

## Attachment 8

---

## 8. ERNST & YOUNG REPORT TO AIAL AUDIT CHAIRMAN - NOVEMBER 1999

---

687405/800

21 November 1999

Mr Tony Frankham  
Chairman Audit Committee  
Auckland International Airport Ltd  
PO Box 73020  
Auckland International Airport  
AUCKLAND

Dear Sir

Valuation - Auckland International Airport

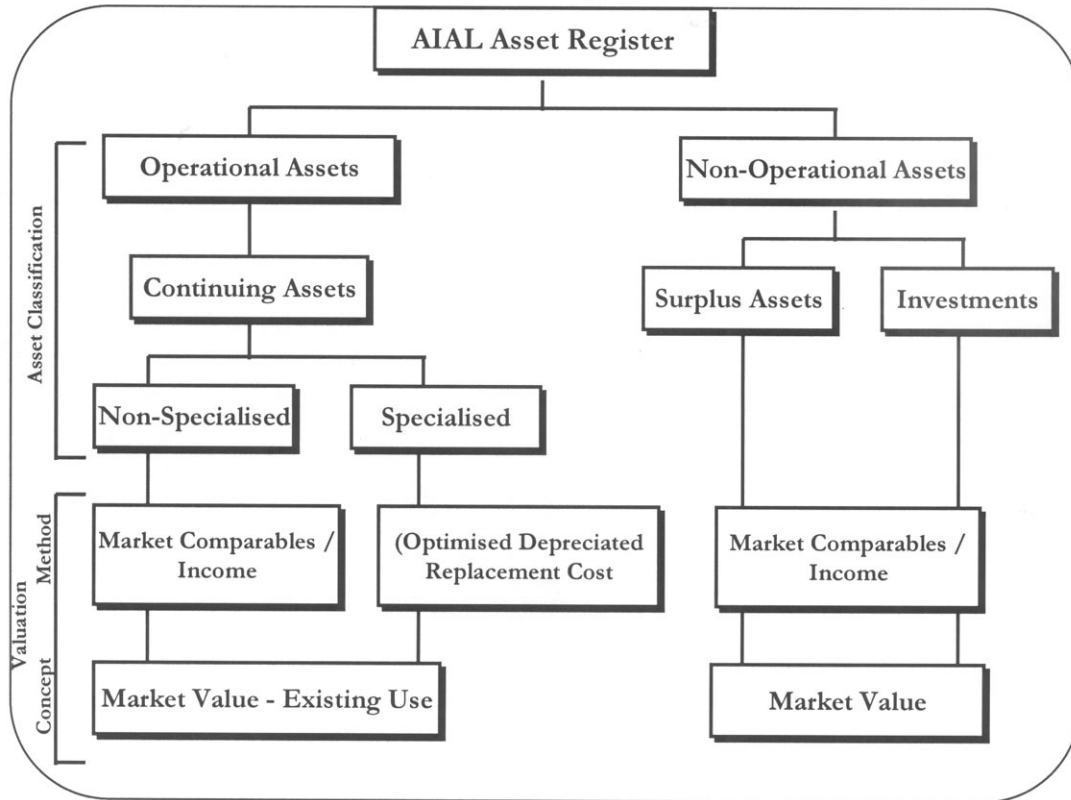
We have found it necessary to revise our initial advice to you as to the quantum of the valuation which was prepared on behalf of Auckland International Airport Ltd (AIAL) in accordance with management's instructions. We have identified an error in the valuation which has seen the seawall double counted by virtue of its inclusion both as a civil works asset and as an element in the land value. This has reduced the overall valuation by an amount of \$9,787,000 with the adjustment having been taken against the land value. The valuation remains effective 30 June 1999, has been carried out by independent valuers and is required to support financial reporting and consultation concerning airport charges.

### **Basis of Valuation**

The basis of valuation adopted is market value for the existing use (MVEU) using market value as the primary method of valuation for non-specialised operational assets and optimised depreciated replacement cost (ODRC) for specialised assets. The ODRC valuation of the improvements has been completed by Beca Valuations Ltd who have also provided valuations of the Civil Works. Seagar & Partners have undertaken market valuations of the non-specialised assets and have provided ODRC valuations of the airport land.

**The Valuation Process**

The valuation follows an outline methodology developed by Ernst & Young Real Estate Group (EYREG) as outlined in the following chart:



The New Zealand Institute of Valuers Valuation Standards provide primary guidance for an asset valuation of Auckland International Airport. Regard should, and has been, given to other valuation directives as are applicable. The two valuation approaches are summarised below:

**Market Comparables/Income Basis**

The sales comparison and income or investment approaches are generally well known to valuers. Both methods draw directly on market transactions considered to be relevant. For commercial property, the income approach is usually the most appropriate as the primary motive for the investment is regular receipt of rental income. Airport activities such as retailing, carparking, offices and warehousing (for which the rentals at Auckland International Airport have been commercially negotiated) are common applications of commercial property. As such, we consider the income approach to be the most appropriate.

**Optimised Depreciated Replacement Cost (ODRC)**

ODRC is a surrogate for valuing assets in their existing use where there are neither competitive markets for the assets or for their services or outputs.

