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Infratil

update

# AIRPORT CHARGES

In February 2003 Wellington International Airport Limited ("WIAL") increased aeronautical charges 77.7%, about $3.50 (excluding GST) per passenger using the airport.

The new charges do not result in WIAL becoming an expensive airport. WIAL is close to the city with modern efficient facilities.

| AIRPORT PER PASSENGER INCOME | TOTAL AIRLINE & PASSENGER CHARGES | TOTAL AERONAUTICAL INCOME |
|---|---|---|
| WIAL NOW | $9.20 | $10.13 |
| AUCKLAND 2002 | $11.46 | $12.66 |
| CHRISTCHURCH 2002 | $6.46 | $7.81 |
| WIAL 2002 | $5.66 | $6.63 |

THIS **UPDATE** PROVIDES A BACKGROUND TO RECENTLY ANNOUNCED AERONAUTICAL CHARGES AT WELLINGTON INTERNATIONAL AIRPORT (OWNED 66% BY INFRATIL AND 34% BY WELLINGTON CITY COUNCIL) AND COMMENTS ON THE POTENTIAL AIR NEW ZEALAND-QANTAS ALLIANCE.

The new charges were determined after a 19 month consultation process with WIAL's major airline customers, which occurred in parallel with a Commerce Commission inquiry into airfield charges. With this scrutiny, and the clear threat of regulatory intervention, WIAL was very careful to consult fully and set charges at defensible levels, while naturally intending to provide a fair return on the Airport's assets.

The new charges mainly relate to WIAL seeking a return on its investment in the terminal that opened in 1999. In 1997 when aeronautical charges were last fixed the terminal was signed-off by the airlines, but they received a "rent holiday" until the 1997 pricing agreement expired.

The background and circumstances to the new charges has not stopped some airlines calling for Government to impose further price controls on WIAL. Outlined below is an explanation of the charges and why further Government price controls are neither necessary nor desirable and why WIAL could not be satisfied with just lifting its returns from increasing cappuccino sales (as one airline executive suggested). Airports and airlines have a complementary, but not always complimentary relationship.

## Government's Regulatory Role

WIAL is already highly regulated and the current debate is about whether further controls are warranted and the details of any price control regime. Regulations may be intended to ensure asset owners and users both get a fair deal, but it is recognised that more onerous regulations mean more cost.

Government recently reviewed the regulation of seaports and concluded that regulations of the form currently imposed on airports were not warranted for seaports as they would result in unnecessary costs and inefficiencies. The Commerce Commission estimated costs and inefficiencies of about $2.5 million per annum from price control of WIAL.

WIAL'S **OLD** DOMESTIC TERMINAL

Current airport regulations require WIAL to provide annual "disclosure accounts", giving details of aeronautical income and assets employed, and its target rate of return. It must also consult with its major airline users on aeronautical charges at least every five years. Consultation is a highly transparent process where an airport completely opens its books to the airlines and must explain and justify all aspects of its aeronautical business and proposed charges.

## Commerce Commission Inquiry

In March 1998 the Commerce Commission was instructed by the then Minister of Commerce (Maurice Williamson) to investigate charges for airfield activities at Auckland, Wellington and Christchurch international airports and to recommend if price controls were desirable. The original Ministerial reference is rumoured to have resulted from the National–New Zealand First coalition agreement and it was not in any way supported by a case that the airports warranted review. Airport regulation had only just been extensively revised. The total direct cost of the subsequent inquiry is estimated to have been about $10 million.

Four and a half years later in August 2002 the Commission reported that Auckland had been over-earning and warranted control. Wellington was not found to be overcharging, but the Commission proposed a new airfield price control regime that would effectively cover all three airports. The finding was arrived at by the use of idiosyncratic logic and material arithmetic errors (subsequently admitted by the Commission).

If the Commission's recommendation to the Minister of Commerce was accepted WIAL could incur expropriation of up to $40 million from its aeronautical asset value.

### How Does Regulation = Expropriation

In 1998 when the Crown sold its shares in WIAL, the runway surfaces, sea wall, and underground assets were all valued on the replacement cost approach. Infratil as the buyer of the Crown's shares had confidence that this approach to valuation was appropriate and robust.

