Auckland Airport

Updated – public version

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Dear Matthew

Response to information request

A) Operating leverage

As you have noted in your request, our decision on the appropriate target return for PSE3 was informed by our understanding of the changes in systematic risk at Auckland Airport that would flow from the major step-change in our capital expenditure programme relative to historic levels. NERA's analysis provided capex-based empirical evidence that showed Auckland Airport was moving into a phase of higher operating leverage and systematic risk, and set out how this was different to Auckland Airport's historical position as well as to the Commission's sample group of global airport companies. This evidence-based approach was an important part of our decision-making process.

We understand that you are interested in better understanding changes in Auckland Airport's operational leverage over time in addition to the capex-based measures included in NERA's March 2017 report. You have asked us to provide Auckland Airport's historic operating leverage for each year in PSE2, and the forecast operating leverage for each year in PSE3 – where operating leverage is measured as fixed costs divided by total costs.

This response (a) explains in more detail why we have not provided the information exactly in the form that you have requested; and (b) pulls together information from our information disclosure statements that can be used to calculate alternative proxies for operational leverage.

Operating leverage and proxy measurements

At the time of pricing, we were forecasting a fundamental change in the nature of Auckland Airport's costs going forward due to the major step-up in capex relative to our historic baseline. As well as substantially increasing our capex profile, we also knew that the investment plan would have a major impact on our cost distribution – both because the make-up of our total costs would be much more heavily skewed towards capex rather than opex, and because large parts of the capital expenditure programme would be difficult to alter in response to changes in customer volumes. In order to understand the impact of this change on our business, we sought to better understand the impact that this would have on our operating leverage and our systematic risk.

As operating leverage can be difficult to measure precisely, and because Auckland Airport does not have an Activity Based Costing model that categorises all of our historic and forecast costs as either fixed or variable on an annual basis, we did not attempt to precisely calculate our operating leverage in the way you have asked us (i.e. operating leverage measured as fixed costs divided by total costs). Moreover, the change in Auckland Airport's costs over PSE3 is a

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structural shift towards capex as opposed to opex, rather than a change in the composition of opex.[1]

Based on NERA's advice about how overseas regulators had approached the relationship between operating leverage and systematic risk, we also understood that regulators typically did not attempt to categorise costs as either fixed or variable for the purposes of calculating operating leverage, and instead used proxies to inform their understanding of operating leverage.

At the time we set prices, we therefore considered it was reasonable to take guidance from the capex-based measures in NERA's report as a proxy for the nature and broad scale of the change in our operating leverage and systematic risk going forward.

The use of capex-based measures reflected the practical reality that it was the step-change in Auckland Airport's capex that was driving the fundamental change in the nature of our fixed and variable costs in PSE3. Capex-based measures were also used because we understood it was important to examine how Auckland Airport differed from other companies in the Commission's comparator sample set – and reasonable data about capex was more readily available for these comparators as well as for Auckland Airport.

As we did not make a specific adjustment to the target return to account for the forecast increase in operating leverage over PSE3, we did not seek to more precisely quantify our historic operating leverage and the forecast operating leverage for PSE3. Rather, we considered that the proxies in NERA's report supported using estimates of Auckland Airport's beta to inform the target return for PSE3, rather than a beta derived from the Commission's comparator sample. We believe that this approach is somewhat conservative (ie understates Auckland Airport's forecast asset beta) because it uses historic Auckland Airport asset beta data, rather than attempting to adjust the historic beta estimates upwards for the impending increase in operating leverage and systematic risk driven by the unprecedented aeronautical capex to take place over PSE3.

Additional proxies for operating leverage supported by regulatory precedent

That said, we appreciate the Commission is interested in better understanding the change in Auckland Airport's operating leverage over time, and is looking for additional information to cross-check the evidence in NERA's analysis.