ODRC is calculated on the gross replacement cost of modern equipment assets, adjusted for over-design, over-capacity and redundant assets, less an appropriate allowance for depreciation (and major periodic maintenance, where appropriate) to arrive at the optimised depreciated replacement cost.

The ODRC measures the minimum cost of replacing or replicating the service potential embodied in the airport with modern equivalent assets in the most efficient way practicable, given the service requirements, the age and condition of the existing assets and replacement in the normal course of business. The greater the level of optimisation, the lower the implied ODRC value of the airport.

### Application of Both Market Comparables/Income and ODRC Methods

Given that Auckland International Airport contains both monopoly and contestable assets, we consider that a combination of both cost and market-based valuation approaches is required. This will ensure that the resulting valuation is both reflective of market value and a proper basis for pricing monopoly components. Using this approach, the valuation is one which:

- values the market-based (and therefore competitively negotiated) revenue streams in accordance with market benchmarks, specifically, return expectations for the likes of retail, industrial and carparking real estate; and
- provides a proper cost-based assessment for the monopoly components for which the airport entity should be entitled to a market-related return (pricing).

The asset valuation of Auckland International Airport will therefore be calculated as:

<b>Non-Specialised Assets \$</b> (based on market comparables income)	+	<b>Specialised Assets \$</b> (based on ODRC)	=	<b>Auckland International Airport</b> <b>Asset Valuation</b>
---	---	---	---	---

The separation of assets into non-specialised and specialised was undertaken in close consultation with AIAL management. In most cases, the separation was relatively straight-forward. The airport terminals represent the more difficult assets given their composite nature. While certain activities are clearly either non-specialised (eg. retail concessions) or specialised, (eg. baggage make-up and handling), there are certain areas that serve both or could be regarded as common, and therefore an allocation of these areas was required.

Turning to specific asset classes; possibly the most difficult revolves around the valuation of the airport land and some expansion of the valuation approach adopted follows;

Consistent with the concept of separating activities between non-specialised and specialised, the underlying land at Auckland International Airport was similarly divided.

### Non-Specialised

For non-specialised assets, the land value is implicit in the assessed value of the (whole) asset as determined by market comparables/income approach. There is a need, however, for an allocation of asset value between land and improvements (essentially for accounting purposes), and this has been undertaken using ODRC methodology as the constant.

Land held for future commercial development has been valued having regard to the likely use, timing and comparable land values for the likely or proposed use. Where appropriate, the valuers have considered land value as a residual amount, i.e. the residual value derived from the most likely development and associated cashflows.

Where there existed formal land or ground leases between AIAL and third parties (which are common) for a non-specialised activity (eg. a rental car agency ground lease), the asset as valued was the lessor's interest in the land. This was done by either estimating the freehold value of the land and deducting the residual lessee's interest, or alternatively, valuing AIAL's interest based on the ground lease terms and conditions and estimated market rent reviews.

## Specialised

The vast majority of AIAL's land is of a specialised nature, given that it supports aviation activities. Having regard to both valuation standards and valuation guidelines, the land value has reflected:

- its existing (or potential in the case of the second runway) use as an airport;
- the current market buying price of the land in its current use; and
- current reproduction cost of the same service potential or future benefits of the existing asset.

In assessing the value of specialised land at Auckland International Airport, the valuers have had regard to the following approaches:

1. *Market comparables*
2. *Alternative use plus airport costs in bringing to existing use*
3. *Greenfields*
4. *Brownfields*

## Capital Expenditure in Process

There are substantial capital projects currently underway at Auckland International Airport. Each project has been reviewed with AIAL management and the value has been adopted as either:

- costs incurred to date, or
- estimated completion value less cost to complete.

The closer the project was to being finished, the more probable that estimated completion value less cost to complete equated the valuation figure adopted.

## Summation/Allocation

Summation of the non-specialised and specialised value assessments, together with capital expenditure and process, represents the asset valuation for Auckland International Airport.

It has earlier been noted that the valuation method for non-specialised assets will not provide a split between land and improvements. Separation is required by AIAL for ongoing accounting (and depreciation) purposes. For those assets of a non-specialised nature, the apportionment has been calculated as follows:

	<i>Market Comparison / Income Valuation</i>	\$
<i>minus</i>	<i>Estimate of ODRC for Improvements</i>	\$
<i>equals</i>	<i>Notional Land Value</i>	\$

Under this approach, land values reflect the cashflow potential of the improvements.

## Recoverable Amount Test

When revaluing non-current assets, SSAP-28 and ED-82 requires that upon revaluation, the carrying amounts do not exceed their recoverable amount. This is similar to valuation standards which stipulate that cost-based valuations should be "subject to adequate potential profitability" of the asset. Given both of these requirements, it will be necessary to check that the assessed asset valuation is able to be supported by the expected cashflows from the airport's continued use.

