

Air New Zealand Limited

Review of Returns of Auckland International Airport Limited

6 July 2007



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For the attention of Mr Rob McDonald

6 July 2007

Dear Sirs

Report prepared by PricewaterhouseCoopers (PwC) in connection with Air New Zealand's submission on the Review of Regulatory Control Provisions under the Commerce Act 1986

This report (Report) has been prepared solely for Air New Zealand Limited (Air NZ) in connection with Air NZ's submission on the Review of Regulatory Control Provisions under the Commerce Act 1986. It has been produced in accordance with our letter of engagement dated 30 April 2007.

This Report has been prepared solely for the purposes stated herein and should not be relied upon for any other purpose.

To the fullest extent permitted by law, PwC accepts no duty of care to any party other than Air NZ in connection with the provision of this Report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

The information used by PwC in preparing this Report has been obtained from a variety of sources as indicated within the Report. While our work has involved analysis of financial information and/or accounting records, it has not included an audit in accordance with generally accepted auditing standards. Moreover, except where otherwise stated in the Report, we have not subjected the financial information in the Report to checking or verification procedures. Accordingly we assume no responsibility and make no representations with respect to the accuracy or completeness of any information provided to us, except where otherwise stated, and no assurance is given.

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Yours faithfully
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Section 1

Introduction

PwC has been engaged by Air New Zealand Limited to review the historical returns generated by Auckland International Airport Limited

Background and Purpose

- In April 2007, the Ministry of Economic Development (the MED) issued a discussion document entitled 'Review of Regulatory Control Provisions under the Commerce Act 1986' (the Discussion Document). The Discussion Document canvasses:
 - The purpose of economic regulation;
 - Methods of regulation; and
 - Options for change from the status quo.
- The MED has invited submissions on the issues and proposals canvassed in the Discussion Document.
- Air NZ intends to make a submission to the MED, regarding in particular the appropriate regulation of New Zealand airports. Air NZ engaged PricewaterhouseCoopers (PwC) to assist Air NZ in the preparation of its submission.

Scope of work

- In this document, we report to Air NZ on our review of the historical returns generated by Auckland International Airport Limited (AIAL). In particular we consider:
 - The weighted average cost of capital (WACC) of AIAL;
 - The capital employed (or asset base) of AIAL; and
 - The actual returns generated on AIAL's capital employed since 2001.
- By comparing the actual returns on capital employed generated by AIAL with an appropriate WACC, excess returns and, in turn, excess revenues are estimated.

Section 2

Methodology Applied in Estimating Returns

The estimate of excess airport returns is based on the principle that monopoly infrastructure providers should generate a WACC return on capital employed

Introduction

- To estimate whether returns generated by AIAL indicate monopoly profits we have calculated the returns generated by AIAL over the period 2001 to 2006 and compared these returns with AIAL's WACC.
- The relevance of the comparison is based on the assumption that at least some of the assets owned and operated by AIAL have natural monopoly characteristics and the premise that the owners of natural monopoly assets are entitled to:
 - Earn a rate of return on those assets no more and no less than the required rate of return taking into account the risk profile of the assets and the returns available from investment in other assets of comparable risk, assuming a well diversified and deep capital market; and
 - Recover the sunk cost (i.e. capital) invested in the assets.
- This premise assumes that prices for services provided by monopoly assets should replicate, as far as practical, the structure and level of prices that would apply if there was a truly competitive market for those services in long run equilibrium (i.e. the outcome if the assets did not have natural monopoly characteristics).
- In theory, long run equilibrium is reached in a competitive market when long run marginal costs and long run marginal prices are equated. That is, the point where the value placed on services by consumers equals the cost of providing those services.
- In a competitive market, businesses are free to pursue strategies that will provide the greatest increase in value for a given level of risk. However, freedom of entry and exit to a competitive market will ultimately restrain the level of value gain that can be achieved. If producers attempt to price services above the cost of production, and so generate returns above cost of capital, new entrants will be attracted to the market and they will be able to gain market share by pricing below the incumbent producers. Eventually prices will be forced down to the point where they equate to the cost of production and the providers of capital will receive no more or no less than a risk adjusted rate of return on capital invested.
- Similarly, if consumers are unwilling to pay a price for services that reflect the full cost of production, producers will earn sub-optimal rates of return and will not be able to attract capital to maintain their operating capability.

