

## **Attachment 1**

### **Critique of Appendix 8 Commerce Commission Draft Report – Price Control Study of Airfield Activities – 3 July 2001**

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## Introduction and Summary

- 1 AIAL considers that the financial analysis set out in Appendix 8 to the Commerce Commission's (Commission) draft report (Report) is critical to the conclusions that the Commission has reached at this interim stage. As stated earlier in this submission, AIAL considers the Commission's interim draft conclusions are both incorrect and detrimental to AIAL.
- 2 Accordingly, AIAL:
  - Has first checked the financial data contained within Appendix 8 for its accuracy. AIAL has identified quite a number of critical errors, corrected these and, for the Commission's benefit, provided a full Appendix 8 update directly following this commentary;
  - Has checked the assumptions within the Commission's analysis. AIAL and its auditors, Deloitte Touche Tohmatsu (Deloitte's) considers [quite a number/certain] of these to be inappropriate – see further detail below;
  - Has checked all the asset adjustments. AIAL also considers a number of these to be incorrect due to the application of incorrect logic; and
  - Is concerned with the analytical robustness of the Commission's analysis; and
  - Has appointed Deloitte's to confirm:
    - Any changes made by AIAL to the (hard) financial information contained within the Commission's models reflects the correct position in respect of AIAL's airfield operations;
    - Any modifications made by AIAL to the Commission's assumptions are soundly and appropriately based.
- 3 As a result of both AIAL's and Deloitte's work, AIAL also considers:
  - An undue and overstated level of confidence is being placed on figures where no such confidence could possibly be justified;
  - The Commission should, when drawing its conclusions from its numerical analysis, be disclosing the significance of the numerical estimates;
  - Where records are incomplete but significant judgments are to be made and conclusions drawn from such data (eg when assessing supposed excess returns by AIAL), then upper and lower bounds should be used rather than the single point estimates currently used by the Commission; and

## Detailed Discussion of Modeling by Commission

- 4 The Commission has produced three Excel models, one for each of AIAL, WIAL and CIAL. The model for AIAL is entitled “*Appendix 8 – AIAL*” and is detailed in pages 233 to 255 (inclusive) in the Report. AIAL has reviewed the model closely and has noticed a number of significant logical and data errors that, when corrected, do not in AIAL’s view support the Commission’s draft findings.
  
- 5 AIAL has not reviewed the files relating to the either CIAL or WIAL, although it is noted they both appear very similar in structure and approach to those prepared by the Commission for AIAL. It also appears that the models for AIAL and CIAL were both originally built not by the Commission but by either Air New Zealand or its advisors. If this is the case, then this is of concern to AIAL and AIAL would accordingly like to discuss the matter further with the Commission.
  
- 6 The Excel models for AIAL comprise the following spreadsheets:
  - 1 - Page 233 Summary Benefits Analysis – AIAL 2000;
  - 2 - Page 234 Summary Benefits Analysis – AIAL 2001;
  - 3 - Page 235 Summary Benefits Analysis – AIAL 2002;
  - 4 - Page 236 Summary Benefits Analysis – AIAL 2003;
  - 5 - Page 237 Scenarios – Actual Returns AIAL – 1989 – 2003;
  - 6 - Page 238 Scenario 1 (1989 – 98 HC, 1999 ODRC);
  - 7 - Page 239 Scenario 2 (excl 2<sup>nd</sup> r/way land and seabed);
  - 8 - Page 240 Scenario 3 (excl 2<sup>nd</sup> r/way land);
  - 9 - Page 241 Scenario 4 (excl revaluations 1989 HC);
  - 10 - Page 242 Scenario 5 (excl 2<sup>nd</sup> r/way land and seabed - HC);
  - 11 - Page 243 Scenario 6 (excl 2 r/way Land – HC);
  - 12 - Page 244 Scenario 7 (HC, except 99 – OC Land);
  - 13 - Page 245 Scenario 8 (excl 2 r/way land & seabed (HC, except 99 – OC Land);
  - 14 - Page 246 Scenario 9 (excl 2<sup>nd</sup> r/way land (HC except 99 – OC Land);
  - 15 - Page 247 Statement of Financial Performance - AIAL 89 – 00;
  - 16 - Page 248 Statement of Financial position 89 – 00;
  - 17 - Pages 249 – 250 Analysis of Asset Values in Statement of Financial Position - AIAL;
  - 18 - Pages 251 Adjusted Statement of Financial Performance - AIAL;
  - 19 - Page 252 Adjusted Statement of Financial Position- AIAL;
  - 20 - Page 253 Cost of Capital per AIAL (based on Airlines methodology) [?];

- 21 - Page 254 Cost of Capital per Airlines; and
- 22 - Page 255 Cost of Capital per Commission.

### WACC - Spreadsheets 20, 21 and 22

- 7 These contain a number of versions of the simplified Brennan-Lally model based on different estimates of the key inputs. AIAL accepts that the overall modeling of these key inputs is correct, but takes issue with a number of matters, being the use of a variable WACC in each year, the use of single point analysis; and the rationale for not using WACC adopted by AIAL in the consultation given that it is within the Commission's range.
- 8 **Variable WACC:** The Commission has however chosen to use a five-year Government stock rate as an estimate of the risk-free rate, accepting that prices are set every five years or so and that the funding term should generally equate to this same period. The Commission then recalculates the WACC each year and uses each annual WACC calculation to base its decision of excess profits in the relevant year. It would however be more logical to match a WACC benchmark that is fixed over the period of charges, ie five years as the Commission has already assumed that AIAL has secured funding for its current pricing period. AIAL will therefore have a **fixed WACC over each pricing period**, rather than a varying one as the **Commission** has modeled. In AIAL's view, this is another significant logic error.
- 9 To illustrate AIAL's cost of funds, where the WACC is set at the start of a pricing period and fixed for that period (i.e. not varied on an annual basis as effected by the Commission), the following table is provided listing the various WACC estimates of the Commission:

