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Sam Hansen
Manager, Finance
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Dear Sam,

Commerce Commission 56G review submissions – ODRC valuations

The Commerce Commission 56G review entails submissions from interested parties on how effectively information disclosure regulation is promoting the purpose of Part 4 of the Commerce Act 1986 for New Zealand airports. Auckland Airport has received submissions from BARNZ, Air NZ and Qantas. The BARNZ submission and also the Air NZ submission, both refer to "serious concerns raised to the reasonableness of the ODRC valuations undertaken for Auckland Airport.

The 2006 & 2011 ODRC valuations were undertaken by Opus International Consultants Ltd (Opus). Our responses to the issues raised (highlighted in red) are interspersed with excerpt from the BARNZ submission presented below.

Specifically the BARNZ submission includes the following statement.

"The 2006 and 2011 Opus Valuations.
Auckland Airport engaged Opus to revalue its specialised buildings and runway, taxiway and aprons as at 30 June 2006 and again as at 30 June 2011. Significant revaluations were booked in 2006 which were never treated as income. Auckland Airport's 2011 ODRC revaluation similarly includes further significant revaluations - again not treated as income. These 2011 revaluations amount to $60m for runways, taxiways and apron revaluations and $56m for infrastructure revaluations.[43]

The revaluations referred to by BARNZ represent 22% increase for the runway, taxiways and aprons and an increase of 20% for the infrastructure assets over the 2006 to 2011 interval. These increases are consistent with price rises over that period.

Growth cycles in economic activity in the construction sector combined with a wide range of local and international factors had resulted in a significant increase in construction costs over that period. The major factors contributing to these cost escalations included:

43 Auckland Airport Annual Report for the year ended 30 June 2012, page 70, note 11 to the financial statements. Note the infrastructure revaluation will be partly attributable to aeronautical assets and partly attributable to other assets.

- Legislative changes which increase compliance costs (e.g. Health & Safety, greenhouse emissions, environmental protection/standards, labour laws etc.)
- Price of oil
- NZ exchange rate
- Increasing commodity prices fuelled by international demand (China)
- Skill shortages
- National and International disasters (earthquakes and floods)
- Financial Crisis

A measure of costs increases over the 5 year period since the previous valuation can be gauged from published cost indices. The increases in a number of relevant cost indices are tabulated below.

Time period	Index	% Increase
July 2006 to May 2011	Bitumen Price Index	50%
March 2006 to March 2011	NZTA Bridge Construction Index	22%
March 2006 to March 2011	NZTA Road Construction Index	21%
March 2006 to March 2011	NZTA Reseal Index	32%
March 2006 to March 2011	NZTA Maintenance Index	20%
June 2006 to March 2011	Stats NZ CGPI Construction	20%
June 2006 to March 2011	Stats NZ CGPI Transport	19%
June 2006 to March 2011	Stats NZ CGPI Pipelines	24%
June 2006 to March 2011	Stats NZ PPI Construction	23%

The cost indices above are national averages. Auckland cost rates have risen faster than the national average by approximately 5% over the same period. Taking into account the increases in the costs indices above, it can be reasonably assumed (conservatively) that there has been a 20% to 25%increase in construction costs over the 2006 to 2011 period.)

Over the course of consultations in 2000 and 2006 advisors for BARNZ have raised ongoing questions with respect to:

* Whether the unit costs adopted by airport valuers are valid - i.e. do they represent a significant scale of construction or are they indicative for smaller incremental construction projects?

(The unit costs adopted by Opus were based directly on actual construction costs at, or close to, the date of the valuation. Particular care was taken to ensure that the construction contracts used to derive the unit cost rates were of significant scale that reflected the typical development increment associated with that particular, or similar, facility. For example the cost rates used for the 2011 valuation of the terminal buildings were benchmarked against the following contracts; the 3A Arrivals expansion ($77M), the Pier B expansion ($50M) and the First Floor Development ($45M). The costs rates used for the runway were based on the runway reconstruction project ($33M). As demonstrated by these examples the unit cost rates adopted by Opus were based on significant and relevantly sized construction projects.)

