Frontier Economics, Melbourne

Report prepared for AIAL on the Auckland Airport pricing review
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EXECUTIVE SUMMARY

Frontier Economics was engaged by Auckland International Airport Limited (AIAL) to conduct a peer review of its pricing proposal for aeronautical services for the period 2007-2012. Frontier Economics was founded in 1999 by a team of highly experienced consulting economists. Frontier has offices in Melbourne, Sydney, Brisbane, London and Cologne. The peer review of the AIAL pricing proposal was conducted in the Melbourne Office of Frontier Economics by a team headed by Dr Philip Williams.

AIAL is required to consult with its substantial customers every 5 years to set charges for aeronautical services. The recent consultation process commenced in August 2004. Over the course of the consultation process, AIAL has reduced its proposed prices by a significant amount. Its final offer proposes small increases (2.5 per cent per year) in airfield charges and 50 cent rises in passenger (terminal) charges in years 2008-2010.

Frontier Economics was asked to assess whether AIAL's final pricing offer was reasonable. To be reasonable, the prices needed to involve no monopoly pricing, promote efficient airport usage decisions, and allow investors in AIAL to earn a market rate of return. Also, the methodology used to derive the prices had to be objective and transparent.

AIAL proposes to set its prices based on an estimate of its economic costs. AIAL has used a 'building block' approach to estimate costs, where the blocks reflect the recovery of operating costs, depreciation, tax expenses and a return on capital assets (land and other assets, such as the terminal buildings). The building block approach is the most common approach used by government regulators.

There is always an element of subjectivity in any application of the building block methodology. The key issues of application that we address in our report to the Board of AIAL are:

- the valuation of land that is used to provide aeronautical services, and how much of this land that is included for pricing purposes;
- the valuation of other assets (such as the terminal buildings) that are used to provide aeronautical services;
- the treatment of increases in the value of land and non-land assets over time;
- the appropriate rate of return on capital employed by AIAL, as measured by its weighted average cost of capital (WACC);
- the level of AIAL's capital and operating expenditure so that it is efficiently-incurred and a reasonable split of expenditure between aeronautical and commercial activities; and
- the reasonableness of charges when assessed against the charges levied by comparable airports.

Our conclusion is that, when taken as a whole, AIAL's proposed prices are reasonable. They are based on inputs that reflect a reasonable compromise between economic principles and the desire for objectivity, transparency and long-term solutions.

In two respects AIAL has made generous concessions to the airlines in the interest of achieving a resolution – the sharing of past revaluation gains associated with airport land, and the exclusion of airport land which we consider AIAL could reasonably have included in its asset base for pricing purposes.

AIAL's prices also appear reasonable in light of charges at comparable airports in Australasia and around the world. We note that the closest comparator to AIAL, Sydney Airport, has charges that – at least on a per passenger basis – are substantially higher than AIAL's.