	Annual Resets			Fixed for Pricing Period		
	Lower Bound	Upper Bound	Mid Point	Lower Bound	Upper Bound	Mid Point
Mar-89	12.68%	14.25%	13.46%	12.68%	14.25%	13.46%
Mar-90	11.45%	12.99%	12.22%	11.45%	12.99%	12.22%
Mar-91	11.00%	12.88%	11.94%	11.45%	12.99%	12.22%
Mar-92	9.10%	11.46%	10.28%	9.10%	11.46%	10.28%
Jun-93	8.09%	9.82%	8.95%	9.10%	11.46%	10.28%
Jun-94	6.93%	9.03%	7.98%	9.10%	11.46%	10.28%
Jun-95	8.49%	10.23%	9.36%	9.10%	11.46%	10.28%
Jun-96	8.18%	10.26%	9.22%	8.18%	10.26%	9.22%
Jun-97	8.05%	10.02%	9.04%	8.18%	10.26%	9.22%
Jun-98	7.88%	9.09%	8.48%	8.18%	10.26%	9.22%
Jun-99	6.90%	8.57%	7.73%	8.18%	10.26%	9.22%
Jun-00	8.00%	8.80%	8.40%	8.00%	8.80%	8.40%
Average	8.90%	10.62%	9.76%	9.39%	11.33%	10.36%

- 10 AIAL has not modified any WACC numbers within the Commissions' analysis however, but we trust the Commission will reconsider its logic of resetting the WACC on an annual basis.

- 11 **Single Point Analysis:** In the model used by the Commission, (the simplified Brennan-Lally model) there are a number of assumptions necessary, namely the gearing level, the risk free rate, the asset beta, the tax rate and the market risk premium. The Commission sought advice from Martin Lally in their calculation of their WACC estimate for each airport. Mr Lally provided a **range** of WACC estimates. Mr Lally is accepted as a New Zealand authority on WACC and even Mr Lally has not provided a point estimate.
- 12 However, in later using the analysis from Mr Lally, the Commission has decided to split the range and perform **single point analysis** at the midway between his upper and lower bound. This is not, in AIAL's view, a reasonable approach for the Commission to take. A range is provided because it is not clear where exactly within the range the actual WACC should be. Putting this into perspective, AIAL used for pricing purposes a nominal post tax WACC of 8.50% even though its own analysis provided a range of 8.50 – 9.40%. The Commission's advisers also provided a range, 8.00 – 8.80%. The ranges obviously overlap. The Commission has then measured excess returns against 8.40%.
- 13 Given the subjectivity, the Commission should have, in AIAL's opinion, modeled a number of outcomes (eg between 8.00% at the low end, and 8.80% at the high end) rather than an arbitrary single mid point.
- 14 **AIAL WACC Should be Adopted:** It is noted that the Commission's analysis essentially supports the WACC used by AIAL for pricing purposes in that it was within an acceptable and reasonable range. The Commission has also concluded that it could have been 30 base points (8.50 – 8.80%) higher to be a permissible WACC. AIAL therefore considers the Commission should have adopted AIAL's WACC used for pricing purposes on the basis it was within the Commission's range.

#### **Historical Data of AIAL – Spreadsheets 15,16,18 & 19**

- 15 Generally AIAL has no problem with the data entry of its statutory accounts for past financial years. Where the Commission has made estimates (due to the limited publicly available data), AIAL confirms these are materially correct.

#### **Fixed Asset Calculation – Spreadsheet 17**

- 16 The most critical numerical element in the Commission's analysis is the treatment of revaluation gains from 89 - 00. The Commission has tried to recalculate the revaluations through movements in the annual fixed asset levels. This is where a number of errors enter the Commission's analysis.
- 17 To determine an estimate in the level of revaluation gains, the Commission has worked backwards from statutory account data. This is inherently risky and "high-level" at best, especially given the Commission did not have the necessary data available, nor was AIAL requested to provide it. If a request had been made by the

Commission, AIAL would have queried the approach being taken by the Commission as being inherently flawed.

- 18 For instance, in adopting such an approach, it is necessary to have the annual depreciation charge per asset category. This was not publicly available in all years, yet the Commission persisted in its analysis with limited information at its disposal which has resulted in an incorrect revaluation estimation of some significant quantum. In AIAL's opinion, there was however sufficient information available to the Commission to indicate its estimations were indeed incorrect – refer to spreadsheet 15 (page 247) where the Commission does note that the actual total depreciation charge that year was \$30,094 k, rather than only \$8,846 k as used in the Fixed Asset spreadsheet 17 (page 249), the subject of this commentary.
- 19 AIAL has corrected this analysis by providing the actual audited revaluation numbers that apply to the different asset classes for the relevant segments of AIAL's business. As stated above, the actual numbers are significantly different from those derived by the Commission and demonstrate the inherent risk in trying to recreate data backwards without detailed supporting analysis, and without reference to AIAL.

#### **Nine Scenarios Calculated by the Commission – Spreadsheets 6 – 14 (inclusive)**

- 20 This is the key area of analysis by the Commission to determine whether or not AIAL may have extracted excess returns since its corporatisation. AIAL considers the analysis is flawed in both its estimates and logic.
- 21 AIAL has not previously attempted to go back over past years and attempt such an analysis as undertaken by the Commission because, even with the best information that AIAL has available, such analysis will inevitably be “**high level**”. However, given the approach adopted by the Commission, AIAL is now forced to try and rebuild past numbers as best as it is able.
- 22 AIAL's analysis and commentary, as detailed below, relates primarily to scenario 8 (spreadsheet 13, page 245), since this was the preferred scenario adopted by the Commission.

