

ROGER N TAYLOR

*Midland Park Chambers
31 Waring Taylor Street
PO Box 3052
WELLINGTON
Tel 471-0573
Fax 471-0570*

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Commerce Commission Critical Issues Paper Response

Airports Historical Over Recovery Analysis

Introduction

1.1 In order to measure the extent to which the airports may have exceeded or under recovered against their cost of capital since corporatisation a comparison of actual performance against target performance based on ODV valued assets and target WACC was undertaken.

1.2 A number of issues however complicate the analysis. For example:

- No breakdown between non-contestable and contestable activities,
- Airport companies have not provided WACC targets for contestable activities and for the business as a whole,
- Historical WACC targets for each year not provided,
- AIAL and CIAL have not undertaken periodic revaluations,
- Full revaluations figures not included in financial statements.

1.3 To overcome these shortcomings it has been necessary to consider historical performance for the airports as a whole and to estimate a fair contestable cost of capital based on consultation evidence or information included in the disclosure statements for 2000.

1.4 Actual performance data has been taken from published financial reports and reconciled to the appendices provided in the Commerce Commission Critical Issues Papers.

1.5 Attached to this report are financial models showing the over/under recover analysis for each of the three airports AIAL, WIAL and CIAL. Included for each airport are calculations of company and airline assumed cost of capital calculations for each year since corporatisation. It should be noted that this analysis has been updated since the consultation discussions with AIAL and CIAL and therefore there will be some variance with analyses previously provided to those airports.

1.6 The underlying methodology for calculating WACC has been to adopt the targets assumed during consultation (or in the case of WIAL from the disclosure statements) and then to convert them by adopting specific risk free and inflation rates appropriate for each year.

1.7 With respect to the airports contestable WACCs, assumptions have had to be made on the various inputs as these have not been supplied by the companies.

1.8 The WACC figures shown below are corporate wide and include all non contestable and contestable activities.

1.9 To measure performance for the total company over the period since corporatisation it is necessary to spread revaluation gains and compare the annual returns against an appropriate target. Nominal returns will vary each year depending on inflationary expectations and therefore no single rate of return can be assumed.

1.10 In economic terms, revaluations are therefore included as part of income, and a corresponding adjustment made to the value of assets in the balance sheet. The standard formula for measuring the accounting rate of profit (ARP) as detailed in the *Electricity (Information Disclosure) Regulations 1994* , can be expressed as follows:

$$\text{ARP} = \frac{\text{EBIT} - \text{cash taxes} - \text{interest tax shield} + \text{revaluations}}{\text{Average total funds employed} - \text{half the amount of revaluations}}$$

1.11 Total average funds has been calculated as the average of opening and closing assets including revaluations, where revaluations have been spread over the period since corporatisation to the year where the airport company first recorded revalued assets in the financial statements.

1.12 For this analysis it has been assumed that the revaluation return is spread two ways. Firstly a percentage equal to inflation is applied to each years asset base and the remaining revaluation balance is spread as a constant percentage based on net book value of assets. The effect of this is to recognise the impact of inflation on asset values, particularly in the earlier years when inflation was higher, and higher returns would therefore have been expected. The increase in valuation over the rate of inflation is however closely tied to the total investment in assets.

1.13 As detailed below a number of specific adjustments have been made to individual airport analyses.

1.14 Capital work in progress has been added back for WIAL and CIAL as return on investment should only apply when the assets are in use. AIAL has not identified capital work in progress and therefore the analysis tends to understate the over recoveries being achieved.

Auckland International Airport Limited

[Appendix 1]

2.1 At June 1999 AIAL undertook a valuation of its assets and in the 1999 financial statements recorded some of the revaluation pertaining to specialised assets or those associated with non-contestable activities. The financial statements noted that if the full revaluation had been included then total asset value would have increased by a further \$299 million. Investment properties were revalued upwards by a further \$ 2.544 million in the 2000 financial statements.

2.2 Because the company has adopted a valuation policy of no less than 3 yearly revaluations the next revaluation would be no earlier than June 2002. It could be expected however that assets would increase in value during the interim and for the purposes of this analysis it has been assumed that assets, other than investment properties, are revalued by the rate of inflation – ie \$6.702 million.

2.3 The total increase in value at 30 June 2000 therefore is :

Fixed Asset Revaluation Reserve	\$ 258.545 m
Investment Property Revaluation Reserve	\$ 25.321 m
Unrecorded Revaluation at 30 June 1999	\$ 299.000 m
Additional revaluation 30 June 2000	<u>\$ 6.702 m</u>
Total Revaluation	\$ 589.568 m

2.4 The increase in value attributable to the revaluations represent an increase in return to the company and the shareholders. Whilst shareholders are able to capture this increase in value by selling their shares the company will in time capture this increase in cash via increased revenue charges.

