that a price premium would be available in the future
  - retaining Aurora would mean that DCC's Group debt is likely to increase to approximately $[redacted] billion by 2033
  - the risks associated with an undiversified portfolio would remain
  - there would be significant risk around income for Council from Aurora dividends (noting that any dividends from Aurora would likely be debt funded).

- There may be public opposition to the proposed sale of Aurora.

- The staff at Aurora may be unsettled by the proposal.

Option Two – Status Quo

112 Under this option, Council would decide that it does not want to proceed to consultation on the proposed sale of Aurora.

Advantages

- DCHL would continue to own a regulated asset and to get the capital growth from that asset. This may mean that Council could, if Council was to achieve a price premium in the future, potentially get a higher sale price at a later date.

- While it is not possible to predict a revenue stream beyond 2033, if Council was to hold Aurora for the medium to long term, it may receive dividends over that period.

- There would not be any risk of public opposition to the proposed sale of Aurora.

- The staff at Aurora would not be unsettled by the proposal.

Disadvantages

- The public does not get an opportunity to present its views.

- None of the advantages under option 1 would be realised.

NEXT STEPS

113 If Council decides to proceed to public consultation on the potential sale of Aurora and its preferred option for consultation is a sale of Aurora, then:

a) A statement of proposal (including a draft consultation document) and communications plan will be prepared and brought to Council on 20 March 2024 for Council approval.

b) The consultation regarding the proposed sale of Aurora would be undertaken alongside but separate from the Annual Plan for 2024/25. There will be a call for submissions and public hearings on the proposed decision.

114 If Council decides that it does not presently want DCHL to sell Aurora, then DCHL would be advised accordingly.

Signatories

Author:	Karilyn Canton - Chief In-House Legal Counsel Carolyn Allan - Chief Financial Officer
Authoriser:	Sandy Graham - Chief Executive Officer

Attachments

SUMMARY OF CONSIDERATIONS

Fit with purpose of Local Government

This decision promotes the economic well-being of communities in the present and for the future. This decision also enables democratic local decision making and action by, and on behalf of communities as the decision is subject to consultation through the special consultative procedure.

Fit with strategic framework

	Contributes	Detracts	Not applicable
Social Wellbeing Strategy	☐	☐	✓
Economic Development Strategy	✓	☐	☐
Environment Strategy	☐	☐	✓
Arts and Culture Strategy	☐	☐	✓
3 Waters Strategy	☐	☐	✓
Spatial Plan	☐	☐	✓
Integrated Transport Strategy	☐	☐	✓
Parks and Recreation Strategy	☐	☐	✓
Other strategic projects/policies/plans	☐	☐	✓

This decision is primarily about the economic well-being of communities, but a sale of Aurora would generate sufficient funds to allow for the repayment of Aurora's debt and a substantial diversified investment portfolio. The principal in the diversified investment portfolio would be protected (like with the Waipori Fund), but the income could be used by Council to assist in advancing any of its other strategies.

Māori Impact Statement

There has been no engagement with mana whenua about the proposal, but if Council decides to consult then staff will advise iwi/Māori that the consultation is being undertaken in case they want to make submissions on the proposal.

Sustainability

Given the regulated nature of lines companies, sustainability issues are likely to be the same or similar whether Aurora is retained or sold.

LTP/Annual Plan / Financial Strategy /Infrastructure Strategy

Council has resolved to prepare an Annual Plan for 2024/25 for community consultation, followed by a 9-year plan 2025-34. Council's current Long Term Plan is the Long Term Plan 2021-31. A sale of Aurora is inconsistent with Council's current Long Term Plan 2021-31. In accordance with section 80 of the Local Government Act 2002, Council will need to identify that a divestment of Aurora is inconsistent with the current Long Term Plan 2021-2031, and the next Long Term Plan will need to be updated to reflect the decision.

[redacted] The Council will therefore be able to run an Annual Plan process for 2024/25, and a separate Special Consultative Procedure regarding Aurora. The Annual Plan process and Special Consultative Procedure would run concurrently.

Financial considerations

The financial considerations are discussed in depth in this report.

SUMMARY OF CONSIDERATIONS
Significance This decision is considered high in terms of Council's Significance and Engagement Policy. A full discussion is contained in the body of this report, including a discussion on Council's consultation requirements.
Engagement – external There have been discussions with Dunedin City Holdings Limited, who have consulted with various specialist advisers [redacted]. External legal advice has been sought by Council from Anderson Lloyd. External accounting advice has been sought by Council from Deloitte.
Engagement - internal There has been internal engagement with the Executive Leadership Team, Finance Team, Legal Services Team, Civic Team and the Business and Community Engagement Team.
Risks: Legal / Health and Safety etc. There are no identified Health and Safety Risks. [redacted]
Conflict of Interest There are no known conflicts of interest.
Community Boards There are no specific implications for Community Boards.

Proposal to divest Aurora Energy Limited and reinvest in diversified portfolio

Recommendation Paper
March 2024

STRICTLY CONFIDENTIAL & COMMERCIALLY SENSITIVE

DUNEDIN CITY HOLDINGS LIMITED

Contents

1. Executive summary

DUNEDIN CITY HOLDINGS LIMITED

Recommendation

DCHL recommends 100% divestment of Aurora Energy, with proceeds reinvested into the 'Aurora Fund'.

- Council has clearly signalled its desire for higher and more consistent, sustainable cash returns from its investments. To achieve this, **Council needs different assets**.
- Aurora is delivering reasonable capital growth but, as an infrastructure business with growing demand, significant capital expenditure requirements will consume operating cash flows and require more debt. Divestment of Aurora will **reduce group debt** by a forecast $576m, avoid further group debt and reduce risk to Council's future credit ratings, debt covenants and borrowing costs.
- Transaction evidence indicates that major infrastructure investors, with different objectives to Council's, are willing to pay attractive premiums to buy regulated infrastructure businesses. This creates an opportunity to **realise additional value** that might not be there in the future.
- Investing the proceeds in a diversified investment portfolio, with risk diversified across many different assets, rather than just one, will **enable long-run higher cash returns that are more sustainable**.
- Our advice is that the divestment of Aurora is compelling – this is the right thing to do to meet the needs of Council from its investments.

✓ Increase income to Council

✓ Reduce debt

✓ Reduce risk

✓ Realise value available now

Background

Council has asked DCHL to provide strategic options as to the future composition and direction of its portfolio.

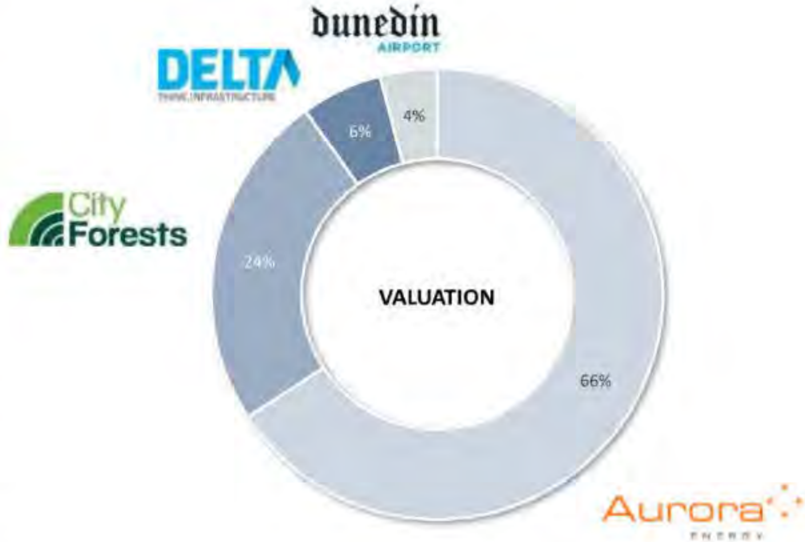
- Dunedin City Holdings Limited (DCHL) is entrusted by Council to govern its portfolio of Council-Controlled Organisations (CCOs). The portfolio comprises both:
  - Commercial enterprises – which are held primarily to deliver returns to the shareholder; and
  - Non-commercial entities – the primary purpose of each of these investments is to drive economic, cultural or other community benefits.
- The purpose of Dunedin City Holdings Limited (DCHL) is to achieve the best for Dunedin from its investments. Dunedin City Council's Letter of Expectation for the year ending 30 June 2024 included an expectation *"to provide the DCC with strategic options for consideration (including consideration as to the future composition and direction of the portfolio) that allows the DCC to consider the implications for the DCC as shareholder with a particular focus on dividends/return on investment from DCHL."*

- This report is an important step in DCHL's response to Council's requirements. The recommendation contained is a considered response and arises from a cumulative body of work undertaken by DCHL, enhanced by insights and analysis from various third party experts.
- The board of DCHL has been appointed by Council and comprises highly experienced professional directors with a broad commercial skill mix. This has been enhanced by the recruitment in 2023 of two directors with deep investment banking and corporate finance experience. The board is well-qualified to provide this advice.

Current commercial portfolio

The current commercial portfolio is substantial, with a valuation of over $1bn, but it is undiversified, illiquid, unbalanced and over-weighted to capital-intensive infrastructure.