#### **Scenario 8 (Spreadsheet 13) Analysis – Row by Row Critique by AIAL**

- 23 **Revenue:** The first input into the model is airfield revenue. AIAL accepts that the Commission has measured the revenue as accurately as it can.
- 24 It is noticeable the Commission has not however recognised the changing shape of AIAL's business over the period under review (89 – 00). Airfield revenue has decreased relative to AIAL's total revenue from 40% to 26% over the period, despite an increase in MCTOW over the same period. The relative level of landing charges (vis a vis all other revenue sources) has accordingly steadily decreased. In

AIAL's view, this is a key driver to apportioning costs. AIAL has modified the Commission's file to add this percentage into the equation in each year.

- 25 **Expenses:** Key to the Commission's analysis is the estimate of AIAL's past expenses. As discussed earlier, this data is quite simply not available and can only be, at best, a rather rough estimate.
- 26 What is available however, is the actual audited segments from the June 2000 disclosure data. The Commission has used the relative proportions of expenses in the 2000 disclosure data to total AIAL costs as an estimate of the expenses that relate to the airfield in the preceding years under review. AIAL considers this is a rather simple approach which has potentially misleading results. It does not recognise that AIAL has been successful in diversifying its activities throughout the period of corporatisation – where, as stated above, airfield income accounted for 40% of total revenue in 1989 but only 26% as at 30 June 2000. Such diversification does come with its consequent additional costs however. These costs did not exist to the same extent in earlier years and therefore current proportions of overall expenditure relating to airfield will logically be higher in prior years.
- 27 Whilst, as stated above, AIAL considers it is inappropriate to try to produce data retrospectively, AIAL has done its best to calculate and incorporate an adjustment factor representing the relative proportion of airfield revenue to total revenue against the 2000 base year.
- 28 **AIAL's View:** In summary, AIAL considers the Commission's expense estimates need to:
- Be more accurate (as per AIAL's calculation) to reflect the changing nature of AIAL's expense profile over time; and
  - Err on the conservative side due to the possible inaccuracies resultant in incomplete or possible incorrect data.

Total AIAL Expenses as per Annual accounts and Commission

	Jun-00 \$000	Jun-99 \$000	Jun-98 \$000	Jun-97 \$000	Jun-96 \$000	Jun-95 \$000	Jun-94 \$000	Jun-93 \$000	Mar-92 \$000	Mar-91 \$000	Mar-90 \$000	Mar-89 \$000
Audit Fees	76	45	171	46	36	36	36	37	39	38	34	36
Depreciatio	29,488	30,094	31,857	27,859	21,712	19,415	16,874	24,187	16,033	15,541	12,288	10,845
Directors'	19	292	175	135	121	110	110	138	110	110	100	96
Repairs, Maintenance and	17,908	20,399	18,521	19,909	18,731	15,538	14,837	19,750	13,339	15,996	14,103	12,845
Utilities and	8,446	8,304	7,162	4,440	4,861	5,241	5,166	4,580	3,482	2,413	2,489	2,200
Rates, Tax and	1,885	1,943	2,098	2,286	2,189	2,282	2,163	2,159	1,976	4,067	3,744	3,449
Staff and Associated	17,908	16,513	15,419	15,480	13,517	12,281	11,774	15,752	12,289	9,828	9,298	8,920
Interest	18,632	19,754	12,774	10,741	9,170	7,990	9,110	13,357	14,485	19,786	20,347	21,077
	94,361	97,343	88,177	80,896	70,337	62,893	60,070	79,960	61,753	67,779	62,404	59,468
<u>Commissions Estimate of Airfield Segment</u>												
Employee Remuneration and	44.8% 8,016	7,392	6,902	6,929	6,050	5,497	5,270	7,051	5,501	4,399	4,162	3,993
Repairs and	13.5% 2,410	2,745	2,492	2,679	2,521	2,091	1,997	2,658	1,795	2,153	1,898	1,729
Depreciatio	19.1% 5,619	5,734	6,070	5,309	4,137	3,700	3,215	4,609	3,055	2,961	2,342	2,067
General	26.5% 2,265	2,202	1,900	1,178	1,289	1,390	1,370	1,215	924	640	660	583
Rates and	26.5% 500	515	557	606	581	605	574	573	524	1,079	993	915
	18,810	18,589	17,921	16,701	14,578	13,283	12,426	16,105	11,799	11,232	10,055	9,286
Total AIAL	169,990	160,366	154,509	140,074	129,930	117,446	105,568	124,496	89,149	88,914	82,919	65,359
Airfield	44,953	42,857	43,465	42,503	42,905	38,162	34,056	33,267	31,435	32,598	31,014	25,990
Proportion of AIAL	26.44%	26.72%	28.13%	30.34%	33.02%	32.49%	32.26%	26.72%	35.26%	36.66%	37.40%	39.77%
Adjustment	Each Year / 2000	100%	101%	106%	115%	125%	123%	122%	101%	133%	139%	141%
<u>Revised Estimate of Airfield Segment</u>												
Employee Remuneration and	8,016	7,470	7,342	7,951	7,555	6,755	6,429	7,125	7,335	6,099	5,887	6,004
Repairs and	2,410	2,774	2,651	3,074	3,148	2,569	2,436	2,686	2,394	2,984	2,684	2,599
Depreciatio	5,619	5,795	6,458	6,091	5,166	4,546	3,922	4,657	4,074	4,106	3,312	3,107
General	2,265	2,226	2,021	1,351	1,610	1,708	1,672	1,227	1,232	887	934	877
Rates and	500	521	592	696	725	744	700	579	699	1,496	1,405	1,376
	18,810	18,786	19,064	19,163	18,204	16,321	15,159	16,274	15,732	15,572	14,222	13,964
Overall Increase in allocated	-	197	1,143	2,462	3,626	3,038	2,733	169	3,934	4,340	4,167	4,678

