BARNZ **Board of Airline Representatives New Zealand Inc**

14 July 2011

Mr Martin Harrington
Chief Financial Officer
Wellington International Airport ltd
PO Box 14175
WELLINGTON

Dear Martin

PRELIMINARY RESPONSE TO DRAFT VALUATION REPORTS

WIAL has provided BARNZ and its substantial customer airlines with draft land, building and civil works valuations for comment.

BARNZ has obtained independent expert planning and valuation advice which has been provided to WIAL, as well as to BARNZ members that operate scheduled services into Wellington Airport.

This letter forms a preliminary assessment by BARNZ on the valuation issues raised by the valuation reports obtained by WIAL from Telfer Young and their intended use by the airport for the purposes of setting charges.

The key concerns highlighted as a result of the analysis by BARNZ, and the independent advice it has obtained, are:

- The inconsistency (and significant differences in monetary terms) between the valuation methodologies proposed to be applied by WIAL (MVEU for land and ODRC for specialised assets) and the methodologies adopted by the Commerce Commission (MVAU for land and the 2009 values rolled forward and indexed by CPI for specialised assets). The uplift within the Telfer Young valuation from MVAU to MVEU amounts to $145m.

- The commercial unlikelihood of the Master Plan adopted by Telfer Young for the alternative use valuation and the aggressive nature of the sell-down period, both resulting in a MVAU valuation which is significantly overstated and one third greater than the 2006 MVAU adopted by WIAL, despite the market being relatively flat over that period

- The significant uplift in the MVEU valuation recommended by WIAL's valuers, which is largely attributable to the cost of capital being significantly increased, reflecting WIAL's own overstated view of its cost of capital

- The very material difference between the revaluations of $69m which were forecast by WIAL when it last set charges and the actual revaluations of $142m, which are double what was forecast in 2006.

These matters, and the advice obtained by BARNZ, are outlined in further detail in this letter.

Please note that this preliminary response by BARNZ should not be read as a response from any of WIAL's substantial customer airlines, who will respond separately in their own right, and whose views may differ from the views expressed by BARNZ.

COMMERCE COMMISSION APPROACH TO ASSET VALUATION

The question of how to value assets was considered in depth during both the Commerce Commission Inquiry into Airfield Charges which took place over 1998 to 2002 (in relation to pricing), and the setting of input methodologies by the Commission during 2009 to 2010 under Part 4 of the Commerce Act (in relation to the determination of input methodologies).

The Commission has taken a consistent approach to land over both processes, considering MVAU the appropriate valuation methodology for both pricing and information disclosure. Its approach to the valuation of specialised assets was clarified in the recent Part 4 Determination.

While the Commission's Determination under Part 4 is, for airports, for the purposes of information disclosure only at present, and is not binding for pricing purposes, the input methodologies represent the considered view of the Commerce Commission after receiving extensive submissions from all interested parties and seeking comprehensive expert advice. BARNZ considers that the Commission's input methodologies are highly relevant to the approach which should be taken to valuing assets for the purposes of setting charges. In this respect BARNZ notes that the Explanatory Note to the Commerce Amendment Bill noted that Input Methodologies would *'provide better information to guide consultations between airlines and airports and pricing decisions'* and *'remove much of the contention under the current regime'.*

Moreover, the Commission's Final Report in the Airport Price Inquiry in 2002 specifically considered the reasonableness of the prices charged by the three airports for airfield activities and is therefore directly relevant to the determination of charges by Wellington Airport.

Commerce Commission Approach to Valuing Land

In respect of appropriate land valuation methodologies, the Commission's decision in the Airport Price Inquiry was that:

- Airfield land should be valued at its opportunity cost, namely its value in its next best alternative use in the event that the airport was closed
- The opportunity cost should be assessed at the highest alternative use value
- Any land holding costs should be valued as specialized sunk assets at historic cost, however, in the case of WIAL the Commission held that these costs were almost fully, if not entirely, depreciated at vesting, with low or no value to WIAL remaining.