- Council's current commercial portfolio comprises only four legacy assets – Aurora Energy Ltd, City Forests Ltd, Delta Utility Services Ltd and Dunedin International Airport Ltd. They are owned by Council due to their history. Whilst we consider them now to be held primarily to generate returns for the shareholder, none of these investments has been actively chosen. Active management of a portfolio would typically involve allocating capital to a range of investments, carefully selected to meet the objectives of the investor, noting risk appetite, period of investing, desire for cash income etc.
- The portfolio is substantial, with a valuation of $[redacted] in 2021 but it is unbalanced and heavily over-weighted to Aurora Energy and City Forests. Accordingly, the portfolio lacks diversification and has high concentration risk, in dollar terms and geographically e.g. AF8 exposure.
- Return on investment comprises both capital growth (growth in the value of the investor's shares) and distributions (cash returned to the investor). Low distributions are not necessarily a measure of a poor investment, but if Council desires an increased income from its investments, the current asset mix is not right.



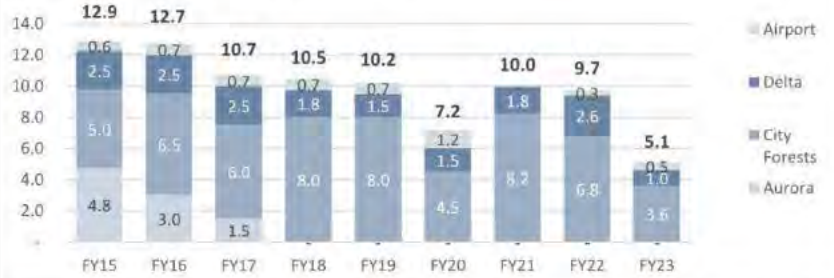
Current commercial portfolio

The current commercial portfolio has delivered reasonable capital growth but low dividends.

- In recent years, the DCHL commercial portfolio has delivered reasonable capital growth, but dividends (distributions) have fallen below expectations. The outlook for dividends in future years remains very challenging, especially since the group's largest investment, Aurora Energy, requires significant capital investment over coming years to renew aged assets, build resilience in its network, meet population growth in Central Otago and meet greater demand for electricity due to decarbonisation. In other words, cash from earnings will largely need to be reinvested in the company rather than returned to the shareholder.
- Notwithstanding the relative performance of individual companies, the shortfall in dividends reflects the portfolio being over-weighted to capital-intensive infrastructure.
- Another important characteristic of the current portfolio is a lack of liquidity. Liquidity is the ability to turn assets into cash when the investor needs it. All investments in the portfolio are shares in privately held companies, with no other shareholders, except for the Crown (in the case of Dunedin International Airport Ltd). Accordingly, raising cash quickly through a sale process would be difficult, time-consuming and could erode value. By contrast, shares in companies listed on recognised stock exchanges can be traded easily.

[redacted]

Dividends paid to DCHL by company $m



Source: DCHL analysis

Portfolio options analysis

To achieve a different outcome, Council needs different assets. Aurora requires large capital investment which will lift DCC group debt and increase financial risks. Divesting Aurora is the best option to reshape and reduce risk.

- Council has strongly signalled a desire for greater, more sustainable, consistent dividends. Council's investment portfolio does not meet its current and future requirements.
- Our advice is that, if Council wants a different outcome, then we need to do something different – we need different assets.
- The portfolio needs to be reshaped with these requirements:
  - Diversifying, reducing concentration risk and rebalancing across investment classes, industries, markets, geography etc;
  - Reflecting Council's risk appetite; and
  - With an appropriate weighting to investments delivering cash income.
- Since Council does not have funds to make new investments to reshape the portfolio, the only plausible course of action is to divest, or sell down, shares in existing group companies and to recycle capital into different assets.
- Based on our analysis and external advice and insights, Aurora Energy is the primary candidate for divestment.
- Updates to the company's Asset Management Plan, supported by [redacted] strategic review, indicates that capital investment spend across the next 10 years is likely to be significantly higher than previously planned. This increased capex spend will lift Aurora's debt levels across the next 10 years, to exceed $[redacted] by 2033.
- Combined with core Council's updated 10-year plan to fund infrastructure, projected group debt would exceed $[redacted] challenging debt limits, funding covenants and the group's credit rating. A downgrade in credit rating would increase the cost of borrowing.
- Elevated capex spend will grow the company's Regulated Asset Base (RAB), whilst also increasing debt levels. However, if a cash dividend stream is required by Council, this spend is also expected to require funding by increased debt.
- Divestment of the largest investment offers greatest potential to reduce concentration risk and reshape the portfolio.
- Our considered view is that Aurora Energy does not require public ownership in order to ensure that community and consumer interests are protected. Consumer outcomes are protected by the regulatory regime. Analysis indicates no discernible difference in performance of privately owned EDBs in other regions of New Zealand.

Assessment of divestment vs status quo

Market evidence indicates a 100% sale of Aurora could generate net proceeds of ~$[redacted]. This would be reinvested in the 'Aurora Fund' – a diversified investment fund.

- Advisors [redacted] have all highlighted that there is likely to be strong market interest in a quality infrastructure asset such as Aurora Energy. Transaction evidence indicates investors valuing infrastructure business at a premium over their Regulated Asset Base (RAB). RAB is a standardised measure of the value of infrastructure assets, regulated by the Commerce Commission. Our analysis indicates a potential valuation range of [redacted] to [redacted] Our divestment scenario assumes that 100% of DCHL's shares in Aurora Energy are sold to a third party investor.
- After repaying Aurora's debt, forecast at $576m, **net sale proceeds in the range of** [redacted] would be available to reinvest.
- We consider that the best way to achieve Council's objectives is to invest net sale proceeds into a diversified investment portfolio, notionally called 'The Aurora Fund'. This would be similar in nature to the Waipori Fund. Like the Waipori Fund, an appropriate mix of investments would be selected, based on Council's risk appetite, investment objectives and ethical position. Mechanisms can also be put in place to ensure that the capital value of the Fund is protected for the benefit of future generations.
- We consider that an average long-run total return of 8% with a distribution policy of 5% is reasonable. This would deliver a **cash distribution of** [redacted] in year 1.

Range	Low	Mid	High
Sale multiple	[redacted]	[redacted]	[redacted]
Net proceeds after debt available to invest in 'The Aurora Fund'	$[redacted]	$[redacted]	$[redacted]
Implied premium on sale (gross proceeds less RAB)	$[redacted]	$[redacted]	$[redacted]
Illustrated returns			
• **8% total return year 1**	$[redacted]	$[redacted]	$[redacted]
• **5% distribution year 1**	$[redacted]	$[redacted]	$[redacted]

- To achieve an 8% total return will require a high allocation of funds to growth assets like equities. It is important to note that 8% is a long-run average and, in any given year, there is risk that the fund will deliver lower returns or even a loss. This is also true of the Waipori Fund, but we would expect higher volatility in the Aurora Fund to achieve higher returns. Careful management will be required to balance maintenance of the capital value of the fund with Council's requirements for income and respond to volatility of returns.

Assessment of status quo vs divestment

Divestment scenario indicates $[redacted] higher dividends in next 8 years and higher total shareholder return.

- In our analysis, the status quo scenario is based on Aurora's FY24 10-year asset management plan. Dividends of $[redacted] may be possible from FY27, **but DCHL considers that there is significant risk around this forecast** due to inherent uncertainties in Aurora's high capital reinvestment requirements, regulatory settings and ordinary business risks. Any dividends during the period modelled would be funded by debt, placing further pressure on the DCC group debt position and its ability to operate within debt limits and maintain current credit ratings and lender covenant compliance. Ordinary, undiversified business risks will also drive some inherent volatility in Aurora's financial performance and ability to pay dividends. We note that Aurora last paid a dividend in FY17 as it has sought to remedy historical underinvestment.
- The divestment scenario assumes a mid-point sale at a multiple of [redacted] with proceeds reinvested in a new 'Aurora Fund', based on the assumptions on the previous page.
- Based on these assumptions, the divestment scenario delivers a superior dividend stream and higher shareholder return.
- Total forecast distributions are $[redacted] higher across the 8-year period modelled, an average of $[redacted] per year additional income to DCC. This equates to [redacted]% of current annual rates revenue.

Projected distributions $m

[redacted]

FY26 FY27 FY28 FY29 FY30 FY31 FY32 FY33

	Status quo scenario	Divestment scenario
Starting equity value 30 June 2025 Ending equity value 30 June 2033	$[redacted] $[redacted] (a)	$[redacted] $[redacted]
Total distributions over 8-year period	$[redacted]	$[redacted]
Total shareholder return	$[redacted]	$[redacted] (b)
IRR	[redacted]	[redacted] (b)

[a] Assumes [redacted] note analysis in section 5 of this report
[b] Includes [redacted] remium received upon sale of Aurora

Source: DCHL analysis

Conclusion

DCHL recommends 100% divestment of Aurora Energy, reinvesting into the 'Aurora Fund' – delivering higher distributions, lower debt and lower risk.

- Council has clearly signalled a desire for a higher and more sustainable cash return from its investments. This requires different assets.
- DCHL recommends full divestment of Aurora Energy and reinvestment of proceeds into a diversified investment fund, the 'Aurora Fund', held for the long-term and structured to meet its investment objectives.
- In the context of higher forecast capital expenditure and increasing debt profiles in both Aurora and core Council, divestment of Aurora would materially reduce group debt and risks to Council's credit rating, debt limits and lender covenant compliance.
- International infrastructure investors are actively seeking investments in regulated infrastructure assets and paying attractive premiums – we consider that now is the time to realise value that might not be available in the future.
- We believe that the divestment case is compelling, and this is not a marginal call. If Council wishes to achieve a materially different outcome, a material change is required. Supporting this recommendation would represent a large step towards achieving Council's investment objectives.