- 29 **Taxation Costs:** AIAL does not calculate tax cost per segment. It is necessary for the Commission to estimate this level each year.
- 30 AIAL has provided this figure for the 2000 year and the Commission has used the appropriate number in that year.
- 31 However, for past years, the Commission has simply applied a blanket 33% tax rate throughout the period of analysis. This is again a blunt and unreasonable estimate. AIAL's **actual** audited taxation costs have been substantially higher than 33% in many of its financial years since 1989.
- 32 AIAL considers a better approach to use than that used by the Commission is to apply the average AIAL taxation rate rather than a notional 33%. Pursuant to this approach, the following rates would apply:

	Commission Rate	Actual Rates for AIAL	Commission Cost	AIAL Cost
Mar-89	33%	42%	4,677	5,037
Mar-90	33%	39%	6,917	6,551
Mar-91	33%	36%	7,051	6,068
Mar-92	33%	40%	6,480	6,295
Jun-93	33%	41%	5,664	6,982
Jun-94	33%	36%	7,138	6,816
Jun-95	33%	38%	8,210	8,262
Jun-96	33%	36%	9,348	8,933
Jun-97	33%	32%	8,515	7,566
Jun-98	33%	35%	8,430	8,634
Jun-99	33%	33%	8,008	7,980
Jun-00	33%	33%	8,627	8,627

- 33 AIAL has borne a higher rate than 33% for tax is largely due to the non-deductibility of airfield accounting depreciation. If it were possible to recalculate **actual** depreciation charges for the airfield, then such rates would be even higher than that modeled above where AIAL has only used the average effective AIAL tax rate rather than its estimate of the probable airfield rate.
- 34 Note, when reviewing the above table, the tax expense/cost columns are a function of both the revised tax rate and the overall apportioned expense levels.

- 35 **NOPAT:** The effect of the recalculation of expenses and taxes (per above) is a downward EBIT calculation as follows:

	Commission NOPAT	Adjusted NOPAT	Variance	%	
Mar-89	12,027	6,989	5,037	-41.9%	
Mar-90	14,043	10,242	3,801	-27.1%	
Mar-91	14,315	10,958	3,357	-23.4%	
Mar-92	13,156	9,408	3,749	-28.5%	
Jun-93	11,499	10,012	1,487	-12.9%	
Jun-94	14,492	12,082	2,410	-16.6%	
Jun-95	16,669	13,579	3,090	-18.5%	
Jun-96	18,979	15,768	3,211	-16.9%	
Jun-97	17,288	15,774	1,514	-8.8%	
Jun-98	17,115	15,767	1,348	-7.9%	
Jun-99	16,260	16,091	168	-1.0%	
Jun-00	17,516	17,516	-	0	0.0%

- 36 **Revaluation:** To produce the Accounting Rate of Profit (ARP) calculation adopted by the Commission (which is not supported by AIAL) a revaluation movement needs to be calculated and apportioned each year. The Commission adopted a complicated approach to backward calculate this level and then used this resultant figure as being attributable to income. This is a very material number in the Commission's analysis. For instance, in 1989 the Commission has calculated NOPAT at \$12,097 m and an additional asset revaluation 'profit' at \$9,020 m or 75% of NOPAT. The significance of this number is even more pronounced when considered against the revised AIAL NOPAT (see above) for 1989, being \$6,989 m, where the Commission's revaluation 'profit' is detailed as 130% of NOPAT.
- 37 Rather than working backwards to try to recalculate the asset revaluations per category, the following table has been extracted directly from the audited worksheets produced as part of the AIAL June 2000 disclosure accounts. This table quantifies the allocations of each asset to AIAL's various business segments. From this analysis, it is then possible to better apportion the revaluation gains between the AIAL's various business segments.

Fixed Assets	Identified Airport Activities	Aircraft and				Total
		Airfield	Terminals	Freight	Other	
	2000 \$000's					
Freehold land						
At valuation	225,887	181,807	21,824	22,256	88,109	313,996
At cost	205	169	36	-	-	1,057
	<u>226,091</u>	<u>181,976</u>	<u>21,860</u>	<u>22,256</u>	<u>86,848</u>	<u>312,939</u>
Buildings and services						
At valuation	173,272	2,325	168,812	2,135	98,355	271,627
At cost	- 476	26	520	18	4,785	4,309
Accumulated depreciation	11,951	167	11,648	136	7,177	19,128
	<u>160,845</u>	<u>2,184</u>	<u>156,644</u>	<u>2,017</u>	<u>95,963</u>	<u>256,808</u>
Infrastructure						
At valuation	64,798	40,326	22,509	1,962	40,826	105,624
At cost	289	130	149	10	7,372	7,662
Accumulated depreciation	2,442	1,366	922	154	1,853	4,295
	<u>62,645</u>	<u>39,090</u>	<u>21,736</u>	<u>1,819</u>	<u>46,345</u>	<u>108,990</u>
Runway, taxiways and aprons						
At valuation	60,985	60,985	-	-	-	60,985
At cost	20,794	20,794	-	-	-	20,794
Accumulated depreciation	3,578	3,578	-	-	-	3,578
	<u>78,201</u>	<u>78,201</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>78,201</u>
Vehicles, plant and equipment	32,606	6,911	25,696	-	6,232	38,838
Accumulated depreciation	23,489	5,546	17,944	-	4,332	27,821
	<u>9,117</u>	<u>1,365</u>	<u>7,752</u>	<u>-</u>	<u>1,900</u>	<u>11,017</u>
<b>Total Fixed Assets</b>	<b>536,900</b>	<b>302,816</b>	<b>207,992</b>	<b>26,092</b>	<b>231,056</b>	<b>767,955</b>

