

Auckland International Airport Limited

Adjusted Commerce Commission Model Review

3 August 2001

DISTRIBUTION:

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cc: Audit Committee

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INTRODUCTION

The Commerce Commission released its Draft Report dated 3 July 2001 of the Price Control Study of Airfield Activities at Auckland, Wellington and Christchurch Airports. Included in this Report was a financial analysis in respect of past and projected airfield activities at Auckland International Airport ("AIAL"). This financial analysis is referred to in this document as the Commerce Commission Model (the "CC Model").

AIAL has reviewed this model and is of the opinion that it includes a number of fundamental errors in respect of financial information presented and assumptions made. AIAL has assumed that this has arisen largely because the model preparer did not have direct access to AIAL's accounting and other records. Whilst incomplete records are an inherent issue in recreating data for prior periods AIAL does have access to more complete information including underlying records supporting the Company's 2000 disclosure financial statements and 1999 pricing consultation data.

AIAL has identified where, in their opinion, the model is in error, has updated it for financial information from their records and amended assumptions to reflect their knowledge of AIAL operations. The updated model is referred to as the "AIAL Model".

The changes to the model have fundamentally changed the key ratios the model was designed to calculate.

In our role as auditors of AIAL, with access to the company's records, we have been requested to review and report on the validity of the amendments made by AIAL to the CC Model.

In this report we have identified where we have been able to confirm the financial information changes to the company's records, where changes in assumptions are supported by information from the company's records and assumptions which are based on judgement and knowledge of AIAL operations,

SCOPE

The scope of the Model Review is set out in our engagement letter dated 23 July 2001. This is summarised below.

The scope of the Model Review encompassed a review of the AIAL Model to identify whether;

- (a) The internal logic used in the AIAL Model was mathematically consistent and correct
- (b) The AIAL Model incorporated and applied all stated assumptions.
- (c) AIAL modifications to financial information inputs and assumptions of the CC Model were appropriate or reasonable.

Specific limitations and exemptions from the scope of work are detailed below:

- (a) We were not required to comment on the validity of the underlying assumptions made in the CC Model on which the AIAL Model was based and any comments we have made on these should not be construed as a comment on the accuracy or otherwise of the underlying

commercial assumptions; and

- (b) We have not reviewed any parts of the Model that were not modified by **AIAL** including:
- Worksheets pertaining to WACC calculations
 - Other such information relating to target rates of return
 - **CC Model** assumptions and data not modified by the **AIAL** Model

In addition to these areas, **Deloitte** have not reviewed the source information pertaining to:

- Future expenditure
- MCTOW growth
- Financial data used in 1999 pricing model
- Expected future depreciation on capital expenditure
- Inflation rates used for spreading unrealised gains from asset revaluations over prior years
- Demand elasticity
- Optimisation or efficiency assessments

METHODOLOGY

The following methodology was adopted for the Model Review:

- (a) Initial discussions with representatives of **AIAL** to review the layout and structure of the Model;
- (b) A review of the logic and mathematical consistency with the **CC Model** of the calculations performed within the **AIAL** Model was undertaken except of those parts of the **AIAL** Model outside the scope of our review as stated in section 5 below;
- (c) We performed a cell by cell review of the **AIAL** Model, except for those parts of the **AIAL** Model outside the scope of our review; and
- (d) We have highlighted any errors or potential issues in relation to the **AIAL Model** and, as appropriate, requested clarification via representatives of **AIAL** of any issues arising from our review of the Model logic, financial data or assumptions.

SUMMARY OF FINDINGS

In our opinion, formed on the basis of the work performed as described more fully below under scope and subject to the restrictions in the scope of our review also described below:

- (a) The internal logic used in the AIAL Model is mathematically consistent with the CC Model.
- (b) We have not identified any material errors or issues in the internal logic or mathematical consistency of the AIAL modifications to the; and
- (c) The AIAL Model incorporates and applies all the original assumptions made in the CC Model as adjusted for the modified assumptions applied by AIAL as stated in Appendix 1.
- (d) The revised financial information that feeds into the AIAL Model has been checked to the underlying financial records of AIAL to the extent described in Appendix 1 attached. We have not identified any material errors in these figures.
- (e) We have commented on the appropriateness of any revised assumptions in Appendix 1 attached. Except for the matter described in paragraph (g) below we consider the revised assumptions to be appropriate.
- (f) It should be emphasised that the adjustments made in the AIAL Model to
 - the asset base;
 - the revaluation profit; and
 - the methodology of forecasting returns for future periodshighlight material errors in the financial data and logic used in the CC Model and accordingly the CC Model is not a reliable basis upon which to determine the benefits of price control.
- (g) Neither the CC Model nor the AIAL Model used direct cost drivers to determine the proportion of company expenses that related to airfield activities pre 1999. The CC Model uses the proportion disclosed in the June 2000 disclosure accounts and applies this to all prior periods. The AIAL Model modifies this assumption by a factor of the change in airfield revenue as a percentage of total company revenue over time. We consider it reasonable to assume a positive correlation between revenue mix and expense mix however there are a number of other variables which could impact the proportion of company expenses relating to airfield activities. Without an analysis based on direct cost drivers, such as nature of maintenance projects, numbers and cost, of employees and consultants and percentage of time spent on each activity undertaken by employees and consultants, (and there are likely to be some difficulties in obtaining historical data to perform such an exercise) we are unable to quantify the impact of the change over time in the proportion of total AIAL activity that relates to airfield activity on the airfield expenses. Accordingly we are unable to conclude whether the CC Model or the AIAL Model produces more accurate expense allocations.

The detailed results of our review are reported in Appendix 1 under the following headings:

- Review of AIAL modifications to financial data used in the CC Model.
- Commentary on AIAL Model modifications to assumptions used in the CC Model.
- A review of the mathematical consistency and internal logic of the model (using the CC Model as the base).

APPENDIX I DETAILED RESULTS

1 Mathematical consistency and internal logic of AIAL model

The review of the AIAL model included assessing the integrity of the internal formulae and mathematical consistency contained within the model, using the CC Model as the base case.

We have discussed a mathematical matter in relation to the expense allocation driver adjustment in section 3 of this Appendix.

There were no material unadjusted errors noted in the mathematical consistency and internal logic of the AIAL Model.

2 Review of AIAL modifications to financial data used in the CC Model

Area	Basis of AIAL financial numbers	Basis of Commerce Commission numbers	Deloitte Response
Airfield Assets in June 1999 and June 2000	Detail behind June 2000 audited Disclosure Accounts and the 1999 Pricing Proposal	June 1999 Pricing Proposal	The weighting of expenditure for preceding years is based on 2000 weightings. For consistency purposes the June 2000 disclosure accounts should be used to calculate the weighting for preceding years. Deloitte agreed the balances used by AIAL to supporting schedules for the audited June 2000 disclosure accounts and the final Pricing Proposal for June 1999 (information not in the public domain).
Taxation	The AIAL Model has used the effective tax rates from prior audited financial statements to estimate the tax that would have been payable solely for the Airfield activities.	The CC Model used the company tax rate of 33 cents.	The effective tax rates used in the AIAL Model are consistent with the published financial statements.

Area	Basis of AIAL financial numbers	B&is of Commerce Commission numbers	Deloitte Response
Optimisation of 2nd Runway	AIAL have used the carrying value of the 2 nd Runway additions in the financial statements for the years prior to the initial revaluation.	The Commission has estimated the value of the 2 nd runway by working backwards from published movements in asset carrying values, depreciation etc.	<p>Deloitte agree with the nature of the AIAL assumption that any optimisation adjustment for each year should be limited to the value of the 2nd runway as contained within the asset base. As the first valuation of the runway was conducted in 1999, the value in the asset base prior to this was essentially the historical cost carrying value of the additions.</p> <p>Deloitte have agreed the amounts noted by AIAL to a listing prepared by the AIAL Properly Manager who has based the listing on purchases of land parcels since 1989, Deloitte have not audited this listing for completeness nor have we agreed the purchased land parcels to the fixed asset register.</p>
Optimisation of Seabed	AIAL have used the actual carrying value of the Seabed in the financial statements of each year	The Commission has estimated the value of the Seabed in the same manner as the 2 nd Runway optimisation described above.	<p>The same logic holds true for the Seabed as for the 2nd runway. The amount of any optimisation adjustment should be limited to the amount that is in the original asset base, We therefore concur with the nature of the AIAL assumption modification.</p> <p>The Seabed value has been agreed into the valuation report issued prior to the Pricing Proposal in 1999.</p>
Optimisation of Seawall	AIAL have used the estimated carrying value for the Seawall in the financial statements of each year (derived from the vesting valuation).	The Commission has used the value contained within the ODRC value as at 1999 for all preceding years.	<p>The same logic holds true for the Seawall as for the 2nd runway. The amount of any adjustment should be limited to the amounts that are in the original asset base. We therefore concur with the nature of the AIAL assumption modification.</p> <p>Deloitte have reviewed the vesting report for initial values used, however we have not been able to agree the estimated value of the Seawall as a separate item as the vesting report is not reported at a detailed level, Deloitte have agreed the amount used as the value in the model is the same as that used in the final Pricing Proposal in 1999.</p>