	Aurora Energy Limited	The 'Aurora Fund'
NATURE OF INVESTMENT	One company, one industry	Many companies, many industries (and other assets)
RISK PROFILE Uncertainty of returns	Regulated but specific single company and industry risks	Risk reduced by diversification
DISTRIBUTIONS Cash income to the shareholder	Low Especially short-term Funded by debt	Higher More sustainable Less volatile
CAPITAL GROWTH Growth in value of investments	Strong	Strong
CAPITAL REQUIREMENTS Need for reinvestment of cash and higher debt	High	Nil
LIQUIDITY Ability to turn into cash when needs change	Highly illiquid	Liquid
MARKET PREMIUM Additional value priced in by investors	Uncertain in the future	Available now

2. Background

DUNEDIN CITY HOLDINGS LIMITED

DCHL group structure

The DCHL Group contains both commercial and community-benefit investments.

- DCC owns 100% of the shares in Dunedin City Holdings Limited. In turn, DCHL owns 100% of the shares in each of the companies set out in the structure diagram opposite, except for Dunedin International Airport Limited (DIAL). DCHL owns 50% of the shares in DIAL; the other 50% is owned by the Crown.
- [redacted]
- We consider Aurora Energy, City Forests, Delta and DIAL to be primarily commercial investments i.e. they are held primarily to create value for the shareholder. We recognise, however, that this classification is not absolute. For example, the airport is also an important strategic asset, contributing economic benefits to the region.
- We consider the remaining companies to be primarily non-commercial. Whilst each company may generate commercial revenue from its assets or activities, the primary purpose of each of these investments is to drive economic, cultural or other community benefits.

- Therefore, DCHL group results reflect the netting of both commercial and non-commercial activities and any dividends paid up to DCC are made after funding non-commercial entities.

DCHL's strategic framework

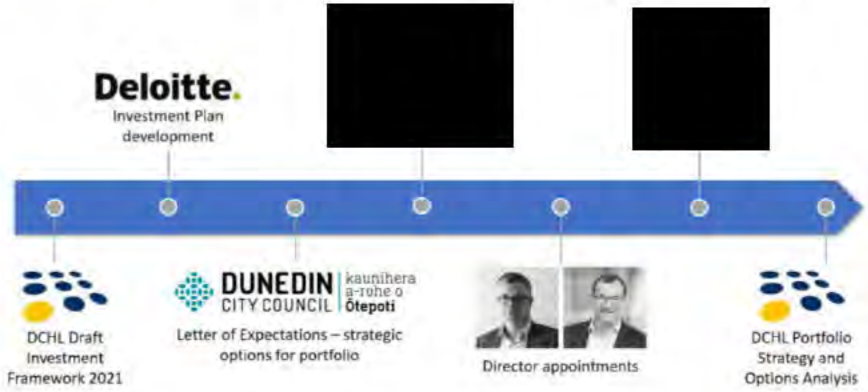
DCHL's purpose is to achieve the best for Dunedin from its investments.

- The purpose of Dunedin City Holdings Limited (DCHL) is to achieve the best for Dunedin from its investments. This purpose is supported by more specific strategic objectives and activities, as shown in the company's strategic framework.
- Dunedin City Council's Letter of Expectation for the year ending 30 June 2024 included an expectation "*to provide the DCC with strategic options for consideration (including consideration as to the future composition and direction of the portfolio) that allows the DCC to consider the implications for the DCC as shareholder with a particular focus on dividends/return on investment from DCHL.*"
- This report is provided in this context. DCHL's recommendation arises from a body of work in response to DCC's expectations and is intended to represent an important step in reshaping DCC's investment portfolio to meet the objectives that Council has articulated to us.

Strategic options analysis work to date

This report is the result of a cumulative body of work and expert advice.

- This recommendation report represents the next milestone in a cumulative and continuing body of work to think critically about the Council's legacy investment portfolio against what Council requires from its investments now and in the future.
- At a DCC group level, Deloitte has worked with Council to develop an investment plan.
- DCHL has given careful thought and analysis to the DCHL group of companies and how it meets the expectations of Council. Greg Anderson and Chris Milne, two directors with deep experience in investment banking and corporate finance were purposely appointed by Council to bring those skillsets to DCHL.
- [redacted] was mandated by the Aurora Energy board to undertake a strategic review of Aurora Energy including an assessment of its forecast capital structure and identification / evaluation of strategic options, considering a range of issues, including asset management planning and strategic planning.



- [redacted]

DCHL's capability

DCHL's board is professional, credible, independent and well-qualified to advise Council.

- Council has appointed highly experienced professional directors to the board of DCHL.
- Greg Anderson and Chris Milne were appointed as directors of DCHL on 1 July 2023. They bring leadership and experience in investment banking and corporate finance, including corporate finance advisory, valuations, capital raising, IPOs, mergers and acquisitions.
- Greg is Managing Director of Northington Partners, which authored the Strategic Review of Christchurch City Holdings.
- Chris is Managing Director of Murray & Co, which has carried out valuations of DCHL companies and other advisory work for DCHL.
- Greg and Chris's investment and corporate finance skillsets enhance the skill mix of the wider DCHL board which encompasses commercial, sales and marketing, accountancy, audit and risk, treasury, financial markets and public sector.
- As directors, they have a statutory duty to act in the best interests of DCHL and ensure that they have no conflicts of interest. They do not act for and will not act for any other parties in connection with any transaction involving DCHL group companies.

Tim Loan
Chair

Greg Anderson
Chair, Investment Committee

Chris Milne

Susie Johnstone

Richard Thomson

3. Current commercial investment portfolio

DUNEDIN CITY HOLDINGS LIMITED

Council's commercial investment portfolio

The portfolio comprises only four legacy assets, the product of history, not active investment choices.

- As discussed in section 2, the group holds only four investments that we consider to be 'commercial' investments at this time i.e. they are held primarily for the purpose of creating value for shareholders.
- We note that all of these companies are 'legacy' investments. Each arose from activities historically undertaken by, or investments historically made for, the benefit of the city. Over time, those activities were moved out of the direct sphere of Council delivery and appropriate governance structures were put in place.
- As investment assets, these companies represent 'wealth' to the city, with the ability or potential to deliver income to the city. However, from an investment perspective, Council has not actively chosen to invest in these specific assets, each with their own specific risk profile, sector issues, capital requirements etc.
- This section considers the make-up of Council's commercial investment portfolio, applying an investment lens.

Aurora ENERGY

- Electricity distribution business, servicing Dunedin and Central Otago
- Revenue $143m
- Total assets $805m

City Forests

- Owns and manages >20,000 hectares of forest in Otago
- Revenue $77m
- Total assets $353m

DELTA THINK.INFRASTRUCTURE

- Contractors constructing, managing and maintaining electricity infrastructure and greenspace
- Revenue $123m
- Total assets $66m

dunedin AIRPORT

- Airport operator with dairy farm and residential housing
- Revenue $21m
- Total assets $114m

Portfolio valuation and performance

The portfolio is substantial but unbalanced and over-weighted to Aurora and City Forests.

- The table below indicates a substantial portfolio with a valuation of $[redacted] in 2021. However, average annual earnings (profit) are relatively low at $45m per annum.
- The graphs to the right analyse the relative contributions of each company in the portfolio by valuation and by earnings (profit).
- The portfolio is highly undiversified and is not balanced. Two investments, Aurora and City Forests represent 90% of the value of the portfolio and 87% of its earnings.
- Aurora's capital value has grown substantially with its asset base, but profitability has lagged during this historical period.
- 56% of earnings are contributed by City Forests, but three quarters of those earnings are fair value gains on forestry assets (trees), correctly reported in its income statement, but which are non-cash i.e. those gains are expected to be realised in cash in future years when trees are harvested and the logs and other products produced are sold.

$	%	[redacted]	Average EBIT (b)
Aurora Energy	100%	[redacted]	13.7m
City Forests (c)	100%		25.0m
Delta	100%		4.1m
Airport	50%		2.0m
TOTAL PORTFOLIO			**44.8m**

(a) [redacted]

(b) 5-year average annual Earnings Before Interest and Tax (EBIT) FY19 to FY23

(c) City Forests EBIT includes an average of $18.6m of fair value gains on forestry assets

Portfolio performance

The portfolio has delivered reasonable capital growth, but dividends have fallen below expectations.

[redacted]

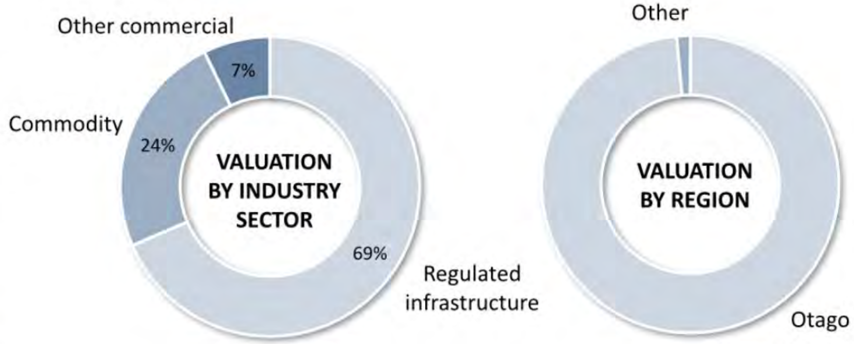
Source: DCHL analysis

- When assessing return on investment, we need to consider both capital growth and dividends paid. To a shareholder, both represent an increase in wealth. When a dividend is paid, the form of that wealth is transferred from the value of its shares in the company to cash.
- Trading subsidiaries are externally valued every three years. The last valuation in 2021 showed significant equity growth.
- [redacted]
- [redacted]
- Conversely, dividend income has been below expectations, especially since FY20 due to the impacts of Covid and subsequent economic impacts – slower growth, high inflation and high interest rates. The most significant investment, Aurora, has not paid a dividend since FY17, as cash generated has been reinvested in network assets, remedying historical underinvestment. For DCC as the ultimate shareholder, this essential work has delivered a substantial increase in wealth, but no cash to fund core services or interest on debt.