In New Zealand "Specialised" assets (electricity lines, roads, underground pipes, airfield surfaces, sea walls) are almost always valued on the replacement cost basis. The Crown, New Zealand's largest owner of such assets, uses this approach to value its Specialised assets. WIAL has been valued on this basis, by the same valuers (OPUS and Ernst & Young), from the time of Government ownership until today. The approach is endorsed in accounting standards. In September 2002 an arbitrator nominated by the airlines and appointed by the High Court reviewed WIAL's valuation methodology and upheld the replacement cost approach for valuing these assets.

WIAL'S TERMINAL ENTRANCE **NOW**

The Commerce Commission's airfield recommendation however opposed the conventional replacement cost approach to valuation and proposed that WIAL should write off a large part of its Specialised assets' value. The recommendation was opposed by two of the five commissioners.

The proposed write off would be tantamount to expropriation and a penalty for acting responsibly. Subsequently, in its recent decisions on valuation rules for the electricity line industry, the Commission majority has reversed its position and is now recommending allowing replacement cost valuations for that industry.

### What Are Aeronautical Charges?

Aeronautical charges are imposed on the airlines for their use of the runway and terminal. Other items of aeronautical income include the rent received in respect of check-in areas of the terminal and the land around the runway and the international departure fee paid by departing international passengers.

WIAL's aeronautical activities are those that are necessary for aircraft and passenger movements; the runway and most of the terminal including check-in, departure lounges, baggage reclaim and customs areas. It also includes some property around the periphery of the runway, which the Airport is obliged to own for operational/environmental/zoning reasons. It does not include the terminal carpark or shopping areas.

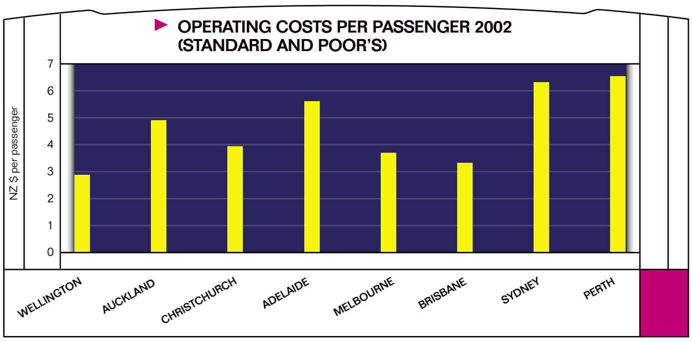
WIAL's target total annual income for 2004 from all aeronautical sources is approximately $44 million, with $32 million from aeronautical charges.

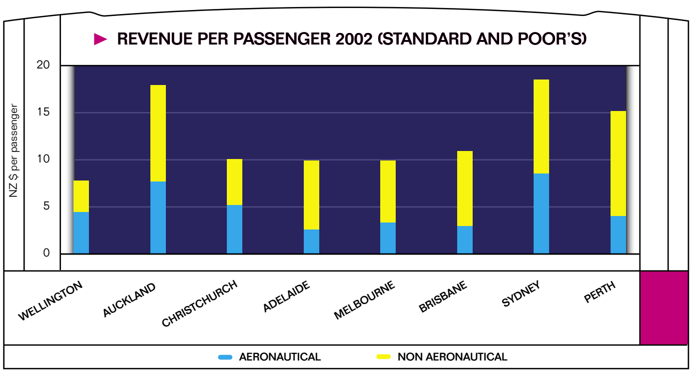
## Are WIAL's Charges Expensive?

WIAL is a highly efficient airport operating on a small, close to the city, site with a new terminal. Its business is dominated by two airlines and approximately 90% of its passengers are on domestic flights. Its charges are influenced by all of these factors.

Comparison of charges between airports is complicated as airports do not provide the same services or facilities. New Zealand airport companies provide fire services and this cost is included in the aeronautical charges. In Australia, a Government authority provides fire services and imposes a separate levy. WIAL owns and provides all terminal facilities at Wellington while at many other airports airlines own parts of their terminals (in some cases whole terminals). To illustrate the scale of this investment, in 2002 Sydney airport acquired the Ansett domestic terminal for A$192 million.