Area	Basis of AIAL financial numbers	Basis of Commerce Commission numbers	Deloitte Response
Scenario's 1 – 7 & 9	All of these scenario's are linked to Scenario 8, up to the NOPAT (excluding revaluation adjustments), therefore the changes above that have effected Scenario 8 have flowed through to the other scenario's, Refer below for assumptions below the NOPAT line in each scenario.	Flow through effect from the Commission's Scenario 8. Refer below for assumptions below this line in each scenario.	The changes noted above have flowed through correctly from Scenario 8 up to the NOPAT (excluding revaluations adjustments) line in the AIAL Model. Refer below for assumptions below this line in each scenario.
Asset Revaluation Adjustment	The asset revaluation adjustments have changed during the Scenario's 1 – 7 & 9 based upon the changed asset base numbers that are dependent both on Scenario 8 and the Scenario parameters.	The same asset base is used as Scenario 8 throughout, only changes relate to Scenario parameters.	The changes in the asset base have correctly flowed through to the asset revaluation adjustment line.
Calculation of Benefits	The underlying numbers that feed the Benefit's calculation have changed; as a result of changes to the Scenario 8 spreadsheet in the AIAL Model (these changes are commented on elsewhere in this report), including the Asset Base and the expenditure	The Commission numbers have been linked to Scenario 8 however have remained constant for three years.	The Benefits spreadsheet has taken into account a number of additional variables that have altered the projected returns of AIAL. These adjustments include additional CAPEX, expenditure growth (both operating and depreciation) and revenue growth (both in volume and price). Deloitte have ensured that the changes have been flowed through using correct internal logic to the Benefits sheet, refer below for discussion on these changes as a change in assumption made by AIAL.

Area	Basis of AIAL financial numbers	Basis of Commerce Commission numbers	Deloitte Response
	<p>growth in Years 1-3. AIAL have also included the net benefit calculation contained in the Commerce Commission Draft Report but not in the CC Model. The methodology in calculation the net benefits is consistent with that applied by the Commission in its Draft Report</p>		
<p>Changes in CAPEX</p>	<p>CAPEX numbers are based upon actual CAPEX schedules for the current year (June 01), proposed Business Plans for the following year (June 02) and an estimated amount in final year (June 03)</p>	<p>The Commission has made no allowance for CAPEX in the coming years.</p>	<p>Deloitte concur that it is appropriate to include estimated future capital expenditure on airfield assets in the calculation of future asset base and hence future returns.</p> <p>Deloitte have agreed the airfield capital expenditure included in the AIAL Model for the June 01 year to the capital expenditure schedules provided to support the fixed asset carrying values in the financial statements for the year ended 30 June 2001 currently being audited by Deloitte. Deloitte has confirmed that the June 02 CAPEX value is based upon a business plan dated 29 June 2001 (and provided to the Board of Directors on July 4 2001) that sets out the indicated amount of CAPEX for the 2002 financial year. We have discussed the June 03 estimate with management who have indicated that roughly \$80M is to be spent over June 02 and 03. There are no detailed schedules to support the \$40M capital expenditure estimate for the 03 year and we have therefore not performed any further work to corroborate this estimate.</p>

3 Commentary on AIAL Model modifications to assumptions in the CC Model

Deloitte have analysed the assumptions in the AIAL model and provided commentary where the assumptions vary between the two models.