#### Calculation of Revaluation Allocations

	Total AIAL Annual Accounts	Airfield Disclosure Worksheets	%	Total AIAL Revaluation 1999 Annual Accounts	Revaluation Applicable to Airfield
Freehold Land	312,939	181,976	58.15%	145,207	84,439
Buildings	256,808	2,184	0.85%	56,607	481
Infrastructure	108,990	39,090	35.87%	49,443	17,733
Runways Taxiways and Aprons	78,201	78,201	100.00%	5,913	5,913
Plant	11,017	1,365	12.39%	0	-
	<u>767,955</u>	<u>302,816</u>		<u>257,170</u>	<u>108,566</u>
Less Optimised Assets	Value in Accounts		HC Value		
Revalued Value for 2nd Runway	36,757		11,368		25,389
Revalued Value for Seawall	9,787		2,447		7,340
Revalued Value for Seabed	30,113		-		30,113
	<u>76,657</u>		<u>13,815</u>		<u>62,842</u>

#### Airfield Revaluation Reserve Relating to non-Optimised Assets

Freehold Land	28,937
Buildings	481
Infrastructure	10,393
Runways Taxiways and Aprons	5,913
Plant	-
	<u>45,724</u>

- 38 Three key inputs into the above table do merit some further discussion. These are:
- The second runway land;
  - The seawall; and
  - The seabed.
- 39 **Second Runway Land:** AIAL has reconciled the **actual** purchase cost of all land purchased for the second runway since 1989. The total purchase cost is \$11,368 m (from a total of thirteen transactions). Therefore, the valuation increase is \$25.389 m, which is the current value less the original cost. The calculation is provided with the revised Scenario 8 analysis to the annexure.
- 40 **Seawall:** The original value of the seawall is not available as much of the seawall was present prior to corporatisation, and the accounting records do not detail this asset. AIAL has also revisited the vesting valuation and the seawall value is not listed in that valuation either. A notional 25% of the 1999 historical value has been included in the analysis as a reasonable estimate of the probable level to accrue. An alternative would be to conclude, as the Commission has done, that it has no value at all.
- 41 **Seabed:** The seabed has been valued in the AIAL June 2000 valuation reports at \$30.113 m. This value was reduced to \$10.110 m in the AIAL 1999 model for pricing purposes (June 1999). Prior to June 1999, the seabed was not included within the vesting valuation reports nor in AIAL's prior annual fixed asset register. Putting the Commission's economic rationale to one side, which AIAL disagrees with, the Commission has chosen to optimize the seabed asset from AIAL's asset base. However, not only has the Commission removed the seabed value from the asset base for the two years it was included in AIAL's fixed asset register at the **wrong amount**, it has also removed a sum representing the seabed for those years (89 – 98) where the seabed **did not even exist** in AIAL's fixed asset register.
- 42 AIAL has corrected the two mistakes (i.e. values ascribed and years applicable). The valuation increase has therefore been assumed as \$30.113 m for 2000 (as this is the value listed in the AIAL June 2000 disclosure accounts) and \$10.110 m for 1999 as this was the value it was included in the asset base in the 1999 accounts used by the Commission (ie the pricing model).
- 43 **Revaluation summary:** In summary, the total revaluation of airfield assets by AIAL amounts to \$108,566 m but approximately \$62.8 m relates to assets the Commission feels are inappropriate to attribute to the airfield for charging purposes. The final revaluation increase is therefore \$45.724 m in relation to spreadsheet 13 (scenario 8) not as per the Commission's number, being \$102.7 m (i.e. \$52.9 m + \$49.8 m). It does differ for other scenarios and AIAL has corrected these also. Refer to the updated spreadsheets attached to this commentary.

- 44 In spreadsheet 13 (scenario 8), non-land asset values are reduced to historical cost and seabed, seawall and second runway land are all removed (optimised out). The net revaluation gain is, once corrected, actually \$28.937 m (relating to land only) which has been allocated over the entire period since corporatisation. This is against the Commission's \$52.935 m from its 'backwards' calculation.
- 45 The Commission models this revaluation gain by apportioning a notional revaluation gain each year. AIAL confirms that, under the approach adopted by the Commission, it is necessary to recognise this gain over the entire period. In apportioning this revaluation gain, the Commission has adopted a twin approach. First it has calculated the initial gain that inflation alone would have provided, and then secondly spread the balance based on relative NOPAT each year. AIAL can see absolutely no justification why its NOPAT would drive asset appreciation. Inflation, together with the asset levels, should be the only drivers used to apportion asset gain through the period of analysis.
- 46 What is also significant is that, after the **actual** figures are entered into the model, the asset values have not kept up with even underlying inflation. Pursuant to the Commission's analysis, AIAL asset values have not kept up with inflation by \$15.315 m, while under AIAL's analysis, the gap is even wider at \$25.164 m. If one was to measure this gain under a real model (rather than nominal) this shortfall between inflation and actual appreciation would have resulted in a loss rather than a gain as determined by the Commission.

	<b>Commission</b>	<b>AIAL</b>
Actual overall revaluation gain	\$52.935 m	\$28.937 m
Notional inflation gain expected	\$66.016 m	\$54.101 m

- 47 **Asset Base:** There are also major errors in this section of the Commission's spreadsheet 13 (scenario 8). An obvious key input into the model is the asset values. The numbers used by the Commission have been transposed between the 99 (pricing model) and 00 (June 2000 disclosures) years incorrectly. AIAL has now reconciled these numbers with both the 99 and 00 pricing model and June 2000 disclosure accounts. This is a major error with significant consequences in the analysis overall.
- 48 In addition, the Commission needs to consider all assets. Therefore, current assets must also be included to reconcile with the June 2000 disclosure accounts.
- 49 The Commission appears to have calculated the June 99 numbers from the pricing proposals put to AIAL's airline customers and in other years by looking at the proportion of airfield assets in June 00 against the total company assets as an allocation driver for these other years. AIAL has not provided an alternative basis except to note that it is necessary for the June 00 asset levels to be recorded

accurately in order to effect such analysis. The level of adjustment by AIAL to correct the Commission's errors is significant. For instance; runways, taxiways and apron valuations were adjusted from \$60.986 m to \$78.201 m, an upward movement of \$17.215 m or 28%. The higher number reconciles with all AIAL's audited accounts.