The graphs show rating agency Standard & Poor's calculation of aeronautical and non-aeronautical income at a range of New Zealand and Australian airports in 2002 and costs over the same period.

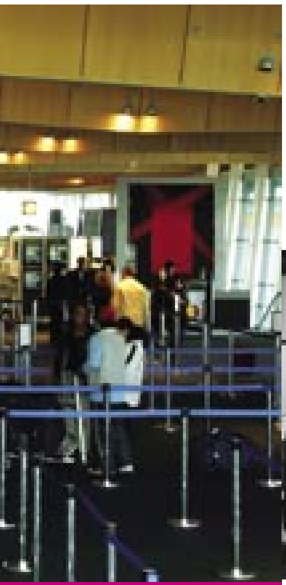



Since these figures were collated WIAL has increased its aeronautical charges by $3.50 per passenger and most of the Australian airports have also increased charges (Melbourne by up to 66%, Brisbane by up to 41%, Perth 137% and Adelaide 195%. Sydney's increase was small in 2002, but it had increased charges 97% in 2001).

In Australia there is a separate Airservices fee covering fire service and air traffic control. This fee ranges from A$7.20 per 747 passenger at Sydney to A$4.75 per Metro passenger at Adelaide. In New Zealand air traffic control is separately charged to the airlines.

All charges are averaged over arriving and departing passengers.



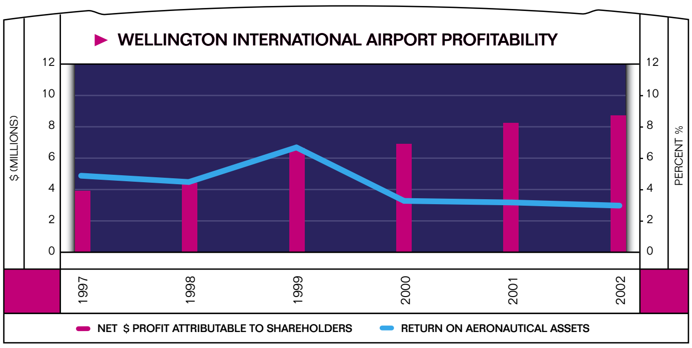
## WIAL's Rate of Return Targets

WIAL is a relatively low risk business with appropriate target returns. However, it is not riskless and cannot be satisfied with the 3% per annum returns it has been achieving since the substantive terminal investment in 1999.

WIAL's target return on its aeronautical business over the next five years is 10% per annum after tax. This return includes expected revaluations of WIAL's aeronautical assets. The "cash" return target is about 8% per annum.