* Whether it is appropriate to be revaluing these assets on an incremental brownfields basis?

(The incremental brownfields approach is widely recognised internationally as an appropriate method for valuing infrastructure networks and large scale facilities like an airport terminal that grow and are replaced on an incremental basis. The methodology recognises that these particular types of asset are never built or replaced in entirety but in economically viable blocks/increments. It also recognises that as these assets grow there is increasing intensification both within the asset and its surrounding area, increasing the value of the asset. The impact of this is appropriately reflected by the increasing browning of costs used to assess the replacement cost of the asset.)

* Whether the add-ons which have been applied as part of the valuation for working in an operational airport environment, including additional security costs and air side costs, are valid? These add-ons are calculated by the valuers based on information provided by the airports and cumulatively, combine to factors of more than 2.5.

(The add-on costs were back-calculated from actual airport construction costs. A top down approach was specifically adopted to calculate these add-on factors to ensure that they reflected actual add-ons and that their inclusion with the direct costs resulted in valuation that closely matched total costs of actual projects.)

* Whether it is appropriate to be including costs which were never incurred in the first place when the assets were originally constructed, such as today's OSH, security and RMA costs?

(The approach adopted by Opus is to apply unit cost rates and add-ons costs that reflect the actual operational environment relevant to each asset. For non-depreciable assets, the cost rates and add-on allowances were set to reflect the operational environment that existed when they were originally constructed. For example the sea protection works and reclamation were valued using greenfield cost rates with no brownfield mark-ups. Depreciable assets on the other hand, have been valued using unit cost rates and add-on allowances that reflect the actual cost for their renewal and replacement. For example the runway has been valued using unit costs and add-on allowances that reflect the stringent airside security constraints and restrictive working conditions associated with the replacement of this asset.

In other words, the valuations of these assets are a fair reflection of the actual costs incurred.

* Whether instructions given by airports as to the level of holding costs or finance costs are appropriate?

Opus was not given instructions by the airports as to the level of holding or finance costs to be used for the ODRC valuations. The allowance used by Opus for the 2011 valuation has been limited to the capitalised interest charges on the debt component of construction costs. The level of debt was taken from information published in the most recent AIAL's annual report. That was D/(D+E) = 36.6%. The add-on allowance was less than 1% for the passenger terminal buildings, runway, taxiways and aprons and all other infrastructure assets except for the sea protection and reclamation assets which were 6.1% and 4.2% respectively. These latter two allowances reflect the long 3 to 5 year holding period for these assets. The amounts capitalised into the asset valuations for financial costs are modest allowances.

* Whether the cost of capital adopted within the valuation is appropriate?

No allowance for the costs of capital was included in the Opus 2011 valuation.

BARNZ therefore has serious concerns with respect to the reasonableness of both ODRC revaluations, and is strongly opposed to the on-going practice of airports revaluing specialised assets using ODRC. The use of historic cost or indexed historic cost is preferred by BARNZ."

The ODRC valuation methodology is internationally recognised as the appropriate method for valuing specialised assets such as an airport. The revaluations undertaken by Opus are in full compliance with international accounting and valuation standards.

BARNZ's suggestion that historic cost or indexed historic cost is preferable is inappropriate for a number of reasons. Specifically:

1. Historic Cost.

   Suitable records of historic costs do not exist. Rather I suspect that BARNZ are referring to historic ODRC valuations of Auckland Airport. While this information is available they are far from reasonable representations of "fair" value. Considerable improvements have been made to both the knowledge/data of the assets involved but also in the ODRC methodologies and their application.

2. Indexed Historic Cost

   Indexing of costs over medium to long periods is fraught with uncertainty. Indices are based on national averages which can vary significantly for individual assets and locations. Also each type of asset has different combinations of inputs which can result in a wide variation of increases between asset groups

The more recent revaluations are a significantly better indication of "fair" value compared to those valuations BARNZ would prefer to use.

Yours Sincerely

John Vessey (Partner of Opus)
Technical Principal, Economic Assessment and Asset Valuation