The three specified airports had argued that land should be valued by market value existing use. The Commission rejected MVEU despite extensive submissions on behalf of WIAL and the other airports, stating:

> *the Commission considers that none of those valuations are appropriate for the purposes of either judging the efficiency of asset allocation between alternative uses, or for pricing. From an economic perspective, the owner of an asset that earns at least as much in its current employment as in its next best alternative use will have no incentive to transfer that asset to that alternative use. Any return over-and-above that minimum amount called the asset's transfer earnings is economically a rent, that is, a return beyond that needed to retain the services of the asset in its current employment.*

In its Input Methodology Determination the Commission affirmed its position that land should be valued using opportunity cost. The Commission provided detailed instructions in Schedule A of its Determination to the effect that opportunity cost should be determined by the land's value in its highest and best use, other than for supplying airport services, which is **physically possible,**

appropriately justified, legally permissible, financially feasible, and results in the highest valuation of the land in question. In addition, the MVAU valuation must exclude the value of costs required specifically to convert the land into a form that is suitable for the supply of specified airport services, such as resource consents, holding costs and land reclamation costs.

The Commission considered that in a workably competitive market, land values will reflect the opportunity cost of the land in its next best alternative use. Past land conversion costs will either be reflected in the opportunity cost value of the land (such as levelling costs) or will already have been recovered long ago. As such there is no need to allow airports to earn a return on these past costs in order to encourage investment. Allowing airports to add on land conversion costs would simply have the effect of increasing the ability of airports to earn higher profits without those profits appearing excessive. The Commission stated at para 4.3.64:

> *Including most of these items would therefore have no other effect than to reduce the apparent level of profitability for an Airport for a given level of pricing. This would be likely to materially increase the level of prices that Airports could justifiably charge their consumers without consumers receiving any offsetting benefit.*

Thus, both for pricing purposes and for information disclosure and monitoring purposes, the Commission has consistently considered that opportunity cost is the means by which airport land should be valued.

Commerce Commission Approach to Valuing Non-Land Assets

With respect to the methodology by which to value non-land assets, the members of the Commission in the Airport Price Inquiry were divided:

- Three Commissioners favoured using historic cost as at the time of corporatisation. This formed the Commission's decision in its Final Report.
- Two Commissioners dissented as they considered ODRC should be used for specialised assets.

In its Determination of Input Methodologies under Part 4 the Commission directed non-land assets to be valued using the valuation disclosed by the airport in its 2009 disclosure accounts, thereafter rolled forward by acquisitions, disposals and depreciation, and indexed at CPI. The Commission considered that this would not prevent airports from earning a normal return on the original cost of installing assets. The Commission considered that further revaluations of specialised assets were not warranted, noting that, if an airport was to materially increase its prices, such revaluations would enable an airport to extract excessive profits without this being apparent to interested persons. The Commission stated: (refer para 4.3.11-12).

> *A material one-off increase in the regulatory value of an Airport's past investments on the basis of a replacement cost-based approach meets with similar objections to a material decrease on the basis of an opportunity cost valuation. An increase in pricing of the scale that could be implied by a new replacement cost-based revaluation would be equally inconsistent with the outcomes produced in workably competitive markets characterised by on-going relationships between suppliers and consumers.*

WIAL'S APPROACH TO VALUATION

WIAL is proposing to set charges using asset revaluations undertaken as at 31 March 2011 using market value existing use (MVEU) for land and optimised depreciated replacement cost (ODRC) for civil works and buildings. As such, the approach proposed by WIAL is inconsistent with both the input methodologies determined by the Commission under Part 4 as well as with the principles contained in the final report of the Airport Price Inquiry.

WIAL revalued its assets in 2006 (on which charges were set in 2007) and again in 2009 using the same methodologies.

The increase in value between 2006 and 2011 is material, amounting to more than $200m. However, the information provided to date by the airport, does not enable a definitive picture to be obtained as to what proportion of the valuation movements are due to capital expenditure, depreciation, revaluations and asset reallocations. This is because of the changes to asset allocation since 2006, the lack of detail around movements in valuations in the FY07 Disclosure Statements (under the previous financial reporting rules) and because the Information Disclosure Statements for FY11 have yet to be published. WIAL has, however, advised that revaluations represent $142m of the uplift.

The movements in WIAL's total identified airport activity values are set out below.

WIAL Identified Airport Activity Asset Values

	2006	2009	2011
Buildings	108.8	93.5	134.7
Land	212.5	145.5	263.3
Civil Works	Included above	117.4	133.1
Plant and Equipment	8.5	10.2	11.8
Work in progress	12.2	12.4	
Total	**$341.9m**	**$378.9m**	**$542.9m**

SOURCES: The 2006 and 2009 values are sourced from WIAL's Financial Disclosure Statements released under the Airport Authorities Act. The 2011 values are as disclosed by WIAL in its Initial Information provided during consultation.