- 50 The vesting values of the airfield and the total company also require reconciliation and do not correspond to AIAL's financial records. However, no change has been made at this stage to the Commission's model.
- 51 From this point in the Commission's analysis, a book value for AIAL airfield assets is then calculated from which a number of optimisation adjustments are necessary. AIAL accepts the logic of this approach, but the Commission has effected two further material errors. It has written down the wrong amounts and it has also removed values that were not incorporated in the original book values. AIAL has corrected these – refer below.
- 52 **Runway Maintenance Provisions:** AIAL makes no comment and accepts the adjustment effected by the Commission for this purpose.
- 53 **Optimisation of Second Runway:** The Commission has also relied on its questionable 'backwards' calculation of revaluation gains to quantify the revaluation gain attributable to the second runway value. This is a material number in the overall analysis and is again wrong. AIAL has quantified the carrying value of second runway land in its accounts each year by reference to actual purchase prices paid. The details are contained on the bottom of AIAL's revised Appendix 8 (attached). The book values of the second runway land have been adjusted downward considerably:

	<b>Commission</b>	<b>AIAL</b>
March 1989	34,492	1,067
March 1990	35,005	1,192
March 1991	38,507	2,887
March 1992	40,907	3,285
March 1993	41,414	8,015
March 1994	42,882	8,015
March 1995	44,619	8,015
March 1996	46,872	8,015
March 1997	49,783	8,015
March 1998	54,328	11,368
March 1999	33,796	36,757
March 2000	14,037	36,757

- 54 The Commission's numbers are obviously incorrect when considering that, after the revaluation to market value undertaken by AIAL in June 99, the second runway land had a value of \$36,757 m. It was never therefore going to be \$54 m as suggested by the Commission for the prior year – March 98. The actual purchase cost of land reserved for future expansion to the north (including the land reserved for as the second runway land) was \$19.444 m. However, only 58% of this land relates to airfield purposes so the allocated value should therefore only be \$11.368 m.
- 55 **Optimisation of Seabed:** The next adjustment made by the Commission is to remove seabed values from the asset base. As stated above, the seabed was first valued in June 99. Prior to that date there was no book value in AIAL's accounts relating to the seabed. The adjustment necessary is therefore to remove from the asset base, the amount that was included for seabed in the asset base.

	<b>Commission</b>	<b>AIAL</b>
	<b>\$000s</b>	<b>\$000s</b>
March 1989	16,521	-
March 1990	16,766	-
March 1991	18,444	-
March 1992	19,593	-
March 1993	19,836	-
March 1994	20,539	-
March 1995	21,371	-
March 1996	22,450	-
March 1997	23,845	-
March 1998	26,021	-
March 1999	23,150	10,110
March 2000	7,534	30,113

- 56 The seabed was included in the 99 valuation at \$30.113 m. For pricing purposes it was however written down to \$10.110 m. As the Commission appears to have sourced asset values from the pricing data for June 1999 year, only the seabed value used in that valuation is the appropriate value to remove.
- 57 **Optimisation of Seawall:** The seawall has been removed by the Commission from all years except 99 and 00. Unfortunately, this is exactly the opposite adjustment to that which should be made by the Commission. Furthermore, AIAL notes the obvious error in the Commission's approach, namely to remove **current** values based on the 99 ODRC valuation from the historical asset values. The only adjustment that is appropriate would be to remove the ODRC value from the June

99 and 00 accounts and the book value prior to that date. AIAL has estimated the book value prior to 99.

- 58 **Revaluation of Optimised Assets:** This adjustment specifically relates to the difference between historical cost and the ODRC valuations for sealed surfaces and all other assets excluding land. The Commission has calculated the difference as \$49.773 m in year June 00, although the number sourced from AIAL's audited accounts suggest a much lesser amount, being \$16.787 m.
- 59 There has only been one revaluation undertaken by AIAL and therefore the number in each year would be expected to be the same, or slightly lower than in June 00 due to some assets possibly being written off or being depreciated at a slightly higher level. The Commission's numbers are therefore, in AIAL's view, not logical, nor do they reconcile to AIAL's audited accounts.
- 60 Furthermore, in AIAL's opinion, the definition of assets needs to be more comprehensively described so as not to be misleading. The Commission refers to 'sealed surfaces' and implies this is runways, taxiways and aprons. The adjustment is for far more than this. It includes all assets other than land such as roads, plant, water systems, stormwater infrastructure, boat ramps, boats, vehicles, computer systems, reticulation systems and security fencing.
- 61 **Net Result:** Based on the significant adjustments detailed above, the overall difference in reported ARP from that detailed by the Commission and that derived by AIAL, is significant.
- 62 Even putting to one side differences AIAL has with certain of the economic concepts espoused by the Commission, there is, in AIAL's view, upon taking into account the above amendments to the Commission's data and approach, no evidence to suggest any over-recovery by AIAL in the past as suggested by the Commission under spreadsheet 13 (scenario 8). It is also timely to note that, with the necessary adjustments made by AIAL, there is no over-recovery in any of the other 8 scenarios modeled by the Commission.