Sustained long-term returns in excess of WACC would not be expected in a competitive market

- It would be reasonable to assume that revenue to be generated by monopoly assets should be calculated in a manner to provide customers with economically efficient price signals and avoid monopoly pricing. This is the premise underlying the approach of most regulators. This can be achieved by proxying the revenue that would be generated if the assets were providing services in competitive equilibrium. That is, the revenue should not result in super profits but should be sufficient to maintain operating capability. This means setting revenue at a level to generate sufficient cash to just cover all costs of production (which includes cost of capital). There are a number of implicit assumptions in this approach:
 - The assets are operated in an efficient manner and operating costs are as low as practically can be achieved given obligations to customers. Cost minimisation cannot be viewed in isolation but should be coupled with objectives about the quality of the services;
 - Sufficient revenue will be generated over time to fund efficient operating costs and provide investors with a return on their capital and return of their capital over the life of the assets. This is consistent with a competitive market scenario where over time prices must provide sufficient revenue to cover all costs, including cost of capital, to ensure that businesses can secure capital to finance operating assets; and
 - The key principle is that prices should replicate, as far as practical, the structure and level of prices that would apply if there was a truly competitive market for services in long run equilibrium. Revenue should be set at a level to generate sufficient cash to cover all costs of production, including cost of capital.
- This principle implies that, over time, sufficient cash should be generated from using the assets to provide both debt and equity providers with returns equal to cost of capital. Returns in excess of cost of capital suggest that revenue and prices exceed those which would apply in competitive equilibrium. Returns below cost of capital mean investors are not being adequately compensated for the risks they bear in relation to the capital they have provided to the company.

We have considered the returns for AIAL as a whole as well as separately estimating the aeronautical and non-aeronautical returns

- Airports in New Zealand typically divide their activities into two tills; aeronautical and non-aeronautical. In analysing the returns of AIAL, we have considered the returns generated by AIAL on its entire operations and then separately considered the returns generated on the aeronautical and non-aeronautical activities.
- We note that the UK Competition Commission has recently stated that it is difficult to sensibly separate commercial and aeronautical activities and that, to the extent that some of the judgements that have to be made are arbitrary, considerable potential exists for regulatory credibility to be undermined.
- Be that as it may, AIAL is required under the Airport Authorities (Information Disclosure) Regulations 1999 to publicly disclose certain financial and other information relating to their aeronautical activities on an annual basis.
- The first Disclosure Statements were published in respect of the 2000 financial year. Accordingly, we are able to calculate returns for AIAL's aeronautical activities from 2001 as returns are calculated on the average capital employed over a particular year.
- We have derived returns for AIAL's non-aeronautical activities simply by deducting the aeronautical disclosed financial results from the consolidated financial results. AIAL does not separately report on its non-aeronautical activities.

Estimation of the level of capital employed is a critical assumption

- The estimation of returns is based upon three key parameters:
 - Capital employed;
 - WACC; and
 - Earnings.

Capital employed

- Capital employed represents the assets used in the provision of services and upon which a return should be generated. The components of capital employed are illustrated below.

$$\begin{array}{l}
 \left. \begin{array}{l}
 \text{Non interest-bearing} \\
 \text{Net Working Capital} \\
 + \\
 \text{Non-current assets} \\
 \text{(Land, buildings \&} \\
 \text{equipment, etc)}
 \end{array} \right\} = \left. \begin{array}{l}
 \text{Debt Capital} \\
 + \\
 \text{Equity Capital}
 \end{array} \right\} = \text{Capital Employed}
 \end{array}$$

- A critical issue in the excess return estimate is the appropriate level of capital employed against which to measure the rate of return performance.

- In its simplest form, a return on investment analysis should be based on actual cash invested – the amount of cash subscribed by investors plus any subsequent earnings not distributed to the investors. Earnings generated by the business from holding and/or using cash invested should be related to the initial cash invested to measure rate of return performance.
- In the case of AIAL, however, the measurement of capital employed is complicated by asset revaluations.
- The treatment of the revaluation of monopoly assets should recognise the principle that investors are entitled to a return on capital invested no more and no less than WACC. All other things being equal, this principle lends weight to the argument that monopoly assets should be carried at depreciated historical cost (DHC), reflecting the actual cash invested, for pricing purposes. Owners of monopoly assets should not be able to raise prices to monopoly asset users by simply revaluing the assets.
- The Commerce Commission reviewed asset valuation issues as part of its Airfields Pricing Inquiry. It argued, on economic efficiency grounds, for an opportunity cost approach to the valuation of non-specialised assets and DHC for specialised assets.
- While there are arguments for and against the use of DHC, opportunity cost or some form of current replacement cost, the fundamental issue we are concerned with is the treatment of asset revaluations in measuring rates of return. How should revaluations, whether up or down, be treated? Is it appropriate for assets to be revalued and charges reset to provide a return on the revalued asset base?