Portfolio risk profile

The portfolio has high concentration risk and lacks diversification.

- When selecting a portfolio, company-specific risks can be dramatically reduced through appropriate diversification – across investment classes, industry sectors, geographical markets etc.
- One expression of risk is volatility in results. If one holds shares in one company, returns will vary year to year in line with individual business performance, market conditions, regional economics, one-off events etc. If one holds shares in many companies, across many industries, many markets and multiple countries, unfavourable variation in performance in some companies will be offset by favourable performance in other companies.
- Council's portfolio is over-weighted to regulated industry assets (Aurora Energy and the airport). In a stable environment, regulated assets can be desirable since regulation enables predictable revenue. However, infrastructure businesses require continuous reinvestment i.e. cash generated by the business is invested back into its infrastructure assets, reducing or eliminating the availability of surplus cash to pay dividends. In recent years, Aurora Energy has been addressing historical underinvestment in its infrastructure assets, such that all cash generated by the business has been consumed by capital expenditure and no dividend has been paid since FY17.



Source: DCHL analysis

- Council's portfolio also has a high exposure to City Forests' business risks, which drive inherent volatility in financial performance - global commodity price movements (log prices), foreign exchange risk, weather events, carbon price risk, all of which are compounded in valuation risks to its forestry assets. Forestry assets are also a long-term investment – any new plantings will be harvested in 20-30 years.
- The portfolio also has a very high regional exposure – almost all assets and business activities are in the Otago region. New Zealand has seen recent examples of extreme events impacting severely on regions such as earthquakes in Canterbury and Cyclone Gabrielle in Hawkes Bay.

Outlook for portfolio companies

The outlook for dividends remains challenging and Aurora requires significant future capital investment.

- The table opposite analyses the outlook for group companies, with particularly consideration for ongoing capex investment requirements, growth prospects and ability to pay dividends.
- Aurora's asset management plan indicates continued demand for network investment in response to decarbonisation and population growth in Central Otago, driving higher debt and restricted dividends.
- City Forests has opportunities for continued organic growth through land acquisition but only if it can retain cash. In the current environment, it is bearing the highest load in meeting Council's dividend requirements.
- Delta and Dunedin Airport are smaller investments with limited growth prospects. Due to its location, the Airport will require high investment in landside infrastructure, particularly water assets.

Source: DCHL analysis

	Risks / opportunities	Capex	Growth	Dividends	Comments
Aurora Energy	• Decarbonisation/electrification driving demand • Central Otago growth • Regulation likely to allow for higher investment • Resourcing and supply chain cost pressures	High	✓	✗	High investment will grow earnings and equity but consume cash, increase debt and limit dividends.
City Forests	• Land acquisition opportunities as economics of climate change drive land use changes • Medium term value of carbon units • High exposure to China • Sector risks: commodity prices, foreign exchange and carbon price	Low	✓	✓	Earnings and availability of cash for dividends will be innately volatile. Trade-off between desire for cash dividends and growth opportunities through land acquisition.
DELTA	• Elevated investment of Aurora and electricity sector drives opportunities for Delta (Aurora c50% of revenue) • High customer concentration and contract risks • Resourcing and supply chain cost pressure challenges • Current profitability issues	Low	?	✗	Some growth opportunities but short- and medium-term operational challenges limit earnings and dividends.
dunedin airport	• Passenger recovery post-Covid faster than expected • Return of international routes, regional network etc • High landside infrastructure investment req'd (inc water) with limited scope to recover through revenue	High	?	?	Outlook stable but elevated capex will restrict dividend flow.

Summary observations

The portfolio lacks liquidity and is misaligned with Council's dividend expectations – it is over-weighted to assets that deliver long-term capital growth but not dividend income.

- Council has indicated in its Letter of Expectation a desire for "*a greater level of certainty [and transparency] when it comes to dividend payments and retentions*". In response to this, we make the following observations.
- The nature of equity investments is riskier than other forms of investment, such as bonds or term deposits, which offer contractual cash flows. Since earnings available for dividends are what is left over after a company meets its contractual obligations including debt – shareholders bear the residual financial risk in the business.
- The over-weighting of infrastructure businesses in the portfolio, most materially Aurora, means that it is structured towards capital growth and away from dividend income. This does not mean that Aurora is a poor investment or that is not run well – it is the nature of the investment.
- It is important to understand that return on investment comprises both capital growth (growth in the value of the investor's shares) and distributions (cash returned to the investor). Low distributions is not necessarily a measure of a poor investment, but if you desire an income from an investment, it might be that it is not the right investment for you.
- As an example, Meta Platforms Inc recently paid its first dividend, 20 years after the founding of Facebook. Its market capitalisation is USD 1.16 trillion. Shareholders have enjoyed extraordinary capital growth but, until now, no dividend income.
- There is also a high weighting to a forestry business, which has shown impressive capital growth as it has made considered additions to its estate. The business has also been profitable but, due to the 20-30 year maturity horizon for new plantings, there is an inherent lag between investment and the ultimate generation of cash.
- Another important characteristic of the current portfolio is a lack of liquidity. Liquidity is the ability to turn assets into cash when the investor needs it. All investments in the portfolio are shares in privately held companies, with no other shareholders, except for the Crown (in the case of DIAL). Accordingly, raising cash urgently through a sale process would be difficult, time-consuming and could erode value. By contrast, shares in companies listed on recognised stock exchanges can be traded easily.

Summary observations

Historical portfolio performance has been mixed with weak dividend flows. If Council wishes to increase dividend income from its investments and make it more consistent, it needs different assets.

- Assessing historical performance against DCHL's strategic objectives opposite, shows mixed results, predominantly due to the legacy structure of the portfolio.
- The group and governance structures, which are well-established, have enabled group companies to operate effectively and independently, within boundaries. They have also contributed to Council's goals, whilst striking a balance with the commercial freedom needed to generate the returns Council requires.
- The 2021 valuations indicated significant growth in the value of Council's investment portfolio and there is strong evidence that the value of the investment in Aurora has continued to grow significantly, as discussed later in this report. However, we recognise that growth has not been consistent across the group and there have been missteps along the way, notably the historical issues at Aurora, which we believe have now been largely remedied.
- Clearly, the amount and sustainability of dividends to Council have fallen short of expectations. However, we assert clearly that the primary reason for this is the nature of the assets inherited in the portfolio.

Enhance the value of Council's assets and investment for future generations	Sustainably grow the value of Council's investment portfolio	Provide a sustainable dividend to Council	Contribute to Council's goals for the city	Ensure independence between Council and companies' operations

- If Council wishes to increase dividend income from its investments and make it more consistent, it needs different assets.
- Returns can be improved or optimised through active, effective governance and management, and this is important, but gains are likely to be marginal, rather than transformative. For example, steps are being taken to improve the financial performance of Delta, which is budgeting to pay a dividend of $1m in FY24. With improved performance, dividends might return to the region of $2.5m+ but this will not shift the dial in the manner Council is seeking.

4. Portfolio options analysis

DUNEDIN CITY HOLDINGS LIMITED

Portfolio options analysis

Council's investment portfolio does not meet its current and future requirements. Change is required – we recommend reducing our existing shareholdings and creating an investment fund similar to the Waipori Fund.

- The conclusions from our analysis are clear. Council's investment portfolio does not meet its current and future requirements.
- The portfolio needs to be reshaped with these requirements:
  - Diversifying, reducing concentration risk and rebalancing across investment classes, industries, markets, geography etc;
  - Reflecting Council's risk appetite; and
  - With an appropriate weighting to investments delivering cash income.
- In deciding the appropriate mix of investments, the portfolio should be considered alongside DCC's other investments – the Waipori Fund and DCC's commercial property portfolio.
- If DCC's portfolio were generating significant free cash flows (surplus cash after capital expenditure), the portfolio could be reshaped incrementally by investing in other assets. That is not the case. Surplus funds are already required as income to fund services or to service debt. Therefore, the only plausible course of action is to divest, or sell down, shares in existing group companies and to recycle capital into different assets.
- This would have the effect of moving from shares in only four companies to having shares in many companies, as well as other appropriate investment classes e.g. bonds and fixed interest investments.
- We believe the most appropriate approach is to create a diversified investment fund, similar to the existing Waipori Fund, under professional fund management, applying the principles of evidence-based investing.

The Waipori Fund

The Waipori Fund is a well-established example of a diversified investment portfolio.

- The Waipori Fund was established in 1999, using proceeds from the sale of the Waipori electricity generation assets. The Fund is a diversified investment portfolio comprising a mix of asset classes, selected to meet Council's investment objectives.
- Equities comprise direct investments in shares in many companies, publicly traded in New Zealand, Australia and in international markets. This illustrates the principle of diversification. By holding shares in many companies, across many sectors and markets, a loss in value of one shareholding can be offset by gains in another.
- However, overall market risk might remain. The chart below illustrates that returns vary year on year and, in a given year, losses are possible. For example, significant losses were observed in 2008, triggered by the Global Financial Crisis. Craigs estimate the probability of a negative return on the Waipori Fund as 1 year in 4.5 – although historical performance has been more favourable than that.