The asset values are affected by the approach to asset allocation, particularly leased assets. In 2006 WIAL included leased assets within the definition of identified airport activity assets for disclosure (as is appropriate), but excluded them from its pricing asset base (as is appropriate). In 2009 WIAL also excluded leased assets from its disclosure asset base (which was incorrect). In 2011 WIAL has included leased assets within its disclosure asset base (which is appropriate), but is also proposing including leased assets within the asset base on which it sets common charges (which the Commerce Commission expressly considered inappropriate for pricing in the Airport Price Inquiry, which is inconsistent with ICAO charging principles and which would result in cross-subsidisation between users).

BARNZ requests that WIAL ensures sufficient information is provided as consultation continues so as to enable participants to obtain a clear understanding of the composition of the valuation movements. In particular, information in the same format as note 10 to the FY09 and FY10 Disclosure Financial Statements for valuation movements in FY07 and FY11, and forecast movements for FY12, is needed. In addition, a detailed breakdown is required on the outcome of the asset allocation methodology, so that airlines have a full understanding of which components of the airport assets make up the asset base included in the aeronautical asset base proposed to be used for pricing.

COMMENT ON WIAL'S LAND VALUATION

BARNZ has requested Mr Dougal Smith, a registered valuer with Property Advisory Ltd, to undertake a peer review of the MVAU land valuation prepared by Telfer Young for Wellington Airport. Property Advisory was assisted by Mr Mike Foster, a town planner with more than 30 years of experience.

Outline of WIAL Land Valuation

WIAL has undertaken an MVAU valuation in accordance with the methodology set out by the Commerce Commission (although the land use plan and inputs are questioned by the BARNZ advisers as outlined below).

However, WIAL has then added on the costs of holding the land and converting it to an airport – thus resulting in a market value existing use valuation, which is substantially higher than the opportunity cost of the land, in this case $145m higher. The approach used by WIAL was rejected by the Commission in both its Airport Pricing Inquiry and the recent Input Methodology determination. The Commission has consistently concluded that in workably competitive markets, land values will reflect the opportunity cost of the land in its next best alternative use, and adding on an uplift reflecting today's value of land conversion costs, which were incurred many many years ago, is not justified.

The recent movements in the inputs to WIAL's land values over time are summarised below:

	2006	2009	2011
Hypothetical Subdivision DCF Value			
Area	110.6ha	111ha	103ha
Use	30% low density res 20% med density res 20% industrial/commercial 10% reserves 20% roads	30% low density res 20% med density res 20% industrial/commercial 10% reserves 20% roads	6% low/med density res 32% med/high density res 7% retail town centre 7% bulk retail 21% office park 9% reserves 18% roads
Gross realisation	$368m	$377m	$461m
Development costs	$44m	$44m	101m
Discount rate	25%	Circa 21%	25%
Development period	10 years	10 years	7 years
Value	$145m	$145m	$166m
Other land already in highest use			$31.2m
Total MVAU	$145m	$145m	$197m
MVEU cost to bring land to airport use			
MVAU	$145.3m	$145.6m	$166m
Plus rates	$6.3m	$7.5m	$7.5m
Plus planning approval	$2.2m	$8.0m	$8.0m
Holding risk	$84m	$89.9m	$129.6m
Cost of capital	9.5%	10%	11.8%
Sum to bring to airport use	$92.4m	$105.4m	$145.2m
MVEU land value	$237.7m	$251m	$311m
Other land already in highest use			$31m
Total MVEU			$342m
MVEU Zonal Value			
	All land = $231.1m	All land = $234.5m	$236.9m Unclear if all land or 103ha only. No reasons or detail provided in report.

This comparison highlights:

- The significant shift in land use in the 2011 MVAU to more intensive highly valued uses than in earlier valuations, and the resulting large increase in gross realisation
- The shortening of the development period in the MVAU from 10 years in 2006 and 2009 to 7 years in 2011
- In the MVEU the increases to the adopted cost of capital in each subsequent valuation from 9.5% in 2006 to 10% in 2009 to 11.8% in 2011
- That the MVEU based on zonal market values (block comparisons) has remained relatively static over the five years, increasing from $231m in 2006 to $237m in 2011
- The significant difference between the latest MVAU value of $197m and the MVEU of $342m
- The significant difference between the holding cost MVEU proposed to be adopted by WIAL of $342m and the zonal block comparison MVEU also undertaken by Telfer Young which produced a value of $237m, despite both valuations purporting to be the market value of the land in its existing use as an airport

In BARNZ' view an opportunity cost valuation of the land in its next best alternative use other than as an airport should be adopted by WIAL for the purposes of pricing. Any higher value is greater than the return that would be able to be earned in a workably competitive market, and represents an expectation of monopoly rents.