	Scenario 8 Commission	Scenario 8 Corrected	WACC Commission (mid point)		WACC AIAL (low estimate)	
				Variance		Variance
Mar-89	14.56%	7.03%	13.46%	6.43%	13.22%	6.19%
Mar-90	21.00%	9.58%	12.22%	2.64%	11.97%	2.39%
Mar-91	16.88%	8.60%	11.94%	3.34%	12.51%	3.91%
Mar-92	11.25%	6.04%	10.28%	4.24%	10.07%	4.03%
Jun-93	9.02%	6.02%	8.95%	2.93%	8.87%	2.85%
Jun-94	11.12%	7.26%	7.98%	0.72%	7.74%	0.48%
Jun-95	14.64%	8.67%	9.36%	0.69%	9.79%	1.12%
Jun-96	16.18%	9.78%	9.22%	-0.56%	8.85%	-0.93%
Jun-97	14.51%	9.49%	9.04%	-0.45%	8.57%	-0.92%
Jun-98	11.26%	8.47%	8.48%	0.01%	8.69%	0.22%
Jun-99	9.77%	8.04%	7.73%	-0.31%	7.41%	-0.63%
Jun-00	11.40%	8.45%	8.40%	-0.05%	8.56%	0.11%
Average	13.47%	8.12%	9.76%	1.64%	9.69%	1.57%

63 In fact, on the basis of all the adjustments detailed above, the revised average actual returns are lower than both AIAL's and the Commission's allowable return. They are also lower than the Commission's lower band on the possible WACC estimate, ie 8.12% on average ARP against an average WACC of 9.76%.

#### Future Returns – spreadsheet 5

64 The Commission then summarises all its scenarios into a single worksheet (spreadsheet 5) and further extrapolates its returns for three additional years. The individual scenarios have all been adjusted to the revised historical figures provided by AIAL.

65 In AIAL's view, the extrapolation by the Commission also needs to be modified to correct what AIAL considers to be logic errors used in this high level analysis.

66 To estimate future returns, the Commission grosses up revenue by AIAL's future price increases and then divides this by its adjusted asset base as at 30 June 2000. The first correction to make is to amend the value ascribed by the Commission to AIAL's asset base (including annual capital expenditure and depreciation). AIAL has already amended the starting position for the value of the asset base per the discussion above, to \$219.3 m rather than the Commission's \$186.8 m. Actual and forecast capex are significant numbers which have now been included within the model. The second correction to make, is that it is not appropriate to only gross up revenues. Forecast expenditure also needs to be modeled. AIAL has now modeled both.

67 To further elaborate on the issue of capex recovery, AIAL has announced future price increases to reimburse it for costs of committed capital expenditure. There

are a number of other key drivers that will also affect AIAL's future airfield returns. These include:

- Expense growth;
- Increased depreciation charges;
- MCTOW growth;
- Capital expenditure;
- Price increases (in month of change, ie September); and
- New asset levels.

Even if one accepted the Commission's spreadsheet 13 (scenario 8) whereby the second runway land, seabed and seawall have been excluded, the predicted returns for 2001-2003 do not exceed the current WACC estimates of either AIAL, or indeed, the Commission.

Assumption	Jun-00	Jun-01	Jun-02	Jun-03
<i>Expense Growth</i>		12.0%	5.0%	5.0%
<i>Compounded Nominal Expense increases</i>		1,583	2,242	2,902
<i>Add. Depreciation Charge</i>	5,619	958	2,387	3,387
<i>MCTOW Growth</i>		3.50%	3.50%	3.50%
<i>Capital Expenditure</i>		31,330	43,539	40,000
<i>Price Increases (in September)</i>		8.5%	5.0%	5.0%
<i>Base landing charge plus growth</i>	44,157	45,702	47,302	48,958
<i>Price Increase effect from September each Year</i>		48,940	53,461	58,099
<i>NOPAT recalculated</i>	18,259	19,761	21,391	23,387
Commission's Scenario Number				
1	6.83%	5.86%	5.75%	5.85%
2	8.04%	7.58%	7.24%	7.24%
3	7.52%	6.57%	6.38%	6.44%
4	9.14%	8.63%	8.12%	8.03%
5	9.33%	9.19%	8.57%	8.43%
6	9.72%	9.08%	8.48%	8.36%
7	7.07%	6.16%	6.02%	6.11%
8	8.45%	8.10%	7.68%	7.64%
9	7.76%	6.96%	6.72%	6.76%

68 **Second Runway Land:** The Commission has concluded that the second runway land should be excluded from the asset base used for pricing in past years. It is quite another question however as to whether this asset should be excluded from the asset base for future years. If it is included, the obvious question is: at what value is it brought into the analysis? AIAL considers this asset should be included for future years, but for the purposes of present discussion and calculation has continued to exclude it per the scenarios modeled by the Commission.

### Quantifying Future Benefits of Price Control – Spreadsheets 1- 4 (inclusive)

- 69 The final area of analysis by the Commission relates to the quantification of benefits of regulation. There are four spreadsheets (1-4 pages 233 - 236) for each of years 00 to 03. AIAL has a number of significant concerns with this analysis. Most relate to incomplete data being used by the Commission.
- 70 **Assumed Revenue:** The revenue estimated by the Commission takes no account of movements in passenger numbers, nor does it provide any credit to upward prices not being charged for the entire year. Capex levels are also ignored as well as expenditure growth. These are, in AIAL's view, (a view which is supported by its advisors and auditors), all significant flaws in the modeling. This has resulted in an incomplete and misleading picture being provided by the Commission.
- 71 **WACC:** The model uses the mid point in Mr Lally's range rather than the AIAL estimate which is also within his estimated range and an equally justifiable WACC estimate to use – refer to a more comprehensive discussion on this at paragraphs 7-13. AIAL has accordingly adjusted the WACC used in the Future Benefits analysis from 8.40% to 8.50%.
- 72 **Asset Base:** The asset base, as previously discussed above (paragraph 46), needs to be corrected for each year of analysis. This correction is significant in each case. For instance, the Commission has used \$186.8 m in the June 2000 year (and indeed in every subsequent year) which has now been adjusted to \$219.3 m.
- 73 In the 03 year (Spreadsheet 4 – page 236) the asset level has now been amended from \$186.6 m (the Commission's figure) to \$306.2 m. This amended figure includes actual and forecast capex (AIAL is spending in the vicinity of \$40 m per year on airfield activities) and depreciation in the intervening periods (confirmed as reasonable by AIAL's auditors – see the attached report from Deloitte's).
- 74 One can only conclude that, by not taking account of such items, the Commission analysis is predisposed to recognising income but not associated costs. Once again a misleading picture is the result.
- 75 **Calculations - One Sided Analysis: Allocative Efficiency:** All formula used by the Commission in the future benefits analysis in the calculation of allocative efficiency (excess returns to **providers or acquirers**) specifically only quantifies the situation where the provider is over-recovering but does not quantify the situation in the reverse where the provider (as is the case for AIAL although no change has yet been made to the Commission's models) is under-recovering.
- 76 If the inputs made by the Commission were however corrected, the analysis would show acquirers are, contrary to the current picture being portrayed by the Commission, receiving favourable benefits at the expense of providers. Allocative inefficiency is equally problematic either way. This is another flaw in the Commission's analysis.