Waipori Fund - target asset allocation

Asset class	%
NZ equities	16%
Australian equities	11%
International equities	15%
Property	3%
TOTAL GROWTH ASSETS	**45%**

Asset class	%
NZ fixed interest	45%
Short-term deposits	10%
TOTAL INCOME ASSETS	**55%**

WAIPORI FUND
Summary of Equity Investments

Equity	Market Sector	Currency	Holding	Market Price Local	Market Value NZD
N Z Equities					
Auckland International Airport Ltd	NZ Transportation	NZD	155,729	8.80	1,370,415
Contact Energy Ltd	NZ Utilities	NZD	140,000	8.01	1,121,400
EBOS Group Ltd (NZX)	NZ Healthcare	NZD	42,000	35.50	1,491,000
Fisher & Paykel Healthcare Corp Ltd (NZX	NZ Healthcare	NZD	77,700	23.60	1,833,720
Freightways Group Ltd	NZ Transportation	NZD	150,649	8.50	1,280,516
Genesis Energy Ltd	NZ Utilities	NZD	270,000	2.51	676,350
Mainfreight Ltd	NZ Transportation	NZD	41,000	69.30	2,841,300
Manawa Energy Ltd	NZ Utilities	NZD	109,000	4.29	467,610
Mercury NZ Ltd	NZ Utilities	NZD	212,000	6.60	1,399,200
Meridian Energy Ltd	NZ Utilities	NZD	328,000	5.54	1,817,120
Oceania Healthcare Ltd	NZ Retirement Villages	NZD	428,074	0.76	325,336
Port of Tauranga Ltd	NZ Transportation	NZD	135,000	5.60	756,000
Ryman Healthcare Ltd	NZ Retirement Villages	NZD	101,148	5.90	596,773
Spark New Zealand Ltd	NZ Telecommunications	NZD	213,500	5.18	1,105,930
Vector Ltd	NZ Utilities	NZD	165,500	3.73	617,315

Source: Craigs Investment Partners, Dunedin City Treasury

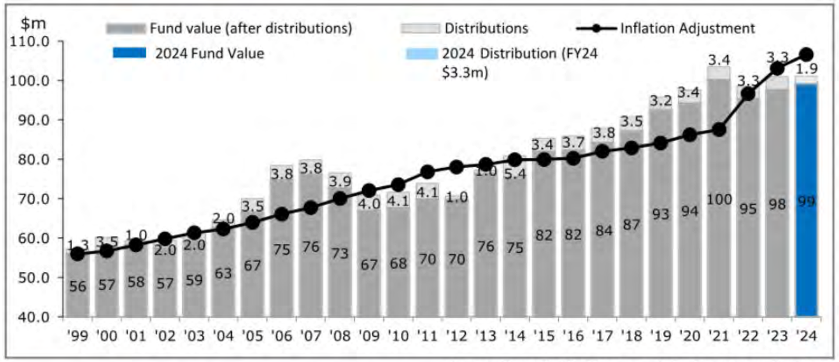
The Waipori Fund

The Waipori Fund is a well-established example of a diversified investment portfolio.

- The Fund is managed by Dunedin City Treasury Limited on behalf of Council, utilising professional fund management services and advice from Craigs Investment Partners.
- Council's objectives are set out in the Statement of Investment Policy and Objectives (SIPO) approved by Council. The SIPO defines the primary objectives of the fund to be:
    - Maximise its income, subject always to a proper consideration of investment risk and;
    - Grow the Fund's base value, while maintaining an agreed cash distribution to Council.
- The SIPO can also set rules to ensure that investments are consistent with the ethical position of Council.
- The returns on the fund since 2014 are shown opposite. Returns since inception in 1999 are similar. The Waipori Fund is relatively conservative. To achieve desired returns, the Aurora Fund is expected to require a greater allocation to growth assets such as equities. In line with the direct relationship between risk and return, we would therefore expect greater volatility in fund performance.
- Protecting the capital value of the fund against inflation is an important principle so targets are adjusted accordingly.

6.4% total return (since 2014)

10.2% return on equities (since 2014)



Source: Dunedin City Treasury, Craigs Investment Partners

Divestment considerations

Only Aurora Energy and City Forests have sufficient scale to shift the dial on reshaping the portfolio.

- The analysis opposite summarises our assessment of the relative attractiveness of divesting (selling or selling down) each of the four companies in the portfolio.
- Only Aurora Energy and City Forests have sufficient scale to 'shift the dial' in addressing the issues with the existing portfolio.

	Materiality	Saleability	Stakeholder risk	For divestment	Against divestment
Aurora Energy	✓	✓	?	• High capital demands drives high debt and limited dividends to DCC group, esp near term • Latest projections model debt $[redacted] in 2033 (assuming dividends resume in FY27) • Regulated returns and investment opportunities attractive to infrastructure investors with long term horizons and low cost of capital • Potential to reduce portfolio concentration	• Foregoing growth in equity value. • Stakeholder perception risk around losing control of essential regional infrastructure, although EDB regulatory framework mitigates this risk
City Forests	✓	✓	?	• Commodity price, foreign exchange, China and carbon price risks lead to volatile earnings and dividend flows • Potential to reduce portfolio concentration • Market demand for forestry assets	• Growth outlook for forestry industry • Favourable historical performance
DELTA	✗	✗	?	• Industry consolidation opportunity could be attractive to a competitor	• Too small to shift dial • [redacted]
dunedin AIRPORT	✗	?	✗	• Regulated assets attractive in market	• Too small to shift dial • Strategic importance to region • 50% stake, with Crown as other partner

Source: DCHL analysis

Divestment considerations

Aurora Energy is the primary candidate for divestment and offers greatest potential to reshape the portfolio.

- Based on our analysis and external advice and insights, Aurora Energy is the primary candidate for divestment.
- Updates to the company's Asset Management Plan, supported by [redacted] strategic review, indicates that capital investment spend across the next 10 years is likely to be significantly higher than previously planned.
- This increased capex spend will lift Aurora's debt levels over the next 10 years, towards $[redacted] by 2033.
- Combined with core Council's updated 10-year plan to fund infrastructure, projected group debt would exceed $[redacted] challenging debt limits, funding covenants and the group's credit rating. We note that a downgrade in credit rating would increase the cost of borrowing.
- Elevated capex spend will grow the company's Regulated Asset Base (RAB), increasing shareholder value. However, this spend is expected to either restrict the availability of cash to pay dividends or, if a dividend stream is required by Council, it may need to be funded by increased debt.
- [redacted] indicate strong demand from infrastructure investors and significant sale premiums.
- As the largest investment in the current portfolio, divestment offers greatest potential to reduce concentration risk and reshape the portfolio.
- Further assessment of the proposal follows in the next section.

Aurora ENERGY

5. Assessment of Aurora divestment proposal vs status quo

DUNEDIN CITY HOLDINGS LIMITED

About Aurora

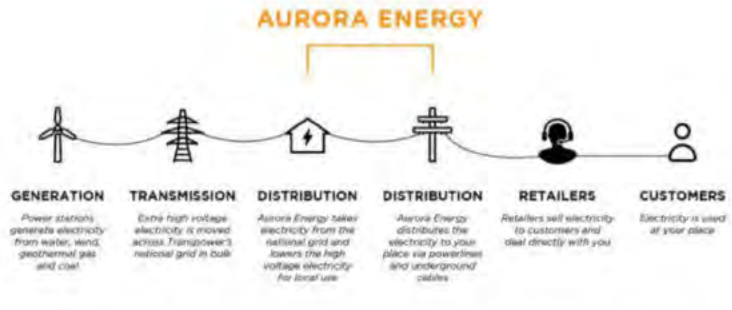
Aurora owns and operates the electricity distribution networks for Dunedin, Central Otago and Queenstown Lakes.

- Aurora owns and operates the regulated electricity distribution networks for Dunedin, Central Otago (including Wānaka) and Queenstown Lakes.
- Aurora's electricity network was largely built in the 1950s and 1960s and requires renewal, as over the intervening decades investment was kept low also helping to keep distribution prices for customers low. However, this led to gradual deterioration of asset condition and backlog of renewal work which started to impact performance.
- This culminated in Aurora having to bring forward greater investment and undergo a restructure which impacted profitability.
- Aurora agreed a Customised Price Path (CPP) with the Commerce Commission in 2021 to enable higher prices to be charged to customers than under the default price path (DPP), allowing funding of Aurora's capex programme to improve the network.
- Whilst the Dunedin population is relatively stable, current and forecast population growth in Central Otago and Queenstown Lakes is requiring enhanced infrastructure and new connections.

[redacted] industry risks

EDB sector is facing a significant step up in network investment, creating cash flow pressure.