In one of the regulatory cases discussed by NERA in its original advice to us, the UK Competition and Markets Authority (CMA) made an adjustment to Bristol Water's asset beta to reflect its higher operating leverage relative to the sector as a whole.[2] The CMA considered a range of proxies for operating leverage, recognising that none are perfect:

- Operating cash flow (OCF) / revenue; (lower %, higher operating leverage)
- Total expenditure (TOTEX) / RAB; (higher %, higher operating leverage)
- Revenue / RAB; (higher %, higher operating leverage)

As already noted, the change in Auckland Airport's circumstances is driven by a structural change towards capex, rather than change in the composition of opex from variable to fixed costs. This change is captured by the TOTEX / RAB measure and, to a lesser extent, by OCF / revenue.[3] As shown in the following charts, each of these measures shows a substantial change for Auckland Airport in PSE3 relative to PSE2.[4] We have also presented net cash flows / revenue for a further comparison.

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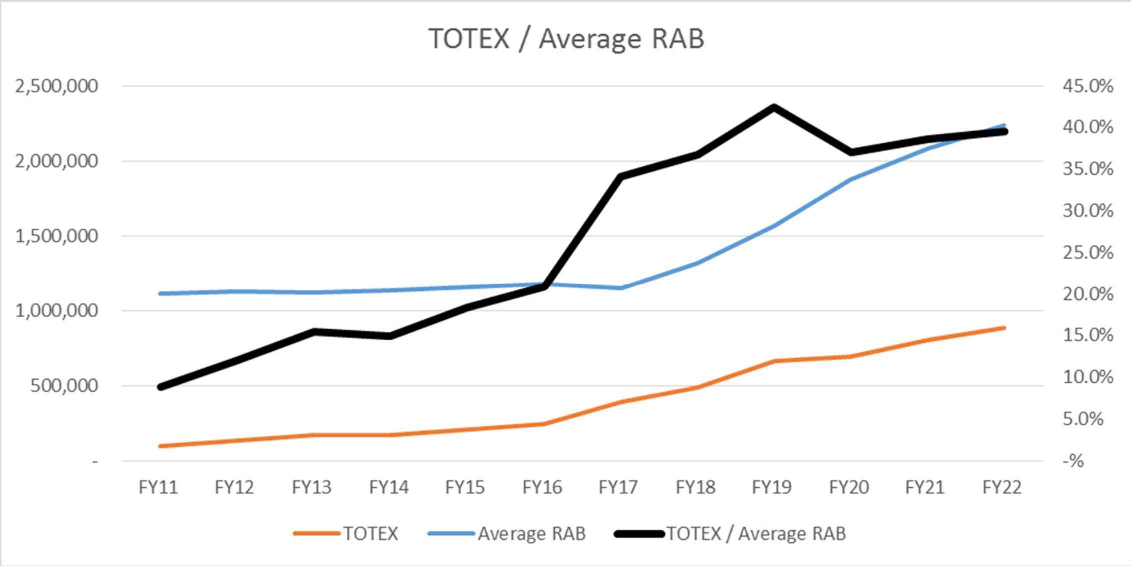
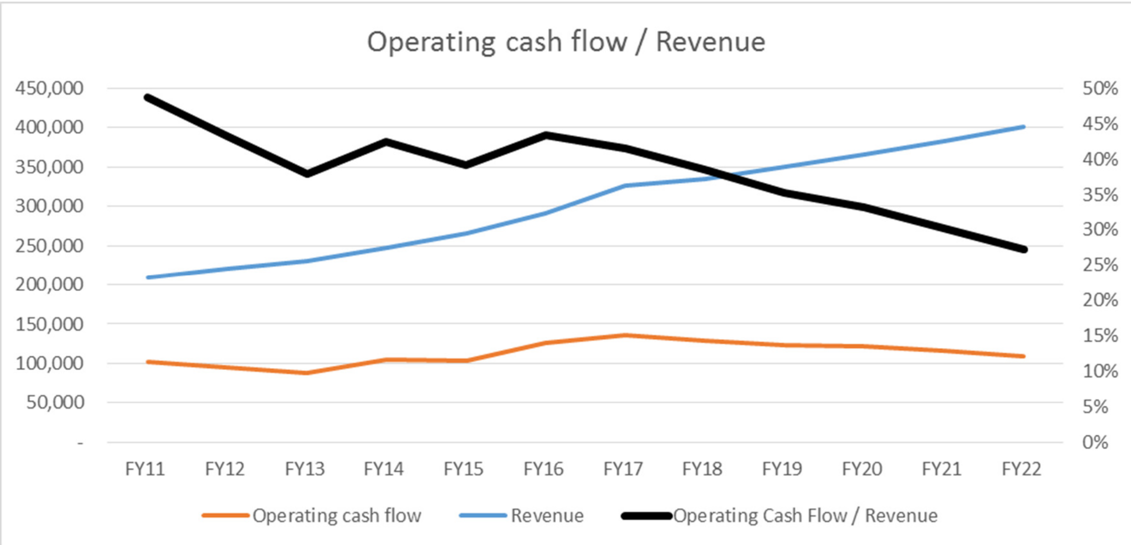
1 It is ultimately the proportion of Auckland Airport's cash outflows that are fixed, rather than the proportion of a category of costs (opex) that is fixed.