2.5 To measure the extent to which AIAL has over or under achieved against its target returns or against what is considered a fair market benchmark, given the risks associated with its business activities, the real returns considered in the 2000 Consultation Round have been converted to nominal returns for each of the financial periods. As noted above this was achieved by adopting mid point inflation rates and government stock rates for each period. Other assumptions could be adopted, but would not be expected to significantly change the outcome of the analysis.

2.6 The average returns achieved by AIAL over the period since corporatisation was 13.68% compared to an average target return based on AIAL's view of required return of 10.63% and the airlines' determination of 8.62% (based on appendices 1b & 1c). It should be noted, in the absence of advice from AIAL that assumptions have had to be made as to what is considered appropriate cost of capital for contestable activities.

2.7 Based on this analysis AIAL has over-recovered by:

➤ AIAL average target return - 10.63%	\$208.648 m
➤ Airlines average target return - 8.62%	\$386.970 m

Christchurch International Airport Limited

[Appendix 2]

3.1 CIAL has revalued land on a number of occasions and like AIAL refers to unrecorded revaluations in its annual financial statements. In addition the CIAL pricing proposal assumes that the net book value of sealed surfaces is significantly higher (an increase of \$10,257 net of reseal reserve) than that shown in the financial statements. For the purpose of this analysis the unrecorded revaluations at 30 June 1999 and 2000 have been included, as well as an assessment of \$1.238 million, being an increase due to inflation on assets other than land and building in the year 2000 .

3.2 The total revaluations at 30 June 2000 is:

Fixed Asset Revaluation Reserve per financial statements	\$47.483 m
Unrecorded Revaluations at 30 June 1999	\$14.893 m
Additional revaluation at 30 June 2000	<u>\$ 6.296 m</u>
Total Revaluation	\$68.672 m

3.3 The increase has been spread according to the formula described above. It has been assumed that the total revaluation figure at June 1999, including the increase recorded in 1996, is spread over the previous 11 years.

3.4 To measure the extent to which CIAL has over or under achieved against its target returns or against what is considered a fair market benchmark, given the risks associated with its business activities, the real returns considered in the 2000 Consultation Round have been converted to nominal returns for each of the financial periods.

3.5 It should be noted that for the CIAL target returns the WACC model adopted at the last moment by CIAL to set charges has been used. It is also noted that CIAL changed its non competitive WACC target between its final advice to the airlines dated 6 October 2000 and its final pricing document dated December 2000.

3.6 The average returns achieved by CIAL over the period since corporatisation was 11.66% compared to an average target return based on CIAL's view of required return of 11.46% and the airlines' determination of 8.53% (based on appendices 2b and 2c).

3.7 Based on this analysis CIAL has over-recovered by:

➤ CIAL average target return – 11.46%	\$ 6.143 m
➤ Airlines average target return - 8.53%	\$62.042 m

Wellington International Airport

[Appendix 3]

4.1 WIAL has not been involved in consultation under the present legislation and therefore the airlines have not had the opportunity to either review recent financial data or engage the new majority owners on issues such as asset valuation or cost of capital.

4.2 Despite the lack of consultation a review of the historical performance of WIAL has been undertaken on the same basis as for AIAL and CIAL.

4.3 WIAL has adopted a policy of annual revaluations since 1993 including 2000 and therefore no additional revaluations are incorporated into the analysis.

4.4 The WIAL disclosure statements for 2000 has been used to derive the company's WACC.

4.5 The average return achieved by WIAL over the period was 9.16% compared to a target return based on WIAL's required return of 10.42% and the airlines' determination of 7.96% (based on appendices 3b and 3c) .

4.6 Based on this analysis WIAL has (under) / over-recovered by :

➤ WIAL average target return - 10.42%	\$(21.703) m
➤ Airlines average target return – 7.96%	\$ 10.118 m

4.7 The variation between the two cost of capital calculations highlights a particular issue of how to select the appropriate cost of capital target for the whole period, given the change of ownership of the company in 1999. Based on the disclosure statements the new owners appear to be targeting a significantly higher return than that sought by the former majority owner the Crown, as well as the minority shareholder the Wellington City Council.

4.8 Basing the required returns in the pre acquisition period on that indicated in the year 2000 disclosure statement therefore overstates the cumulative under recovery to March 2000. By comparison the airlines' based WACC more closely mirrors the return sought in the earlier years by the then owners.

4.9 It should also be noted that a similar issue also applies to CIAL and AIAL and results in the under recoveries being understated when the company derived WACC is used.

Roger N Taylor