- Retaining the group's investment in Aurora Energy means accepting the risks associated with that investment into the future.
- [redacted] was engaged by the Aurora Energy board to:
  - Evaluate Aurora Energy's current financial / operating environment;
  - To help Aurora Energy in developing a view on the overall strategic direction for the business;
  - Including an assessment of its forecast capital structure and identification / evaluation of strategic options, considering a range of issues, asset management planning and strategic planning.
- [redacted] highlighted a number of themes that are affecting most of the electricity distribution business (EDB) sector:
  - The EDB sector is facing a significant step up in network investment – due to decarbonisation (electric vehicle requirements, process heat conversion etc) and increased resilience requirements;
  - Regulatory returns (given higher interest rates) and capex will drive long-term value; but
  - Capex funding requirements will create cashflow pressures on EDBs;

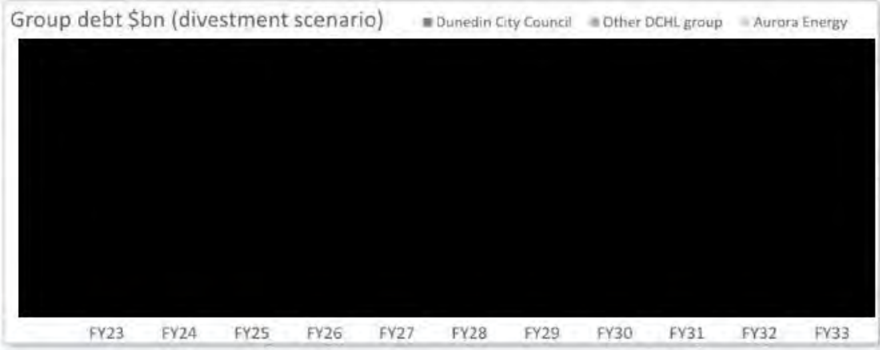


- This will limit free cash flows available for distribution in short- and medium-term; and
- Workforce constraints and inflation will put further pressure on capital expenditure.

Forecast group debt

Council and Aurora forecast debt will challenge funding limits, covenants and credit ratings.

- Aurora Energy's current base case indicates its debt moving to $[redacted] in FY33. Noting risks around demand, inflation, dividend requirements etc, other scenarios move closer to $[redacted] [redacted] observed that Aurora Energy has a relatively high level of leverage (its level of debt funding) compared with other EDBs.
- During the same time horizon, Council borrowing is also forecast to lift substantially to fund infrastructure improvements. [redacted]
- Divestment of Aurora would enable repayment of its debt – forecast at $576m at 30 June 2025 At 30 June 2033, group debt would be substantially lower at $[redacted]
- Core Council debt is assumed in our modelling to be unchanged under the divestment scenario opposite. As indicated later in this report, we expect a significantly higher cash flow to Council under the divestment scenario but Council would have choices around what this is applied to.



Source: Dunedin City Treasury, debt forecast 23 Feb 2024, modified by [redacted] base case scenario

Status quo scenario – forecast group debt

Council and Aurora forecast debt will challenge funding limits, covenants and credit ratings.

- DCC group interest costs are forecast to lift from $[redacted] in FY23 to $[redacted] in FY33.
- To manage risk of default, lenders put in place covenants, based on financial ratios. Net interest expense divided by rates income[a] is a key ratio used to measure the ability of a borrower to service debt. If the DCC group's ratio exceeds the covenant of 30%, it would be in breach of the lender's covenant. In the graph opposite, the dark line needs to remain below the dotted line to be compliant.
- Under the status quo scenario, this ratio is forecast to come under pressure, especially from FY30. In practice, specific covenants may be negotiated with lenders, but the graph opposite is indicative of the challenge posed by higher debt to lenders' assessment of risk.
- Elevated group debt, relative to rates income, could also risk a credit rating downgrade, impacting on group cost of funds. We know that debt burden is a key factor in S&P's rating process. It is possible that imposing debt limits and restricting capital expenditure in later years might become necessary.
- Under the divestment scenario, group interest costs will reduce significantly. The interest/rates ratio calculation would also be adjusted for interest and dividends from the Aurora Fund, creating significant headroom and increasing borrowing capacity.

Source: Dunedin City Treasury

(a) Calculation is based on consolidated DCC group accounts. Group interest expense is adjusted for interest income and dividends, noting that interest and dividends from subsidiaries and associates are eliminated on consolidation.

Status quo scenario – industry specific risks

Maintaining the status quo means retaining industry risks that could otherwise be diversified away.

- As highlighted in section 3, maintaining the status quo and retaining ownership of Aurora Energy in an undiversified portfolio, means that the portfolio and its returns remain subject to risks specific to the company and the industry in which it operates.
- Aurora management has also articulated a number of industry specific risks:
  - *Investment uncertainty* – capital investment and debt projections reflect current forecasts but industry-wide assumptions have been trending upwards, driven by system growth, resilience requirements and digital transformation.
  - *Cost inflation* – forecast supply chain and input costs could trend above inflation and regulatory inflation allowances, reducing earnings.
  - *Regulatory uncertainty* – future regulatory settings could impact on returns.
  - *Energy affordability* – as sector investment increases and energy prices to consumers rise, there is an increasing risk of adverse regulatory or political response.
- *Risk of major events* – earthquake, weather event, major network or system failure, safety incident etc.
- *Recruitment and retention risk* – there are sector wide skills shortages and high competition across the sector – as a regional operator, risks are higher than metropolitan EDBs.
- *Reputation risk* – adverse events could impact the reputation of Aurora and its owners since it is a lifeline utility that supports economic growth and prosperity.

Divestment scenario – indicative sale premiums

Market evidence suggests strong global interest with a potential valuation range of [redacted] to [redacted] RAB.

- [redacted] have all highlighted that there is likely to be strong global interest in a quality infrastructure asset such as Aurora Energy.
- Evidence indicates that regulated network assets trade at a multiple of Regulated Asset Base (RAB). [redacted]
- Specialised infrastructure investors pay premiums over RAB and have consistently demonstrated they are the highest value owners, having a lower cost of capital and valuing scale, New Zealand stability and other attributes – see the graphic opposite.
- The Regulated Asset Base (RAB) is equivalent to the 'book value' of the assets in a network and represents the accumulated value of investments that a business has made (considering cost, inflation and depreciation).
- However, some potential investors, with different investment objectives and/or capital structures, place a higher value on those assets than their book value. We refer to the difference between these two values as a 'premium'.

[redacted]

- Appendix 1 illustrates premiums achieved in New Zealand and Australia transactions involving regulated network assets since 2008, supporting the indicative range we suggest in our analysis.

Divestment scenario – illustrated returns

Modelling indicates potential net proceeds of ~[redacted] and higher cash returns.

- Our **divestment scenario** assumes that 100% of DCHL's shares in Aurora Energy are sold to a third-party investor.
- After repaying Aurora's debt, forecast at $576m, net sale proceeds in the range of $[redacted] would be available to reinvest.
- We consider that the best way to achieve Council's objectives is to invest net sale proceeds into a diversified investment portfolio, notionally called 'The Aurora Fund'. This would be similar in nature to the Waipori Fund.
- However, we note that the Waipori Fund is relatively conservative. A less conservative profile, designed for long-term hold, with a higher asset allocation to growth assets (e.g. equities) could achieve higher returns. We believe that an average long-run total return of 8% with a cash distribution policy of 5% is reasonable. This would deliver cash income to Council of $[redacted] to $[redacted] in year 1.
- As noted on page 28, in order to deliver a higher long-term return, we would also expect greater volatility in fund performance than the Waipori Fund.

Range	[redacted]	[redacted]	[redacted]
Sale multiple	[redacted]	[redacted]	[redacted]
RAB (at 30 June 2024)	$[redacted]	$[redacted]	$[redacted]
Gross proceeds	$[redacted]	$[redacted]	$[redacted]
Less: Aurora debt	($576m)	($576m)	($576m)
Net proceeds after debt available to invest in 'The Aurora Fund'	$[redacted]	$[redacted]	$[redacted]
Implied premium on sale (gross proceeds less RAB)	$[redacted]	$[redacted]	$[redacted]
Illustrated returns			
• **8% total return year 1**	$[redacted]	$[redacted]	$[redacted]
• **5% distribution year 1**	$[redacted]	$[redacted]	$[redacted]

Source: DCHL analysis

Status quo vs divestment - distributions

The divestment scenario delivers a superior dividend stream.

- In our analysis, the status quo scenario is based on Aurora's FY24 10-year asset management plan. Dividends of $[redacted] may be possible from FY27, but DCHL considers that **there is significant risk around this forecast** due to inherent uncertainties in Aurora's high capital reinvestment requirements, regulatory settings and ordinary business risks. Any dividends during the period modelled would be funded by debt, placing further pressure on the DCC group debt position and its ability to operate within debt limits and maintain current credit ratings and lender covenant compliance. Aurora Energy's financial performance and **dividends paid are likely to show volatility** due to the ordinary, undiversified business risks of a single company investment. This is inconsistent with Council's desire for consistent, sustainable distributions. We also note that Aurora last paid a dividend in FY17 as it has sought to remedy historical underinvestment.
- The divestment scenario assumes a mid-point sale at a multiple of [redacted] FY24 RAB, with proceeds reinvested in a new 'Aurora Fund', based on the assumptions on the previous page. Based on these assumptions, the divestment scenario delivers a superior dividend stream.

Sources: DCHL (divestment scenario), Aurora/[redacted] (status quo scenario)

- Total forecast distributions are $[redacted] higher across the 8-year period modelled, an average of $[redacted] per year additional income to DCC. This equates to [redacted]% of current annual rates revenue.

Status quo vs divestment – total return

The divestment scenario delivers higher total shareholder return.

- Total shareholder return evaluates the combined returns of both capital growth and distributions across the period modelled. The divestment scenario delivers the higher total shareholder return and Internal Rate of Return[(c)].
- As discussed earlier in this report, there is strong evidence that certain investors are prepared to pay a premium for infrastructure assets today. This value would be realised (converted to cash) on divestment.
- This raises the question whether a premium would still be available if the business were sold at some point in the future. Our analysis here assumes that it will not, since this is highly uncertain.
- If the same premium could be achieved in 2033, the status quo scenario would deliver a marginally higher shareholder return. Our sensitivity analysis at appendix 2 indicates that to deliver a total shareholder return (IRR) of [redacted]%, equal to our base scenario for a diversified portfolio, would require a premium of [redacted] to still be available in the market in FY33.