BARNZ therefore requested Property Advisory Ltd to undertake a peer review of the MVAU land valuation prepared by Telfer Young for Wellington Airport. As noted above, Property Advisory was assisted by Mr Mike Foster, a town planner.

Town Planning Advice

Mr Mike Foster has reviewed the Boffa Miskell proposed town plan of the airport land and has advised that in his opinion the proposed master plan in its current form is seriously flawed. In particular, Mr Foster considered that:

- The town centre and retail areas (both traditional and large format) are too large, given the potential catchment area and the significant adverse effects on existing centres
- The office park development is extremely generous
- In light of his experience of similar developments around New Zealand, the sell-down assumptions are too optimistic
- The area allocated to reserves is too small

Overall, Mr Foster's conclusion was that the proposed master plan 'borders on the fanciful'.

Mr Foster identified a more realistic plan as being:

- a 2ha shopping centre (a supermarket with a range of specialty shops, commercial services and fast food)
- an expansion of the existing large format retail area to the west of the existing airport by, say, around 5ha
- no office park development

- expanded reserve areas
- the balance comprising medium and low density housing

Valuation Peer Review

BARNZ requested Property Advisory to undertake a peer review of the draft Telfer Young MVAU valuation of Wellington Airport land. Property Advisory believe the highest and best alternative use hypothetical subdivision plan used by Telfer Young is too aggressive with respect to:

- The 'consent-ability' of the plan
- The planning and construction timeframe
- The assessment of the required profit and risk margin to the developer
- The level of perceived demand for commercial land (i.e. traditional retail areas, bulk retail and office park land)
- The appropriate sell down period for the land
- The exclusion of seawall maintenance costs from the land value analysis

As a result of these factors Property Advisory has advised that it considers the Telfer Young MVAU value to be significantly overstated.

COMMENT ON WIAL'S APPROACH TO VALUATION OF NON-LAND ASSETS

Since charges were last set in 2006, WIAL has revalued its non-land assets (its civil works and buildings) in 2009 and again in 2011. Both revaluations were based on the ODRC methodology.

As noted above, the Commerce Commission held different views among its members in 2002 when the Airport Price Inquiry took place, with the majority considering a historic cost value should be adopted and the minority preferring an ODRC value. In 2010 when the input methodologies were determined for information disclosure purposes, the Commission adopted a 'deemed historic cost' of the values disclosed in 2009 by each provider, with those values thereafter being indexed forward at CPI.

BARNZ is not yet in a position to be able to calculate the difference between the Commerce Commission's approach and the 2011 ODRC values proposed to be used by the airport, given the absence of the information disclosure statements for FY2011 and FY2012. WIAL is requested to provide this information with its Initial Pricing Proposal.

BARNZ has previously adopted the position that the asset base for pricing purposes should only include revaluations to the extent that they have been treated as income when setting charges. In the 2006 consultation with WIAL, BARNZ applied this principle to the 2002 valuations which had applied at the time of the Airport Price Inquiry, and rolled WIAL's asset base forward from that point taking account of depreciation, capital expenditure, acquisitions and disposals and the revaluations which had been treated as income when charges were set. Rolling forward the asset base in this manner resulted in an asset base which was $120m lower than the 2006 revaluations booked by WIAL. The 2006 revaluations thus allowed WIAL to earn a return on $120m of revaluations, not representing an investment made by the airport or treated as income in the charge setting process.

WIAL forecast revaluations totalling $70m when it set charges for the FY07 to FY12 pricing period. BARNZ forecast revaluations totalling $95m in its alternative revenue calculation based on WIAL's building block structure. Under WIAL's most recent MVEU and ODRC valuations (putting to one side questions of their appropriateness) WIAL advises there have been $142m of revaluations. Hence there are revaluations of between $47m and $72m that have not been treated as income in the price setting process. The exact figure is dependent on the wash-up arrangement which WIAL proposed and adopted at the conclusion of the 2006 consultation process, which WIAL has not applied within the preliminary information provided to date, advising instead that this issue will be addressed within its Initial Pricing Proposal. BARNZ therefore reserves further comment until that information is provided.

CONCLUDING COMMENT

BARNZ trusts that these preliminary comments on WIAL's draft valuations, and the airport's indicated approach to asset valuations for pricing purposes, are clear.

Yours sincerely

John Beckett
Executive Director