There should be consistency in the treatment of revaluations between capital employed and income

- The basic principle that owners of capital invested in monopoly assets should be entitled to a return on the capital invested of no more and no less than WACC in our view implies a general rule that revaluations should not result in value gains for the benefit of monopoly asset owners at the expense of users. In this context the Commerce Commission noted in the Airfields Pricing Inquiry that:

“when the revaluations associated with ODRC are treated as income, both DHC and ODRC valuations (when each is used over the entire life of an asset) generate a life-time revenue requirement stream that, when set against the initial outlay, and discounted at the same rate, equate to zero in net present value terms.”
- At the Airfields Pricing Inquiry conference, AIAL proposed a similar argument – as long as ODRC revaluations are treated as income, both DHC and ODRC could generate the same level of return over an assets’ life and preserve the incentives to invest.
- The general rule does not stop monopoly asset owners from revaluing assets and does not mean that DHC must be used to produce the desired outcome – in terms of economically efficient prices opportunity cost might be considered a better representation of value. **The important issue is the treatment of revaluations in a manner that is neutral in present value terms for both monopoly asset owners and users.**
- The simplest solution to this issue is to treat revaluations as part of the return that accrues to the owners from holding and using the monopoly assets. Including the holding gains or losses as income in any year will reduce or increase the level of cash income required from the users to achieve the required rate of return in that year. This approach is supported by the Commerce Commission and was recently adopted in its review of gas pipeline businesses and control inquiries of electricity line businesses.
- A holding gain for a productive asset (as reflected in a revaluation) can only arise if there is an expectation of an increase in future cash flows. A holding gain for a monopoly asset can only be sustained if cash flows from providing services using the assets are to increase in the future. This implies that price increases, volume increases (given prices) and/or cost efficiencies need to occur. There might be arguments about the extent to which the benefits from cost efficiencies should be shared between customers and owners, but the concept of simply raising prices to support a revaluation of assets is difficult to sustain.
- Free of any sort of effective regulatory oversight it appears that the major airports have, by and large, set their own rules in valuing their asset bases and the treatment of such revaluations for pricing purposes. The result has been substantial revaluations which we understand have then been used by airports in setting landing charges. To the extent that airports only partially treat revaluations as part of their return yet insist upon pricing such that they generate a return on the revalued assets, a significant distortion arises in favour of the monopoly asset owners.

One alternative is for revaluations to be excluded from both the capital employed and the income calculations

- For the purposes of estimating AIAL's returns we have considered two alternative treatments of revaluations:
 - The first is to exclude the revaluations from both the capital employed and the return calculations;
 - The second is to include the revaluation in the capital employed but, in contrast to AIAL's approach to date, to also include the revaluation in the return calculations.
- It is important to note that under both treatments our analysis has been based solely on public information.
- We discuss the assumptions made in applying each treatment below.

Excluding revaluations

- To exclude revaluations we have estimated the DHC of AIAL's assets as follows:
 - We have used the 2000 opening balance sheet asset values as a base as this is the first year for which Disclosure Statement information is available. This is an important point as it means that the analysis does not adjust for any revaluations prior to 2000. Total revaluations prior to 2000 were \$258m (excluding investment property) for AIAL per the revaluation reserve.
 - Reported capital expenditure since 2000 has been added to the 2000 opening balance sheet asset values; and
 - Depreciation has been estimated using AIAL's historical depreciation rate from 2001 on. Capital expenditure in each year is only depreciated for half a year in the year in which the capital expenditure is incurred.

Capital Expenditure

- Capital expenditure for AIAL is discussed in several places within the airport's Annual Reports and Disclosure Statements including the commentary of the Annual Report and figures provided as part of the commentary. These capital expenditure figures, however, do not match the cash applied to purchase property, plant and equipment (PP&E) as set out in AIAL's cash flow statements. We suspect these differences reflect timing related to the expenditure.
- As our objective is to determine a return on capital employed, we have used the capital expenditure cash flows (i.e. the cash applied to PP&E) from the cash flow statement in our analysis.

After excluding revaluations we have adjusted depreciation to reflect the lower depreciable asset values

Adjusted Depreciation

- AIAL depreciates its fixed assets on a straight-line basis, with the estimated useful lives of the PP&E determined by the asset class (i.e. building, runways, taxiways, aprons, etc). However, without the fixed asset registers and complete capital expenditure information by asset category, we cannot accurately determine the depreciation rate for each asset.
- To estimate the effective depreciation rate for AIAL (on a consolidated level), we have reviewed the historical depreciation, as a percentage of fixed assets (excluding land), for the years from 2000 through 2006.
- As we have excluded the revaluations post 2000, our estimated depreciation figures are lower than the actual depreciation figures reported by AIAL.
- The resulting depreciation rates used in our analysis are:
 - Consolidated AIAL depreciation rates ranging from 4.3% to 6.6% of Net Book Value (NBV) with an average rate of 6.0%; and
 - AIAL aeronautical activities depreciation rates ranging from 4.1% to 6.7% of NBV with an average depreciation rate of 6.2%.