Range	Status quo scenario	Divestment scenario
Starting equity value 30 June 2025 Ending equity value 30 June 2033	$[redacted] $[redacted][(a)]	$[redacted] $[redacted]
Total distributions over 8-year period	$[redacted]	$[redacted]
Total shareholder return	$[redacted]	$[redacted][(b)]
IRR	[redacted]%	[redacted]%[(b)]

[a] Assumes [redacted]

[b] Includes one-off $[redacted] premium received upon sale of Aurora

[c] Internal Rate of Return (IRR) is a measure expressing annualised return on investment, in today's terms, noting that returns are realised at different times in the future under each scenario.

Source: DCHL analysis

- Our view, however, is that this would not change our overall assessment of the two scenarios. To the Council as an investor, we consider that distribution stream, concentration risk and impacts on debt/financial risks are more relevant and persuasive factors.

Consumer protection

Consumer outcomes are protected by the regulatory regime.

- Consumer outcomes are protected by the regulatory regime, overseeing 29 EDBs, irrespective of ownership structures. We note that privately owned EDBs among top performers in sector.
- The regulators are charged with ensuring the right outcomes for communities, applying knowledge and expertise across all EDBs, including Dunedin. If the regulatory framework is effective, we see no greater risk to Dunedin's network if it were to have a different owner.
- Council may influence Environmental/Social/Governance (ESG) outcomes but, in a highly technical industry, a Council owner would need to replicate the sector expertise of the regulators in order to achieve materially different outcomes for Dunedin. This is not practicable.
- In our view, Dunedin does not need to own its electricity distribution network in order to ensure the right outcomes for the community – this is the purpose of regulation. Furthermore, in the status quo, Council's ability to influence different outcomes for Dunedin is also limited by Aurora's regulatory framework.

Commerce Commission

- *Price-Quality Regulation* sets revenue caps and minimum quality standards
- *Information Disclosure Regulation* – wide-ranging powers to require publication of detailed information. ComCom monitors, analyses and summarises disclosures.

Electricity Authority

- Ensures compliance with *Electricity Industry Act* and other regulations
- Sets market and operational rules

Private ownership of EDBs

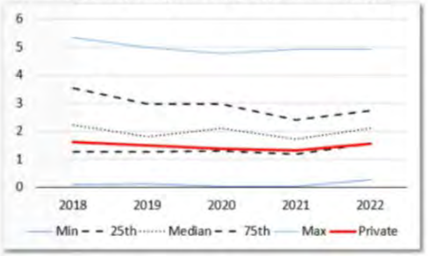
Analysis indicates no discernible difference in performance of privately owned EDBs.

- We note that three EDBs are owned by private interests:
  - Wellington Electricity (CK Infrastructure)
  - PowerCo (AMP, QIC, PINZ, Q Super)
  - FirstLight (Igneo)
- PowerCo and Wellington Electricity have been privately owned for over a decade, while FirstLight (previously known as Eastland) has only recently been privatised. It is therefore not possible to look at the direct impact on the quality and price of services pre and post privatisation. However, it is possible to compare the contemporary performance of these privately-owned EDBs against the performance of trust and council owned EDBs.
- Price or reliability alone is not necessarily a perfect indicator due to the differing geographies and populations of the various networks. However, there is no discernible difference in performance when qualitatively analysing a range of key indicators for private vs community networks. This is demonstrated below based on the ranking of the private networks (out of 29) and on their outage frequency and regulatory profits over time.

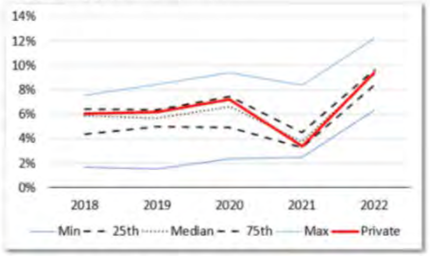
Private networks' relative performance ranking (out of 29)

Measure	PowerCo	Wellington Electricity	Note
Outage Frequency	12	28	1 = most faults
Return on Investment	13	10	1 = highest ROI
Average Daily Charge	11	12	1 = most expensive
Delivery Charge	11	18	1 = most expensive
Capex / total asset base	5	14	1 = highest spend

Normalised frequency of outages by ownership type



Regulatory profit as % of RAB



Source: Commerce Commission - Electricity Distributor Performance and Data

6. Recommendation

DUNEDIN CITY HOLDINGS LIMITED

Recommendation

DCHL recommends divestment of Aurora Energy and reinvestment in a diversified investment portfolio.

- DCHL recommends full divestment of Aurora Energy and reinvestment into a diversified investment fund, held for the long-term and structured to meet its investment objectives.
- Council has clearly signalled a desire for a higher and more sustainable cash return from its investments. This requires different assets.
- In the context of higher forecast capital expenditure and increasing debt profiles in both Aurora and core Council, divestment of Aurora would materially reduce group debt and risks to Council's credit rating, debt limits and lender covenant compliance.
- Divestment would represent a large step in reshaping Council's investment portfolio and enabling it to meet its investment objectives.

Option 1 – divestment

- Reduce financial risk by repaying debt, strengthening financial ratios and protecting credit ratings
- Increase cash distributions from investments in short- and medium-term
- Recycle capital into investment fund balancing income and capital growth to meet needs of shareholder
- Decrease risk due to diversification and improve liquidity
- Realise the premium over RAB currently available in market.

Option 2 – status quo

- Accept higher financial risk around DCC's ability to fund increased capital expenditure, risk to financial ratios and credit ratings
- Accept lower short- and medium-term distributions in favour of capital growth
- Accept higher level of risk due to absence of diversification and challenging EDB sector outlook
- Retain ownership of local infrastructure

Appendices

DUNEDIN CITY HOLDINGS LIMITED

(1) Comparable transaction multiples

This chart illustrates premiums achieved in New Zealand and Australia transactions involving regulated network assets since 2008, supporting the indicative range we suggest in our analysis.

New Zealand transactions have averaged [redacted] RAB since 2008

Australian and New Zealand regulated networks businesses

[redacted]

(2) Status quo vs divestment – IRR sensitivity analysis

The continued availability of a premium over RAB is highly uncertain.

- We note that a key assumption in the status quo scenario is that the premium that can be realised on divestment today will no longer be available in [redacted]. This is highly uncertain – it is difficult to assess the demand for such assets from infrastructure investors [redacted].
- This sensitivity analysis indicates that to deliver a total shareholder return [redacted] equal to our base scenario for a diversified portfolio, would require a premium of [redacted] to still be available in the market in [redacted]
- Arithmetically, the sensitivity analysis above suggests that, if the current market premium continues to be available in the long-term, total shareholder returns would be marginally more favourable under the status quo scenario.
- However, this report notes that we consider that other factors are more relevant and persuasive in our assessment.

Status quo IRR for range of FY33 multiples

IRR

[redacted]

Source: DCHL analysis

Information contained in this report is
STRICTLY CONFIDENTIAL AND COMMERCIALLY SENSITIVE.
Unauthorised disclosure could be destabilising to employees and erode shareholder value.

Dunedin City Council

Statement of Comprehensive Revenue and Expense
for the Years Ended 30 June 2024 - 2034

Actual 2023 $000		Annual Plan Budget 2024 $000	
	Revenue from continuing operations		[redacted]
191,150	Rates revenue	203,358	
2,839	Development and financial contributions	3,844	
50,049	Subsidies and grants	37,507	
18,353	Financial revenue	20,785	
71,644	Other revenue	74,119	
334,035	**Total operating revenue**	**339,613**	
	Expenses		
169,400	Other expenses	143,607	
75,285	Personnel expenses	81,212	
346	Audit fees	366	
16,038	Financial expenses	26,281	
110,128	Depreciation and amortisation	117,128	
371,197	**Total operating expenses**	**368,594**	
(37,162)	**Operating surplus/(deficit) from continuing operations**	**(28,981)**	
-	Share of associate surplus/(deficit)		
(37,162)	**Surplus/(deficit) before taxation**	**(28,981)**	
(781)	Less taxation	(370)	
(36,381)	**Surplus/(deficit) after taxation**	**(28,611)**	
	Attributable to:		
(36,381)	Dunedin City Council and Group	(28,611)	
-	Non-controlling interest	-	

Dunedin City Council

Statement of Other Comprehensive Revenue and Expense
for the Years Ended 30 June 2024 - 2034

Actual 2023 $000		Annual Plan Budget 2024 $000	
	Other comprehensive revenue and expense		[redacted]
81,709	Gain/(loss) on property plant and equipment revaluations	120,000	
-	Gain/(loss) on property plant and equipment disposals	-	
20	Gain/(loss) of cash flow hedges at fair value through other comprehensive revenue and expense	-	
81,729	**Total other comprehensive revenue and expense**	**120,000**	
(36,381)	Net surplus/(deficit) for the year	(28,611)	
45,348	**Total comprehensive revenue and expense for the year**	**91,389**	
	Attributable to:		
45,348	Dunedin City Council and Group	91,389	
-	Non-controlling interest	-	