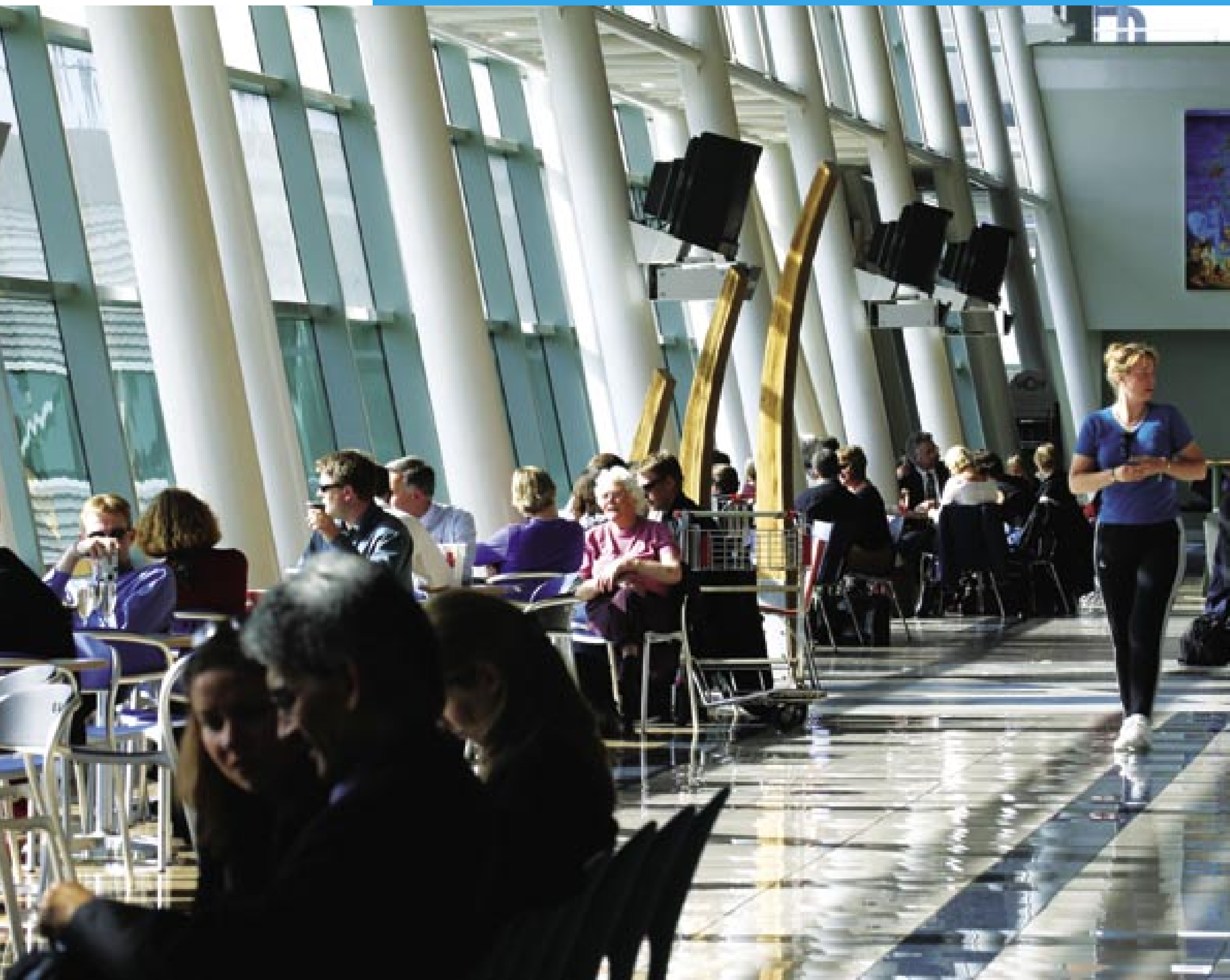
Whether WIAL will actually achieve a 10% per annum return with its new charges remains to be seen. Over the five year period from June 1997, when WIAL's aeronautical charges were last fixed, income targets were not met. Despite airport charges being fixed, the cost of domestic air travel rose 45% and if airlines choose to respond to demand by increasing fares rather than services, there is nothing the Airport can do about it. Income was also reduced as prices were then fixed on the basis of aircraft weight, and the airlines down-sized aircraft (smaller turbo prop aircraft replaced Boeing 737s on domestic routes and B737 replaced B767 on international routes) resulting in a decline in per passenger charges. At the airlines' request WIAL has now restructured charges to be per-passenger rather than per-aircraft. In 2000 WIAL also experienced the failure of AnsettNZ, which resulted in considerable cost to the Airport.

WIAL's profitability is inextricably linked with passenger numbers, which depend on airlines offering services at attractive prices.




## Aeronautical Charges after 2007

WIAL's aeronautical charges reflect forecast passenger volumes. If passenger numbers grow, per passenger charges would be expected to fall when charges are next reset in 2007.



# THE POTENTIAL
# AIR NEW ZEALAND AND QANTAS AIRWAYS ALLIANCE

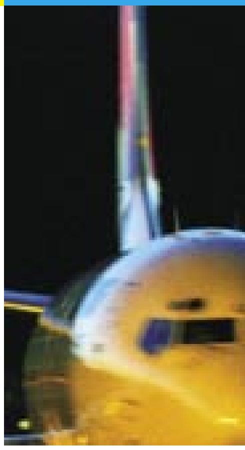
WIAL participated in two submissions to the Commerce Commission against the proposed operational alliance and equity transactions between Air New Zealand and Qantas. Analysis undertaken for WIAL clearly shows that the airline alliance will have significant negative adverse consequences for New Zealand.