Area,	AIAL Assumption	Commerce Commission Assumption	Deloitte Response
Expenditure	AIAL have adjusted the expenditure allocated to the airfield by a revenue factor. This factor is the movement in the proportion of airfield revenue to total revenue between each year and the 2000 year. This factor has been multiplied by the expenditure as allocated by the Commerce Commission.	The Commerce Commission have used the proportion of airfield expenditure to total expenditure in 2000 and used this factor to allocate the airfield expenditure for proceeding years for each expense category.	<p>There is an inherent assumption built into the CC Model that the airfield activities as a proportion of total costs has remained unchanged over an 11 year period. The past 11 years has seen fundamental changes in the operations of the airport as it diversified into other areas. Landing charges as a proportion of total income has dropped from 40% in 1989 to 26% in 2000. Deloitte concur with AIAL's viewpoint that these other areas incur costs previously not recognised and as such believe that the Commission's method of allocating expenditure based on most recent figures may result in inaccurate data.</p> <p>AIAL has modelled the impact of this diversification on expenses using airfield revenue as a proportion of total revenue and adjusting the CC Model assumption to incorporate this revenue factor. Intuitively the diversification of airport operations is likely to be correlated to the proportion of total company expenses relating to airfield activities. However, as there are a number of other factors, which would influence each component of expenditure, there is not sufficient evidence to suggest that the revenue adjustment to the assumption alone provides a more accurate cost driver than that used by the Commission. Mathematically we note that the formula has been calculated and applied as stated by AIAL in their submission document and that the formula could have the potential to allow a situation where the allocated expenditure could be higher than the total expenditure incurred by the airport but that this has not occurred.</p>

Area	AIAL Assumption	Commerce Commission Assumption	Deloitte Response
			<p>Due to difficulties in sourcing reliable historical information on direct cost drivers within the timeframe of our review, Deloitte are unable to conclude whether the assumptions used by AIAL provide a more accurate result than the allocation methodology adopted by the Commerce Commission.</p>
Taxation	<p>The effective tax rate for each financial year should be used to calculate the proportion of tax payable by the airfield.</p>	<p>The corporate tax rate of 33cents should be applied to the airfield,</p>	<p>Deloitte consider that using the effective tax rate provides is likely to provide a more realistic NOPAT for each of the years under review. A detailed analysis of the nature of the permanent differences (and timing differences not recognised) in each financial year would be required to positively confirm the actual effective rate applying to airfield activities.</p>
Revaluation of Non Land Assets	<p>AIAL have used the 1999 revaluations multiplied by the weightings used in respect of the asset base and backed out the value assigned to the assets already optimised</p>	<p>The Commerce Commission have used the 1999 revaluation multiplied by the weightings used in respect of the asset base</p>	<p>Deloitte believe that the Commerce Commission have incorrectly backed out the value of assets that have already been backed out as part of the optimisation process. We have agreed the basis of the revaluation adjustment by AIAL and are satisfied that source information agrees to the underlying records of AIAL. We concur with the nature of the modification to the assumption made by AIAL.</p>
Inclusion of Current Assets as part of Asset Base	<p>AIAL have included certain current assets in the asset base for the purposes of calculating a rate of return and have not distorted the fixed asset categories by the inclusion of current assets</p>	<p>Current assets have been aggregated within the fixed asset allocation.</p>	<p>Deloitte believe that the rate of return should be calculated upon the total asset base used to generate NOPAT. This definition should exclude those assets that generate income falling outside what the Commerce Commission defines as NOPAT for the purposes of this model (AIAL has correctly excluded such items e.g. investments in government stock). We concur with the nature of the modification to the assumption made by AIAL.</p>
Change in treatment of the Asset Valuation	<p>Both the Commission report and the AIAL report assume that even though an asset has only been revalued in 1999 the</p>	<p>The Commission's first adjustment is the same as AIAL. The second adjustment is</p>	<p>We concur with the AIAL modification to the CC Model assumption.</p>

Area	AIAL Assumption	Commerce Commission Assumption	Deloitte Response
Asset Valuation Adjustment	<p>appreciation has taken place over time. The adjustment is split into two allocations. The first allocation is an expected appreciation of the asset due solely to inflation, this adjustment is based upon the inflation of the movement between ending total assets. The assumptions used in the first allocation are the same as the Commission's (note that due to asset base adjustments discussed elsewhere in this report such as current assets being disaggregated from fixed assets in the AIAL Model the asset base on which the revaluation adjustment is calculated differs in the AIAL Model). The second adjustment spreads the difference between the actual total revaluation and the total of the inflationary movement (i.e. the total of the first allocation). This has been spread based upon inflation. This approach is based on the view that the second allocation</p>	<p>second adjustment is weighted across the years based on NOPAT.</p>	