- 77 **Productive Efficiency:** In AIAL's view, productive efficiency is estimated so broadly at 1% of expenses that it is unreasonable to include it in the analysis. AIAL recently consulted with its airlines customers for eleven months and no significant issues relating to airfield productive efficiency were raised in that lengthy process. To assume any amount, without suitable analysis, is arbitrary and inappropriate. At this stage, AIAL has not changed this input as made by the Commission, but questions the rigour and fairness of the Commission's analysis.
- 78 **Dynamic Inefficiency:** Dynamic inefficiency is discussed in much more detail in the main body of this submission. In addition, the following is noted:
- 79 The Commission has calculated the benefits of regulation in reducing dynamic inefficiency as:

The Commission calculation:

+ land (all future expansion including non-airfield related assets)	62,870,000
+ all seabed included in AIAL valuation and statutory accounts (not just the figure used in not pricing)	30,113,000
+ seawall	<u>9,787,000</u>
	102,770,000
Times the risk free rate	<u>x 6.92%</u>
	7,111,684
Less Commission's assessment of alternative income	<u>400,000</u>
Commission's quantification of dynamic inefficiency	<u>\$6,711,684</u>

- 80 The above calculation is an error which has now been acknowledged as such by the Commission.
- 81 To quantify dynamic inefficiency, the Commission must be of a view that the seabed (or the value of the funds utilized) would flow to a more efficient use if it were not so held by AIAL. The Commission has previously stated the seabed has no alternative use and its opportunity cost is accordingly zero. Notwithstanding this, the Commission then, in calculating dynamic inefficiency, suggests that through price control the current value of the seabed being, \$30.113 m, would somehow be realized. This is logically incorrect. It is also noted, that even, if one accepted the Commission's approach, the incorrect value has been used. The correct value for the seabed is \$10.110 m being that value ascribed by AIAL to the seabed for pricing purposes.

- 82 AIAL's view is that the seabed does have a value and is using the seabed for its best use. No dynamic inefficiencies should be attached to AIAL's use of this asset.
- 83 The seawall has never been regarded by AIAL's airline customers as an inappropriate investment. As with the Commission's initial view, AIAL's airline customers consider the seawall should be included as part of the underlying land value. To therefore suggest the seawall is either over-engineered or an inappropriate investment is not, in AIAL's view, correct. Accordingly, no dynamic inefficiencies should be attached to AIAL's use of this asset.
- 84 The value the Commission has placed on the second runway is another error. The Commission has ascribed a value of \$62.8 m. Regardless of what one's view is on the arguments for and against dynamic inefficiency in relation to the second runway asset, the land value is only \$36.757 m. It appears the Commission has included non-airfield related assets in its calculation.
- 85 In addition to the above error, the Commission has provided no supporting analysis in relation to its view that it is dynamically inefficient for AIAL to hold the second runway land. Rather the Commission has simply stated that future users should pay rather than current users by AIAL capitalising holding costs. To suggest this, the Commission would, in AIAL's opinion, have to prove that this asset could be acquired at a cheaper total cost in the future, than the total cost of acquiring it earlier (including holding costs). There has been no such analysis by the Commission. AIAL in the main body of this submission has provided supporting analysis and expert opinion confirming that it was acquired in a dynamically efficient manner.
- 86 AIAL has not amended this principle within the Commission's current modeling, but has at least corrected the figures ascribed to the second runway land. The correct calculation therefore should be:

Land in second runway as already defined by Commission, page 106 (Table 25) and the value optimised out	36,757,000
	<u>x 6.92%</u>
	2,543,584
Less income from land	<u>400,000</u>
"Revised" quantification of Dynamic Inefficiency	<u>\$2,143,584</u>

### **Summary – Commission Spreadsheet analysis**

- 87 In analysing and summarising the various spreadsheets used by the Commission in its airfield model (and using the Commission's economic principles which AIAL continues to disagree with), three key factors emerge:

- There is no evidence of any over recovery since corporatisation based on any scenario modeled by the Commission. In fact, if accurate figures are used quite a contrary picture emerges. AIAL has been under-recovering and, based on the model used by the Commission, the level of under-recovery by AIAL since its corporatisation is significant. Using the mid point in the Commission's WACC range, the shortfall would be \$35 m in nominal terms. If one then adjusted this figure to real current dollars, the level is \$81 m. If one used the upper bound of the Commission's annual WACC estimates, the under recovery would be \$53 m in nominal terms and \$114 m in current dollars;
- Extrapolating the returns over the next three years, after considering future expenditure and growth levels, it is unlikely that there will be returns that equate near to either the Commission's or AIAL's permissible level of return; and
- Considering the net benefits to acquirers and the economy (under the Commission's model), the benefits do not outweigh the costs. In addition, no modeling has been performed to measure the sub-returns suffered by AIAL which is an equally unacceptable allocative inefficiency and should, in AIAL's view, be being considered by the Commission if it were being comprehensive and complete in its analysis.

88 Attached are revised printouts of the Commission's model per the discussion above and audit report prepared by Deloitte's.