If the alliance progresses it will adversely impact air travel within, into and from New Zealand. Its impact on WIAL is uncertain, but fewer air travellers will reduce income. The detriment will also depend on whether competitors emerge or Air New Zealand-Qantas establish “fortress New Zealand”.

With Government having invested $850 million in Air New Zealand and having declared the company to be crucial to New Zealand’s wellbeing, it is not difficult to expect Air New Zealand’s interests being placed ahead of the interests of airline users.

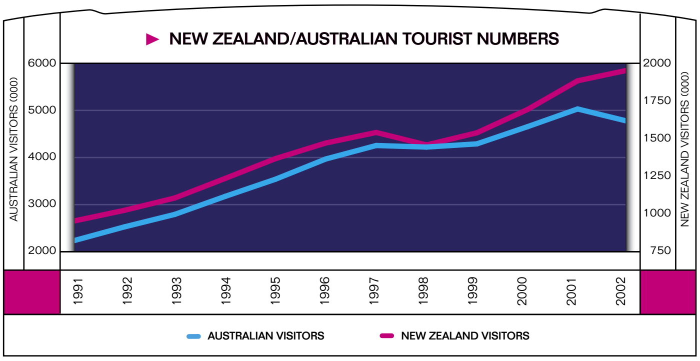
## One Vs Two Links with the World

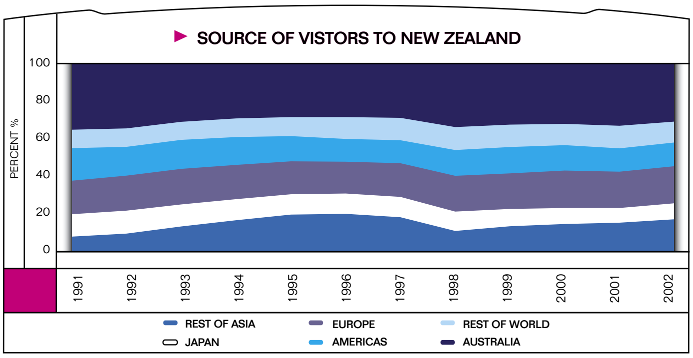
Air New Zealand and Qantas give New Zealanders a choice of the two world-spanning airline alliances, Star and OneWorld. In, say, Nelson you can get on an Air New Zealand Link flight and fly to, say, Dublin on Star. Alternatively get on an Origin Pacific aircraft and fly to Dublin on OneWorld (care of Origin's links with Qantas). And if you start in Dublin the same choice exists in the other direction.



The loss of an international network connection will be of incalculable harm to New Zealand and, on its own, should make the merger unacceptable on national interest grounds.

This year approximately two million tourists will visit New Zealand and on average spend $3,300. A 10% impact would cost New Zealand $660 million a year. This negative consequence does not include the impact on New Zealanders wishing to fly out of New Zealand and no longer having a choice of networks.




## Airline Competition

The airline industry is both competitive and protected. The Chairman of Air New Zealand recently said that the industry was easy to enter and hard to exit. The opposite is more correct. Governments protect national airlines with a web of treaties and regulations. Airlines have dominant positions in relation to airport terminal gate and lounge arrangements that make new arrivals unwelcome. They also have complex sales and distribution arrangements that make it difficult for new entrants (new airlines like Freedom and Virgin Blue sell via the net as a way of gaining access to customers). In 1987 when Ansett was established in New Zealand it was obliged to build its own terminals and to gain regulatory acceptance it had to create a convoluted ownership structure. The high barriers to entry contributed to Ansett's ultimate failure and meant that when Air New Zealand acquired Ansett Australia the New Zealand subsidiary was left as an orphan that quickly failed. Today the barriers largely remain.