Other Assets

- In addition to the estimated DHC of fixed assets, we have included the following other assets as part of capital employed:
 - Investment property and investments in associates (in the consolidated and non-aeronautical calculations);
 - Net working capital;
 - A deferred tax asset reflecting the difference between the tax payable calculated with the adjusted asset base and the tax payable calculated using the reported asset base.

Including revaluations

- AIAL's assets as reported include regular revaluations including revaluations in 2002 and 2006. For the purposes of illustrating the returns generated by AIAL when revaluations are included in both the capital employed and income, we have spread the 2006 revaluation over the four years to which it relates (i.e. 2003, 2004, 2005 and 2006).

AIAL discloses its estimate of the aeronautical WACC

AIAL's disclosed WACC

- AIAL is required to disclose its estimate of the appropriate WACC for its aeronautical activities in its Disclosure Statements. AIAL also discloses the assumptions used in their WACC estimates.
- The key assumptions used in AIAL's WACC calculations are:
 - The cost of debt;
 - The risk-free rate;
 - The market risk premium;
 - The asset beta; and
 - Gearing.
- At Appendix 1 we detail the assumptions used by AIAL in its WACC estimates together with the resulting WACC ranges as included in AIAL's Disclosure Statements.
- The table below summarises AIAL's disclosed aeronautical WACC together with our estimate of AIAL's WACC after adjusting for the items discussed opposite.

	Per AIAL Disclosure Statements			Estimated WACC
	Disclosed Range		Midpoint	
2001	8.5%	to 9.4%	9.0%	8.1%
2002	7.5%	to 9.7%	8.6%	8.1%
2003	7.5%	to 9.7%	8.6%	7.7%
2004	7.5%	to 9.7%	8.6%	7.6%
2005	7.5%	to 9.7%	8.6%	7.9%
2006	8.5%	to 10.4%	9.5%	7.7%

Estimated WACC

- For the purposes of reviewing AIAL's returns, we have estimated AIAL's WACC by adjusting the disclosed aeronautical WACC estimates as follows:
 - We have performed the WACC calculation each year whereas AIAL has only disclosed the WACC calculations performed in 2000, 2002 and 2006. As such, our WACC estimate for each year uses the average risk-free rate for that year (calculated as the average yield on 5 year government bonds);
 - We have used a tax adjusted market risk premium of 7.5% throughout the period rather than a range of 7.0% to 9.0% as used by AIAL; and
 - We have applied a consistent asset beta of 0.45 throughout the period under review whereas AIAL has increased its estimate from a mid-point of 0.45 in 2000 to its latest estimate of 0.6 to 0.8 as disclosed in the 2006 Disclosure Statement. Given that the asset beta should reflect the long-term volatility of AIAL's cash flows, it is difficult to understand why the volatility would change significantly and we note that no explanation is provided in AIAL's Disclosure Statement as to the reasons for the change.

Excess returns are calculated as the difference between ROCE and WACC

Earnings and Calculation of ROCE

- The earnings figure used in the return analysis is net operating profit after tax (NOPAT).
- Return on capital employed (ROCE) is calculated as:

$$\frac{\text{NOPAT}}{\text{Capital Employed}}$$

- When revaluations are excluded from capital employed, we have adjusted NOPAT to reflect our estimate of adjusted depreciation as discussed earlier.
- We note that the calculation of ROCE is based on the average capital employed over the course of the year.

Estimation of Excess Returns

- Excess returns are calculated (both including and excluding revaluations) as:

$$(\text{ROCE} - \text{WACC}) * \text{Capital Employed}$$

- The resulting excess return represents a post-tax excess return figure which is converted to excess revenue by grossing up for tax at the 33% corporate tax rate applicable during the period under review.