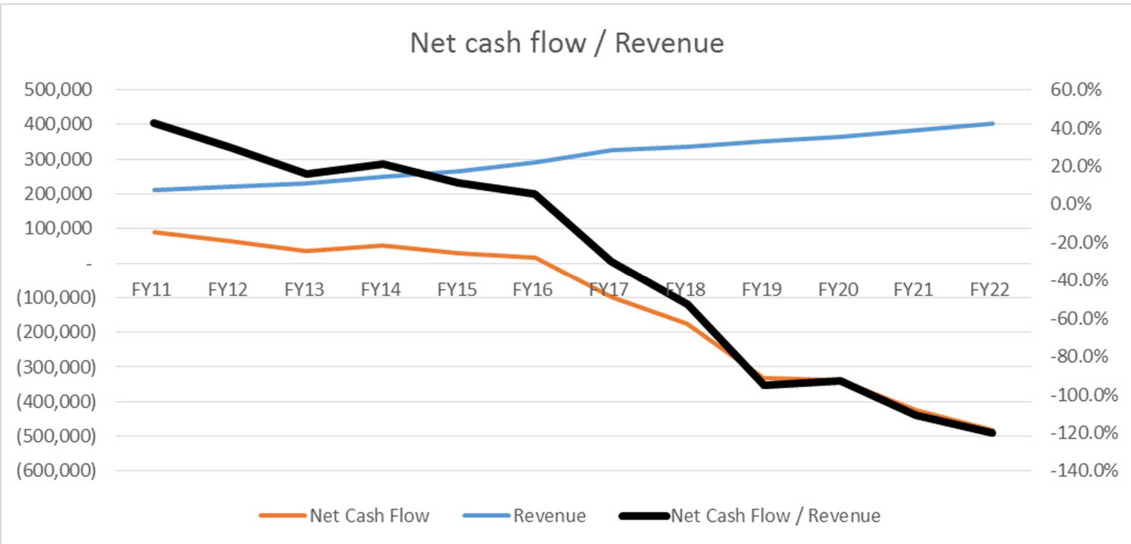
2 Competition and Markets Authority (June 2015): "Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, A10(1)-24, A10(1)-33, cited in NERA March 2017 report at section 2.4.

3 Increased capex will impact OCF / revenue to the extent that capex is financed by debt and therefore interest becomes an increasingly material aspect of the cost base.

4 The information supporting these charts is included as Appendix 1. Calculating TOTEX has required an assumption to be made about the interest cost associated with funding new regulated capex over PSE3. For simplicity of this calculation, the forecast regulated interest expense assumes new regulated capex is fully-funded by debt. This is







an assumption made for simplicity and only for the purpose of calculating these proxies. Auckland Airport is continuing to explore its capital management levers for PSE3 as discussed further in our price setting disclosure published in August 2017.

B) Capital expenditure information

The information requested by the Commission is included as Appendix 2. This table includes some confidential information which has been redacted from the public version of the Appendix.

When reviewing this table, we think it is important to keep in mind that total aeronautical capex in PSE2 was 80% above the PSE2 forecast, as we accelerated capital expenditure in response to the change in market conditions and consumer demands over the period. This included the acceleration of the Pier B project in response to airline feedback.

Please contact me if you have any further questions.

Yours sincerely,

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