Area	AIAL Assumption	Commerce Commission Assumption	Deloitte Response
	is merely a correction of the first and should therefore be spread across years using a consistent driver.		
Change in Calculation of Future NOPAT levels	<p>AIAL have used the Commission's Scenario spreadsheet to show a summary of all the scenario's results. AIAL makes use of additional variables to calculate future NOPAT. These variables include:</p> <ul style="list-style-type: none"> Expenditure growth Additional CAPEX MCTOW growth Price Increases at September Additional depreciation 	<p>The Commissions calculation of future NOPAT does not include any variables with the exception of the increase in landing charges.</p>	<p>Deloitte concur with the nature of the adjustments made by AIAL, the assumption that no other variables besides price increases will effect future NOPAT is not realistic and results in higher revenue with no corresponding increase in the asset base or expenditure. Further commentary on the major additional assumptions incorporated follows:</p> <ul style="list-style-type: none"> • Expenditure Growth- AIAL have made the implicit assumption that operating expenditure will grow in the future. Deloitte agrees with the fundamental assumption that expenses will grow over the next three years however Deloitte have not performed any working on testing the validity of the level of growth rates used. • Additional CAPEX – Deloitte agree with the nature of changes that have been made to the CAPEX assumptions, refer earlier comments on this assumption for work performed on the quantum of the changes. • MCTOW Growth – Deloitte agrees with the assumption that the volume of landings is likely to grow in future years. Deloitte has not performed any work on the percentage of growth stated. • Price Increases (from September each year rather than applicable at the same rate for the entire financial year) – Deloitte agree with the adjustment made and have agreed the percentages used to public information about the relevant changes in future years. • Additional Depreciation – Deloitte agree with the assumption of increased depreciation being incurred, as this is consistent with the above assumption of additional CAPEX. Deloitte have not reviewed the percentages used in calculating the additional depreciation.

Area	AIAL Assumption	Commerce Commission Assumption	Deloitte Response
<p>Optimisation of 2nd Runway Land</p>	<p>AIAL have purchased land during the years which relate to the 2nd Runway however not all land purchased relates solely to the Airfield. Based on the detailed work performed in calculating the 2000 Disclosure Accounts the 2nd Runway is 58% of the Airfield Land. This proportion has been retrospectively applied to all purchases of Land for the 2nd Runway</p>	<p>The Commission uses the “backwards” approach to optimise out the 2nd Runway Land.</p>	<p>The nature of the AIAL modification appears reasonable and Deloitte have agreed the amounts noted by AIAL to a listing prepared by the AIAL Property Manager who has based the listing on purchases of land parcels since 1989. Deloitte have not audited this listing for completeness nor have we agreed the purchased land parcels to the fixed asset register.</p>

APPENDIX 2 RESTRICTIONS, RELIANCE ON INFORMATION AND DISCLAIMER**Restrictions**

Our report is not intended for general circulation or publication, nor is it to be reproduced or used for any purpose other than that outlined above without our prior written permission in each specific instance. We do not assume any responsibility or liability for loss to you or any parties associated with the review as a result of the circulation, publication, reproduction or use of our report or any extracts there from contrary to the provisions of this paragraph. In any event, our total liability to any parties for any reasons whatsoever will be limited to five times the fee charged for this assignment.

We reserve the right but not the obligation, to review our work and, if we consider it necessary, to review our statement in the light of any information existing at the reporting date which becomes known to us after the date of our report.

Reliance on Information

Our procedures and enquiries in respect of the Model Review did not include verification work or constitute an audit in accordance with auditing standards. We evaluated any information that we received through analysis, enquiry and examination for the purposes of forming our conclusions. However, we have not verified the accuracy or completeness of any such information nor conducted an appraisal of any assets. We have not carried out any form of audit on the accounting or other records of AIAL for the express purpose of this model review other than in our normal capacity as auditors of the statutory and disclosure financial statements for the year ended 30 June 2000 except where specifically stated in this report. We do not warrant that our enquiries have identified or revealed any matter that an audit might disclose.

Disclaimer

As our instructions have not extended to testing the reasonableness of the underlying assumptions, we do not express any views whatsoever on the returns calculated.

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