Section 3

Calculation of AIAL's Historical Returns

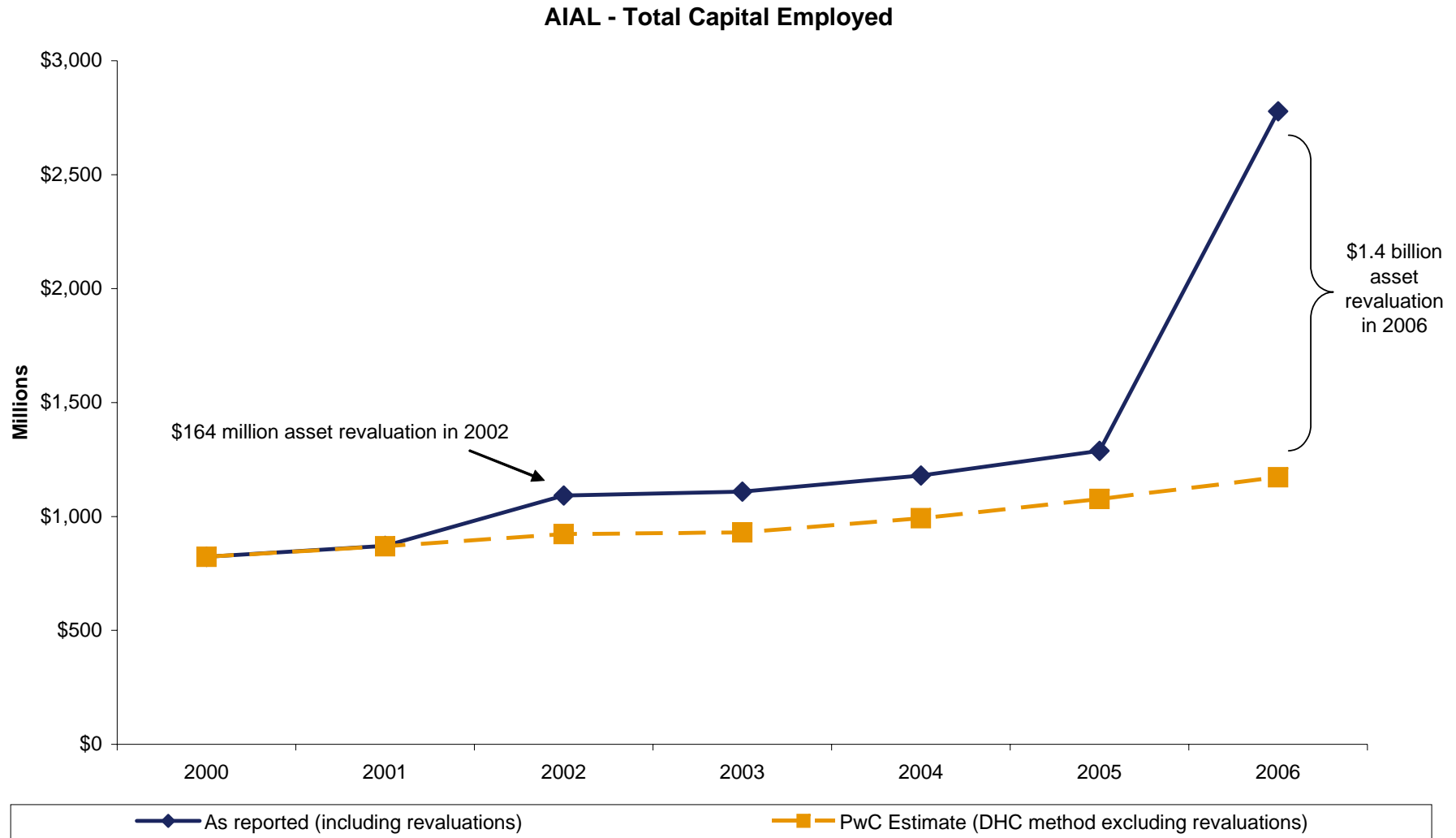
AIAL total capital employed

- Since 2000, AIAL's non-current asset base has increased from \$830 million to \$2.8 billion in 2006. While AIAL has invested approximately \$482 million in capital expenditures over that period, \$1.5 billion of the increase in reported assets is due to asset revaluations in 2002 and 2006.
- The table below summarises the capital employed for AIAL on a consolidated basis and for aeronautical and non-aeronautical activities both including and excluding revaluations.
- Note that capital employed for AIAL has not been adjusted to reflect any items that should be optimised out of the asset base. To the extent that any optimisation is appropriate, the returns we have calculated will be understated.