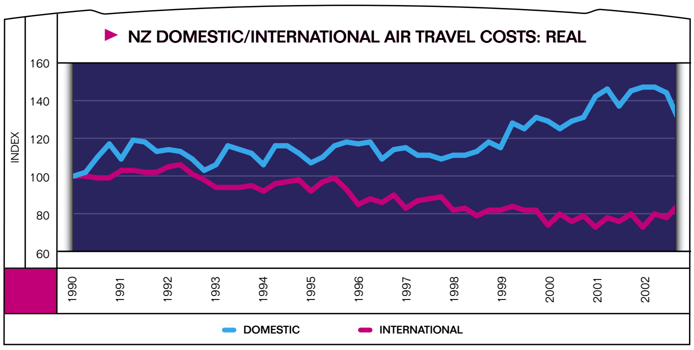
Another barrier to new entrants is incumbents targeting their business. Kiwi International's brief career in 1995/6 was effectively terminated when Air New Zealand established Freedom to compete head to head. Before Kiwi, Air New Zealand and Qantas carried some 90% of Tasman travellers and charged low-season fares of $649 to $749. Freedom's fares got down to $299 and Kiwi did not survive. A bonus to travellers from the period of competition was Air New Zealand and Qantas terminating code sharing in 1997/8 and adopting a more competitive approach on the Tasman.

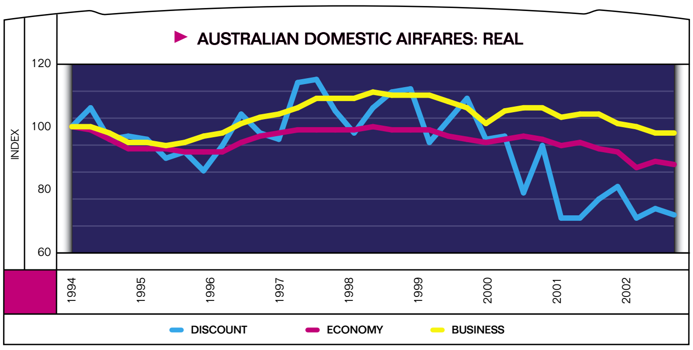
When airlines do compete the results can be spectacular. Southwest in the USA and Ryanair in Europe offer the lowest fares on the routes they service. Southwest is the world's most valuable airline with a market capitalisation of US$10,355 million. Ryanair is the third most valuable airline with a value of US$5,183 million.

Demand for air travel is responsive to cost, frequency, the time it takes to get to a destination, convenience, etc. Business travellers require frequent direct services, but can be insensitive to price. Leisure travellers are price sensitive and less concerned about other factors. Changes in the economic environment will impact demand from the different sectors in different ways. The US airline sector is in poor health due to the decline in high-fare business travellers, but low fare operators such as JetBlue and Southwest are trading strongly and expanding. In Europe the low-cost market is booming with leisure travel and an increasing share of the business travel market.

Competition is the only way airlines are incentivised to innovate and provide excellent, frequent, cheap services to places people want to go. The Air New Zealand–Qantas transaction is about rationalising services and obliging passengers to use the aircraft the airlines want to make available. Why offer services to Australia from Christchurch or Wellington when it is more efficient for the airlines to hub Tasman services through Auckland?

There is no reason for domestic airfares to have risen markedly faster than international ones, other than the relative dearth of competition on the local market. The recent burst of competition between Air New Zealand and Qantas has delivered both lower domestic fares and substantive passenger increases.




Figures from the NZ Department of Statistics and the Australian Bureau of Transport & Regional Economics show that between September 1994 (the earliest Australian figures that are available) and September 2002 (the most recent available figures):

Australian domestic "Discount" fares fell 10.9%

Australian domestic "Economy" fares rose 9%

Australian domestic "Business" fares rose 20.7%

New Zealand international air travel costs fell 5.2%

New Zealand domestic air travel costs rose 45.5%

Why the differences? In Australia there is more competition for budget travellers than for business travellers. In New Zealand there is more competition into and out of the country than within the country.

Without competition fares rise.

## Are the Qantas Transactions Air New Zealand's Only Option?

An important part of Air New Zealand's case for the alliance with Qantas is the assertion that without an alliance one of the airlines will withdraw from the New Zealand domestic market and Air New Zealand will be obliged to reduce its international services. Both developments are unlikely.

- New Zealand domestic can support more than one airline, especially if it continues to grow robustly with the stimulation of lower fares. As a short-haul market it suits low-cost point-to-point services such as provided by Freedom and Air New Zealand Express. Although Ansett struggled after its establishment in 1987 it was a "full service" carrier with a higher cost base than the incumbent, Air New Zealand.