Dunedin City Council

Statement of Changes in Equity
for the Years Ended 30 June 2024 - 2034

Actual 2023 $000		Annual Plan Budget 2024 $000	
	Movements in equity		[redacted]
4,309,630	Opening equity	4,399,089	
45,348	Total comprehensive revenue and expense	91,389	
4,354,978	Closing equity	4,490,478	

Dunedin City Council

Statement of Financial Position
for the Years Ended 30 June 2024 - 2034

Actual 2023 $000		Annual Plan Budget 2024 $000
	Current assets	
9,085	Cash and cash equivalents	11,590
4,396	Other current financial assets	4,380
25,707	Trade and other receivables	17,713
359	Taxation refund receivable	370
346	Inventories	318
905	Non current assets held for sale	-
1,750	Prepayments	500
42,548	**Total current assets**	34,871
	Non-current assets	
200,351	Other non-current financial assets	201,068
133,789	Shares in subsidiary companies	136,339
3,948	Intangible assets	4,388
110,520	Investment property	118,375
4,405,336	Property, plant and equipment	4,657,437
4,853,944	**Total non-current assets**	5,117,607
4,896,492	**Total assets**	5,152,478
	Current liabilities	
45,644	Trade and other payables	43,174
7,035	Revenue received in advance	5,252
10,037	Employee entitlements	7,517
-	Current derivative financial instruments	-
-	Current portion of term loans	-
62,716	**Total current liabilities**	56,443
	Non-current liabilities	
460,273	Term loans	588,973
18,205	Provisions	16,264
-	Non-current derivative financial instruments	-
320	Other non-current liabilities	320
478,798	**Total non-current liabilities**	605,557
	Equity	
1,686,179	Accumulated funds	1,669,042
2,657,874	Revaluation reserves	2,811,165
10,925	Restricted reserves	10,271
-	Cash flow hedge reserves	-
4,354,978	**Total equity**	4,490,478
4,896,492	**Total liabilities and equity**	5,152,478

[redacted]

Dunedin City Council

Statement of Cash Flows

for the Years Ended 30 June 2024 - 2034

Actual 2023 $000		Annual Plan Budget 2024 $000
	Cashflow from Operating Activities	
	Cash was provided from operating activities:	
190,154	Rates received	202,646
122,214	Other revenue	114,649
7,814	Interest received	7,548
6,821	Dividend received	12,254
1,220	Taxation refund received	370
	Cash was applied to:	
(234,120)	Supplies and employees	(228,795)
(14,599)	Interest paid	(24,649)
79,504	**Net cash inflow (outflow) from operations**	84,023
	Cashflow from Investing Activities	
	Cash was provided from investing activities:	
161	Sale of assets	120
-	Reduction in loans and advances	-
-	Decrease in investments	-
	Cash was applied to:	
-	Increases in loans and advances	-
(3,184)	Increase in investments	(2,550)
(205,382)	Capital expenditure	(209,726)
(208,405)	**Net cash inflow (outflow) from investing activity**	(212,156)
	Cashflow from Financing Activities	
	Cash was provided from financing activities:	
126,000	Loans raised	128,700
	Cash was applied to:	
-	Loans repaid	-
126,000	**Net cash inflow (outflow) from financing activity**	128,700
(2,901)	**Net increase/(decrease) in cash held**	567
11,986	Opening cash balance	11,023
9,085	**Closing cash balance**	11,590

[redacted]

Dunedin City Council

Financial Strategy Information

	[redacted]
Debt	
Debt forecast	
Debt limit (at 250% of revenue)	
Total revenue	
Gross debt limit (less than 250% of revenue)	
Target Achieved	
Rates Increase	
Rates revenue	
Increase	
Operating Surplus	
Operating surplus greater than zero	
Target Achieved	
Balanced Budget	
Operating surplus	
Less:	
Development Contributions	
Vested Assets	
External Subsidies for new capital projects	
Gain on fair value of investments	
Balanced budget surplus/(deficit)	
Target Achieved	

Dunedin City Council

Other Financial Metrics

	[redacted]
Interest expense	
Interest expense to term debt %	
Interest as a % of rates (less than 20%)	
Target Achieved	
Interest cover rates revenue	
Interest as a % of total revenue (less than 15%)	
Target Achieved	
Interest cover total revenue	
Operating cashflow exceeds interest expense by 2.5 times	
Target Achieved	
Cashflow	
Operating cashflow	
Depreciation expense	
Operating cashflow less depreciation expense	
Target Achieved	

Dunedin City Council

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Dunedin City Council

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Dunedin City Council

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		-	

Dunedin City Council

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for the Years Ended 30 June 2024 - 2034

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10,925	Restricted reserves	10,271	
-	Cash flow hedge reserves	-	
4,354,978	**Total equity**	4,490,478	
4,896,492	**Total liabilities and equity**	5,152,478	

The accompanying notes and accounting policies form an integral part of these financial statements.

Dunedin City Council

Statement of Cash Flows

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7,814	Interest received	7,548
6,821	Dividend received	12,254
1,220	Taxation refund received	370
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(14,599)	Interest paid	(24,649)
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	Cashflow from Investing Activities	
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	Cash was applied to:	
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(2,901)	**Net increase/(decrease) in cash held**	567
11,986	Opening cash balance	11,023
9,085	**Closing cash balance**	11,590

[redacted]

Dunedin City Council

Financial Strategy Information

[redacted]

Dunedin City Council

Other Financial Metrics

[redacted]

anderson lloyd.

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1 March 2024

Sandy Graham
Chief Executive/Tumu Whakarae
Dunedin City Council

Sandy.graham@dcc.govt.nz

Dear Sandy

[redacted]

2404593 | 8468634

Auckland • Christchurch • Dunedin • Queenstown

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page 2

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page 4

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page 5

Yours faithfully
Anderson Lloyd

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6 March 2024

Karilyn Canton
Dunedin City Council
50 The Octagon
DUNEDIN

Email: karilyn.canton@dcc.govt.nz

Dear Karilyn

PROPOSAL TO DIVEST AURORA ENERGY LIMITED

The Dunedin City Council ("DCC") has requested us to review and make comment on the proposal provided by the board of Dunedin City Holdings Limited ("DCHL") (report: Proposal to divest Aurora Energy Limited and reinvest in diversified portfolio, dated March 2024).

Context

The DCC has been working through the development of an investment plan. Key elements of this included:

- The need to diversify the portfolio (there is a large investment concentration risk with Aurora Energy Limited comprising 66% of the portfolio).
- The nature of an infrastructure investment such as the Aurora energy network (and the future capital expenditure requirements) doesn't align well with the DCC as shareholder.
- The need for improved dividends for the DCC. The historical dividends received by the DCC have not been satisfactory.
- In 2016 Aurora Energy Limited had a number of issues, including in relation to the state of the network, that resulted in accelerated capital expenditure spend to improve the state of the network. As a result of the increased capital expenditure requirement no dividend was provided for a number of years. This has a material impact on the overall performance of DCHL.

DCHL Recommendation

On page four of the report the DCHL recommendation is a 100% divestment of Aurora Energy, with proceeds reinvested into the 'Aurora Fund'. This is underpinned by the following rationale as extracted from their report:

- Council has clearly signalled its desire for higher and more consistent, sustainable cash returns from its investments. To achieve this, Council needs different assets.

- Aurora is delivering reasonable capital growth but, as an infrastructure business with growing demand, significant capital expenditure requirements will consume operating cash flows and require more debt. Divestment of Aurora will reduce group debt by a forecast $576m, avoid further group debt and reduce risk to Council's future credit ratings, debt covenants and borrowing costs.

Deloitte.

- Transaction evidence, indicates that major infrastructure investors, with different objectives to Council's, are willing to pay attractive premiums to buy regulated infrastructure businesses. This creates an opportunity to realise additional value that might not be there in the future.

- Investing the proceeds in a diversified investment portfolio, with risk diversified across many different assets, rather than just one, will enable long-run higher cash returns that are more sustainable.

Comments

We agree with DCHL's proposed recommendation. The sale of Aurora Energy Limited is essential in order for the DCC to be able to achieve its objectives, primarily:

- The need to diversify the portfolio and eliminate the concentration of investment risk (that manifested itself in 2016 in relation to the returns to DCHL).

- The need to diversify the portfolio across many different assets to enable long-run higher cash returns that provide a more sustainable return for DCC.

In addition, we make comment on other key aspects of the proposal:

- As outlined on page 24, the historical performance has been mixed with weak dividend flows.

- A fund, similar to the Waipori Fund, is a sensible structure for the reinvestment of the proceeds received from the sale.

- The range of sale values used in the analysis is supported by actual sales in recent times.

- The assumptions in relation to future long-run returns from a diversified portfolio are reasonable.

- The proposed distributions under the divest option are $[redacted] higher across the 8-year period modelled. This is material and would have a positive impact on the DCC's ability to invest in other initiatives and/or manage future rating increases.

- The DCC, as part of the investment plan, will have a policy in place to protect the capital from the sale of the Aurora Energy business. This reduces the risk relating to the loss of capital in the future.

Disclaimer

Our review has been carried out on the following:

1. We did not carry out any form of due diligence or audit on the underlying numbers used in the analysis.
2. Our review has been based on the information provided by DCHL.
3. Our review is provided on a hold harmless basis in that Deloitte does not accept any liability to you or any other person, including in relation to your reliance on the advice given in this letter. You will not make any claim or demand or bring any proceeding against us in connection with this advice.

Deloitte.

If you have any questions in relation to our advice, please contact us.

Yours sincerely

Kyle Cameron
Partner
for Deloitte Limited (as trustee for the Deloitte Trading Trust)
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