AIAL - Total Capital Employed							
(\$ in thousands)	2000	2001	2002	2003	2004	2005	2006
Consolidated							
As reported (including revaluations)	823,070	871,572	1,091,935	1,109,483	1,179,365	1,288,368	2,777,845
PwC Estimate (excluding revaluations)	823,070	868,789	922,655	929,664	991,933	1,076,529	1,172,507
PwC Estimate (including 2006 revaluation spread)	823,070	871,572	1,091,935	1,347,511	1,723,486	2,219,768	2,777,845
Aeronautical							
As reported (including revaluations)	532,523	582,867	646,658	644,960	671,898	755,925	1,197,932
PwC Estimate (excluding revaluations)	532,523	582,627	586,443	579,765	606,903	684,507	697,099
PwC Estimate (including 2006 revaluation spread)	532,523	582,867	646,658	731,625	859,195	1,060,072	1,197,932
Non-aeronautical							
As reported (including revaluations)*	290,547	288,705	445,277	464,523	507,467	532,443	1,579,912
PwC Estimate (excluding revaluations)	290,547	286,162	336,212	349,899	385,030	392,022	475,408
PwC Estimate (including 2006 revaluation spread)	290,547	288,705	445,277	615,886	864,290	1,159,696	1,579,912

* Note: Non-aeronautical results are not separately reported by AIAL and have been derived by deducting the reported aeronautical results from the reported consolidated results

AIAL total capital employed



Source: Company Reports, Public Information, PwC Analysis

AIAL's returns excluding revaluations (based on estimated depreciated historical cost)

The table below displays the adjusted returns earned by AIAL excluding revaluations (i.e. based on estimated DHC). We emphasise that we have had to estimate the depreciation that would be incurred on the DHC value of assets.

AIAL - Adjusted Earnings Excluding Revaluations (DHC)							
(\$ in thousands)	2000	2001	2002	2003	2004	2005	2006
Consolidated							
Reported EBITDA	123,690	139,063	152,012	181,082	203,637	221,518	240,161
Depreciation on DHC Asset Base	(29,488)	(30,588)	(30,265)	(32,531)	(32,577)	(30,678)	(29,610)
Adjusted Operating Profit	94,202	108,475	121,747	148,551	171,060	190,840	210,551
Tax on Adjusted Operating Profit	(31,125)	(35,927)	(36,619)	(45,263)	(55,415)	(59,410)	(62,502)
Adjusted NOPAT	63,077	72,548	85,127	103,288	115,645	131,430	148,049
Aeronautical							
Reported EBITDA	56,506	65,164	72,620	83,360	92,526	96,022	108,521
Depreciation on DHC Asset Base	(20,949)	(20,404)	(24,027)	(22,344)	(20,906)	(18,042)	(18,581)
Adjusted Operating Profit	35,557	44,760	48,593	61,016	71,620	77,980	89,940
Tax on Adjusted Operating Profit	(11,748)	(14,825)	(14,616)	(18,591)	(23,201)	(24,276)	(26,699)
Adjusted NOPAT	23,809	29,936	33,977	42,425	48,419	53,704	63,241
Non-aeronautical							
Reported EBITDA*	67,184	73,899	79,392	97,722	111,111	125,496	131,640
Depreciation on DHC Asset Base	(8,539)	(10,185)	(6,238)	(10,188)	(11,671)	(12,636)	(11,029)
Adjusted Operating Profit	58,645	63,714	73,154	87,534	99,440	112,860	120,611
Tax on Adjusted Operating Profit	(19,377)	(21,102)	(22,003)	(26,672)	(32,214)	(35,134)	(35,803)
Adjusted NOPAT	39,268	42,612	51,150	60,863	67,226	77,725	84,808

* Note: Non-aeronautical results are not separately reported by AIAL and have been derived by deducting the reported aeronautical results from the reported consolidated results

AIAL's returns including revaluations

The table below displays the returns earned by AIAL including the 2006 revaluation spread over the previous four years as income.

AIAL - Adjusted Earnings Including Revaluations							
(\$ in thousands)	2000	2001	2002	2003	2004	2005	2006
Consolidated							
Operating Profit	94,202	108,363	120,212	150,489	172,150	189,623	201,615
Tax on Operating Profit	(31,125)	(35,890)	(36,158)	(45,854)	(55,768)	(59,031)	(59,849)
NOPAT	63,077	72,473	84,054	104,635	116,382	130,592	141,766
Recognition of revaluations (w/o investment property)	-	-	-	234,949	297,449	376,573	476,746
Investment property	2,544	112	5,165	3,078	8,644	10,707	13,615
Adjusted NOPAT	65,621	72,585	89,219	342,663	422,475	517,872	632,127
Aeronautical							
Operating Profit	35,557	41,805	48,845	61,736	70,398	73,872	82,781
Tax on Operating Profit	(11,748)	(13,846)	(14,692)	(18,811)	(22,805)	(22,997)	(24,573)
NOPAT	23,809	27,959	34,153	42,925	47,593	50,875	58,208
Recognition of revaluations (w/o investment property)	-	-	-	86,665	100,632	116,850	135,683
Adjusted NOPAT	23,809	27,959	34,153	129,590	148,225	167,725	193,890
Non-aeronautical							
Operating Profit*	58,645	66,558	71,367	88,753	101,752	115,751	118,834
Tax on Operating Profit	(19,377)	(22,044)	(21,466)	(27,043)	(32,963)	(36,034)	(35,276)
NOPAT	39,268	44,514	49,901	61,710	68,789	79,717	83,558
Recognition of revaluations (w/ investment property)	2,544	112	5,165	151,363	205,461	270,430	354,679
Adjusted NOPAT	41,812	44,626	55,066	213,073	274,250	350,147	438,237