  Were Qantas to withdraw from New Zealand, Virgin Blue could fill the gap to become the only fully Australasian airline. A development both Air New Zealand and Qantas would certainly contest. The Qantas CEO's threat of grinding Air New Zealand into the dust if the merger is opposed, is meaningless rhetoric. Not least because predatory pricing is illegal and Qantas is under investigation in Australia by the Australian consumer watchdog over allegations that it used predatory pricing against Virgin Blue.

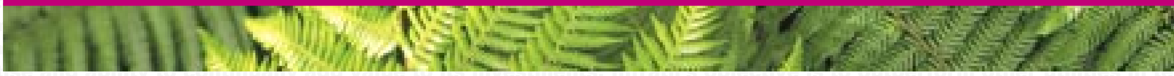
- International visitors to both Australia and New Zealand have doubled in number over the last decade. With the collapse of several US carriers, the competition for Air New Zealand and Qantas in carrying these people is in decline. How strong demand growth and declining competition are a threat to Air New Zealand is a mystery. Rather clearer is the threat to tourism growth from the merger and loss of connection to one of the two global airline alliances.

- On measures of cost per passenger, cost per kilometre flown, age of aircraft and profitability, Air New Zealand seems not to be at a disadvantage. Recent figures show:

| | QANTAS | AIR NEW ZEALAND |
|---|---|---|
| COSTS PER SEAT KILOMETRE | NZ$0.111 | NZ$0.104 |
| MARKET CAPITALISATION | $5,327M | $1,491M |
| AVERAGE FLEET AGE | 10.8 YEARS | 7.9 YEARS |
| RETURN ON EQUITY* | 14.8%PA | 14.6%PA |

* Pre tax. Qantas, year to 30 June 2002. Air New Zealand, six months to 31 December 2002.

Air New Zealand's recent announcement of $93.9 million profit for the six months to 31 March 2002 (with positive cashflow from operating activities of $326 million and improved gearing) underlines the viability of Air New Zealand's business.



## The Airlines' Case to the Commerce Commission

WIAL's economic advisers reviewed the airline case and found that the transaction outcome would result in a significant net cost to the country. The net benefits purported by the airlines are erroneous.

| | AIRLINE ASSESSMENT | LECG ASSESSMENT |
|---|---|---|
| COST SAVINGS | $627M | MODEST TO NIL |
| SCHEDULING | $47M | NIL TO NEGATIVE |
| NEW DIRECT SERVICE | $58M | NIL |
| TOURISM | $645M | NIL |
| ENGINEERING AND MAINTENANCE | $174M | $5M |
| FREIGHT | $11M | SOURCE OF GAINS NOT CLEAR |
| DEADWEIGHT LOSS – NET TRANSFERS | -$129.9M | SIGNIFICANTLY HIGHER |
| PRODUCTIVE EFFICIENCY LOSS | NOT QUANTIFIED | NOT QUANTIFIED |
| DYNAMIC EFFICIENCY | NOT QUANTIFIED | NOT QUANTIFIED |
| **NET BENEFIT** | **$1,302M** | **SIGNIFICANTLY NEGATIVE** |

Explanation of this analysis is contained in the WIAL joint submission to the Commerce Commission (available on either the Commerce Commission website (www.comcom.govt.nz) or that of Infratil (www.infratil.com)), but to illustrate just one of the benefit arguments (which happens to be the largest one). The airlines claim that if the transaction progresses Qantas will spend an additional $14 million per annum marketing New Zealand, which will increase annual tourist numbers by 50,000 and provide the country with a benefit of $645 million over five years.

Why Qantas should spend this money is not explained. Nor is it explained why Air New Zealand isn't chasing these people now rather than waiting for Qantas. But if Qantas does spend $280 to get another person to fly on Air New Zealand, and Qantas owns 22.5% of Air New Zealand, Air New Zealand will have to make $1,244 after tax profit from that passenger for Qantas to break even (22.5% of $1,244 is $280). The figures are implausible.

In Air New Zealand's 1996 successful application to the Commerce Commission to increase its shareholding in Ansett to 100% the airline forecast that it would benefit in the order of $70 million to $170 million per annum from that transaction. No doubt the Commission will be more sceptical of airline figures this time, when more is at stake.

Update