## Valuation

In our opinion, albeit we are reliant upon the separate valuations of Beca Valuations and Seagar & Partners, Auckland International Airport Ltd's marketable interest in the property known as Auckland International Airport as at 30 June 1999 is as follows:

### 1. ODRC Valuation

This valuation has been completed and is summarised in their respective reports as being the sum of:

ODRC valuation of Improvements	\$477,923,600
Land value	\$313,507,000
<i>Plus</i> Adjustment for Storage Shed 3	\$32,500
	<b>\$791,463,100</b>

### 2. ODRC Valuation Adjusted for Investment Properties at Market Value

The ODRC valuation has been adjusted for the ODRC value of the Investment Properties. The net ODRC valuation has then been adjusted for the market value of the investment properties.

The resultant valuation is:

ODRC valuation	\$791,463,100
<i>less</i> ODRC Investment Properties	\$ 46,902,500
Adjusted ODRC valuation (Land and Buildings)	\$744,560,600
<i>plus</i> Adjustment for Work in progress	\$7,300,000
<i>plus</i> Market Value - Investment Properties	\$50,600,275
<b>Total Valuation:</b>	<b>\$802,460,875</b>

### 3. Existing Use Value

The Beca and Seagar valuations have been merged so as to adopt market value as the primary method of valuation for the non-specialised assets and ODRC for the specialised assets. This valuation is apportioned between land, site improvements and buildings, as follows:

Non-specialised Assets:

Investment Properties	\$ 50,600,275
Other Market-Based Assets and Development Land	\$439,668,849
	\$ 490,269,125

Specialised Assets:

Airfield and Other Land	\$251,684,000
Storage Shed 3	\$32,500
Specialised Improvements	\$352,171,175
Work in progress	\$7,300,000
	\$611,187,675
<b>Total Valuation:</b>	<b>\$1,101,456,800</b>

The amount is summarised in the valuation summary table overleaf:

**Summary of Valuation****Non-Specialised Assets****Investment Properties**

Improvements	\$37,539,000
Land Value	\$13,061,275

\$50,600,275

**Retail**

JB International Terminal	\$304,540,000
Air NZ & Ansett Domestic Terminals	\$13,800,000

\$318,340,000

**Carparks**

International	\$34,900,000
Domestic	\$27,600,000

\$62,500,000

**Other Assets**

Commercial Props	\$38,765,000
Development land	\$20,063,849

\$53,828,848

\$439,668,849

**Total Non-Specialised Assets at Market Value (Including Land)**

\$490,269,125

Airfields	\$164,401,000
Sea Bed	\$31,156,000
Development/Vacant Land	\$22,897,000
Other Land Under-Specialised assets	\$29,226,000
Land under Roads	\$4,004,000

<b>Total Land</b>	1,722.6230	\$251,684,000
-------------------	------------	---------------

<b>Storage Shed 3</b>	\$32,500
-----------------------	----------

<b>ODRC Improvements - Specialised Assets</b>	\$352,171,175
---	---------------

<b>Work in Progress</b>	\$7,300,000
-------------------------	-------------

<b>Overall Value</b>	<b>\$1,101,456,800</b>
----------------------	------------------------

The valuations assume that the property is free of encumbrances, restrictions or other impediments of an onerous nature that would affect its value.

In preparing the valuation, no allowance has been made for any liability for Goods & Services Tax and is exclusive of that tax if payable.

Investment properties are shown net of disposal costs, which include, apart from the usual marketing, agency and legal expenses, the costs of survey and title provision for these parcels of land.

Part of the brief given to Ernst & Young was to provide an opinion as to the robustness of the valuation approach and conclusions as derived from the two independent valuers.

We can advise that throughout the valuation process, we have enjoyed a close working relationship with the independent valuers and with AIAL management. We are confident that the valuations are supportable and that they are sufficiently robust to withstand close scrutiny by stakeholders and airline users as required under the consultation process.

Yours faithfully

ERNST & YOUNG

Graeme Horsley

National Director

Real Estate Group

#### **Disclaimer**

Ernst & Young reserve the right to alter or amend any of the calculations or conclusions above should further information become available to us, or to the independent valuers which contradicts or amends information previously provided to us. We are, however, under no obligation to make such amendments.

We have necessarily relied on information and assumptions provided to us by AIAL, Beca Valuations Ltd and Seagar & Partners in reaching the views and conclusions stated in the foregoing report.<sup>7</sup>

<b>1</b>	<b>ODRC</b>	<b>\$791,430,600</b>
<b>2</b>	<b>ODRC (Inclusive of Investments)</b>	<b>\$795,160,875</b>
	Investment Properties	\$50,600,275
	Specialised Assets:	
	Airfiled and other land	\$304,176,000
	Specialised improvements	\$440,384,600
		\$744,560,600
		<b>\$795,160,875</b>
<b>3</b>	<b>Existing use value</b>	<b>\$1,094,124,298</b>
	Non-specialised Assets:	
	Market Based Assets	\$50,600,275
	Other Market based Assets	
	Development land	\$439,668,848
		\$490,269,123
	Specialised Assets:	
	Airfiled and other land	\$251,684,000
	Specialised Improvements	\$352,171,175
		\$603,855,175
		<b>\$1,094,124,298</b>