* Note: Non-aeronautical results are not separately reported by AIAL and have been derived by deducting the reported aeronautical results from the reported consolidated results

AIAL's return on capital employed

The table below displays AIAL's historical return on capital employed under the alternative methods of calculation.

AIAL - Return on Capital Employed						
(\$ in thousands)	2001	2002	2003	2004	2005	2006
Consolidated						
Based upon AIAL's results as reported	8.6%	8.6%	9.5%	10.2%	10.6%	7.0%
PwC Estimate (excluding revaluations)	8.6%	9.5%	11.2%	12.0%	12.7%	13.2%
PwC Estimate (including 2006 revaluation spread)	8.6%	9.1%	28.1%	27.5%	26.3%	25.3%
Aeronautical						
Based upon AIAL's results as reported	5.0%	5.6%	6.6%	7.2%	7.1%	6.0%
PwC Estimate (excluding revaluations)	5.4%	5.8%	7.3%	8.2%	8.3%	9.2%
PwC Estimate (including 2006 revaluation spread)	5.0%	5.6%	18.8%	18.6%	17.5%	17.2%
Non-aeronautical						
Based upon AIAL's results as reported *	15.4%	13.6%	13.6%	14.2%	15.3%	7.9%
PwC Estimate (excluding revaluations)	14.8%	16.4%	17.7%	18.3%	20.0%	19.6%
PwC Estimate (including 2006 revaluation spread)	15.4%	15.0%	40.2%	37.1%	34.6%	32.0%

* Note: Non-aeronautical results are not separately reported by AIAL and have been derived by deducting the reported aeronautical results from the reported consolidated results

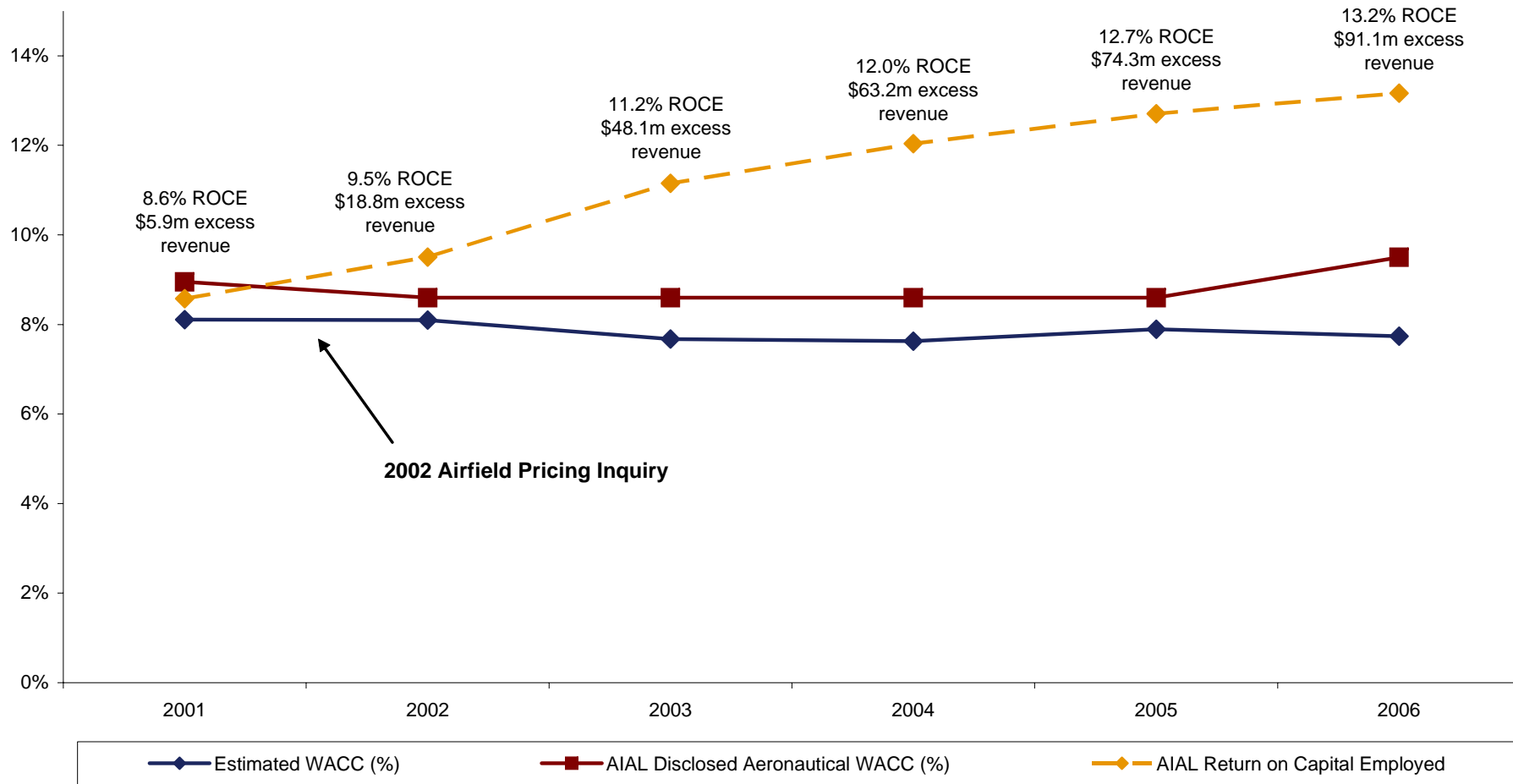
Estimation of AIAL's excess returns and revenue

