BANCORP

BANCORP TREASURY SERVICES LIMITED

11th Floor, 191 Queen Street, PO Box 4270, Auckland 1, New Zealand
Tel: 64-9 912 7600, Fax: 64-9 912 7601

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Simon Robertson
Acting Chief Executive
Auckland International Airport Limited
P O Box 73 020
AUCKLAND

Dear Simon

INTEREST RATE RISK MANAGEMENT

Further to recent discussions around interest rate risk management please find detailed below comment by Bancorp Treasury Services Limited ("Bancorp Treasury") in relation to market best practice for interest rate risk management and how Auckland International Airport Limited ("AIAL") compares. We also critique the implicit premise of the WACC Input Methodology relating to airport information disclosure that AIAL could manage its interest rate risk to align with the (usual) 5 yearly aeronautical price path resets.

BACKGROUND

As part of our advisory services to a number of infrastructure focused clients in New Zealand and Australia we recently undertook a simple cost of funds survey focusing on companies that operated in the infrastructure space and/or were regulated, in relation to the WACC that they could apply when determining revenues.

The results were on a confidential basis with participants asked to supply their average cost of debt for the 2010/2011 and 2011/2012 financial years. The cost of debt figure supplied was to include margins, line fees, amortised establishment fees and the impact of all hedging in place. The results are detailed below with AIAL highlighted.

	Total Debt						Cost of funds	Cost of funds
	< $200m	$200m to $500m	$500m to $1 billion	> $1 billion	Rated	Non-rated	30/06/2011	30/06/2012
Entity A				✓	✓		6.77%	6.75%
Entity B		✓			✓		6.65%	6.47%
Entity C				✓	✓		7.38%	6.95%
Entity D	✓					✓	7.01%	6.91%
Entity E	✓					✓	7.38%	7.47%
Entity F	✓				✓		6.85%	6.84%
Entity G		✓			✓		6.75%	6.65%
Entity H				✓	✓		7.61%	6.96%
Entity I				✓	✓		7.50%	7.41%
Entity J				✓	✓		7.10%	6.90%
Entity k				✓	✓		6.79%	6.53%
Auckland Airport				✓	✓		6.58%	6.52%

The average cost of funds ranged from 7.50% to 6.58% for 2010/2011 and 7.47% to 6.47% for 2011/2012. AIAL had the lowest cost of funds in 2010/2011 and second lowest in 2011/2012.

All entities surveyed managed their interest rate risk on a portfolio basis taking into account levels of certainty required, specific business operations and assets being funded and also liquidity and funding risk management. No regulated organisations managed interest rate risk to align with a regulatory reset period. This is consistent with what we have observed as market best practice in Australia. Queensland Treasury had historically attempted to manage the debt of state owned entities to the various regulatory cycles but we believe it has abandoned this approach given the material funding and hedging execution risks faced. NSW Treasury has consistently managed interest rate risk for regulated state owned entities on a portfolio basis. Analysis completed by TCorp in 2008/2009 that we were a party to concluded that fixing all debt to the regulatory cycle could impose up to 50 basis points (0.50%) on interest rate swap costs alone.

There has been significant debate in Australia around how the cost of debt is determined by the regulatory authorities. The AER is currently considering how it will determine the Risk Free Rate ("RFR") going forward given the significant flaws widely recognised in using a narrow timeframe ahead of a regulatory reset to determine debt costs. At this stage it seems a 10 year trailing average is the most likely result and this is consistent with methodology being adopted in the United Kingdom.

AIAL has clearly adopted market best practice in terms of interest rate risk management and is also clearly effective at minimising interest cost within a robust treasury policy framework. We do not believe it would be prudent or even practicable for regulated entities to efficiently manage their interest rate risks using derivatives to align the interest rate profile with the underlying regulatory timeframe. This is consistent with our advice to a number of entities that have made submissions to the Commerce Commission on this issue.

If you have any queries in relation to the above please do not hesitate to contact either of the undersigned.

Yours sincerely

EARL A WHITE
Director

ANGELA GRAAFHUIS
Client Advisor

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