- AIAL's return on capital employed is compared to its estimated WACC on the table below. The difference between ROCE and the estimated WACC represents apparent excess returns earned by AIAL.
- We note that the calculation of ROCE is based on the average capital employed over the course of the year.
- Returns have been above cost of capital every year since 2001 and the quantum of the difference has also increased every year.
- We have quantified in the following table the dollar value of the returns above or below cost of capital. Recognising that the returns are post tax, we have grossed up the excess returns to indicate the excess revenue being generated by AIAL on a consolidated basis

AIAL – Estimation of Excess Returns Excluding Revaluations – Consolidated						
(\$ in thousands, rounded)	2001	2002	2003	2004	2005	2006
Return on Capital Employed	8.6%	9.5%	11.2%	12.0%	12.7%	13.2%
Estimated WACC	8.1%	8.1%	7.7%	7.6%	7.9%	7.7%
Excess Return Over WACC (%)	0.5%	1.4%	3.5%	4.4%	4.8%	5.4%
Average Capital Employed	845,900	895,700	926,200	960,800	1,034,200	1,124,500
Excess Return	4,000	12,600	32,200	42,400	49,800	61,000
Excess Revenue (Pre tax)	5,900	18,800	48,100	63,200	74,300	91,100

AIAL's return on capital employed compared to WACC on a consolidated basis

AIAL's Consolidated Return on Capital Employed Compared to WACC (DHC Asset Values)



Source: Company Reports, Public Information, PwC Analysis

Estimation of AIAL's excess returns on aeronautical activities

- AIAL's ROCE for its aeronautical activities is compared to the estimated WACC in the table below. The difference between ROCE and the estimated WACC represents the excess returns earned by AIAL.
- We note that, based upon the financial information in the AIAL Disclosure Statements, aeronautical activities earned returns below the estimated WACC from 2001 through 2003, but that the overall trend reflects improving ROCE.
- We also emphasise that, as previously noted:
 - asset revaluations prior to 2000 have been excluded from the analysis;
 - asset and cost allocations to the aeronautical till have been taken as given from the AIAL Disclosure Statements; and
 - no optimisation of the asset base has been included.
- Since 2004, aeronautical activities have earned returns above WACC increasing to 1.4% above WACC in 2006.

AIAL – Estimation of Excess Returns Excluding Revaluations - Aeronautical						
(\$ in thousands, rounded)	2001	2002	2003	2004	2005	2006
Return on Capital Employed	5.4%	5.8%	7.3%	8.2%	8.3%	9.1%
Estimated WACC	8.1%	8.1%	7.7%	7.6%	7.9%	7.7%
Excess / (Deficient) Return Over WACC (%)	-2.7%	-2.3%	-0.4%	0.5%	0.4%	1.4%
Average Capital Employed	558,100	585,200	583,800	594,000	646,400	691,500
Excess / (Deficient) Return	(15,300)	(13,400)	(2,400)	3,100	2,700	9,700
Excess Revenue (Pre tax)	n/a	n/a	n/a	4,700	4,000	14,500

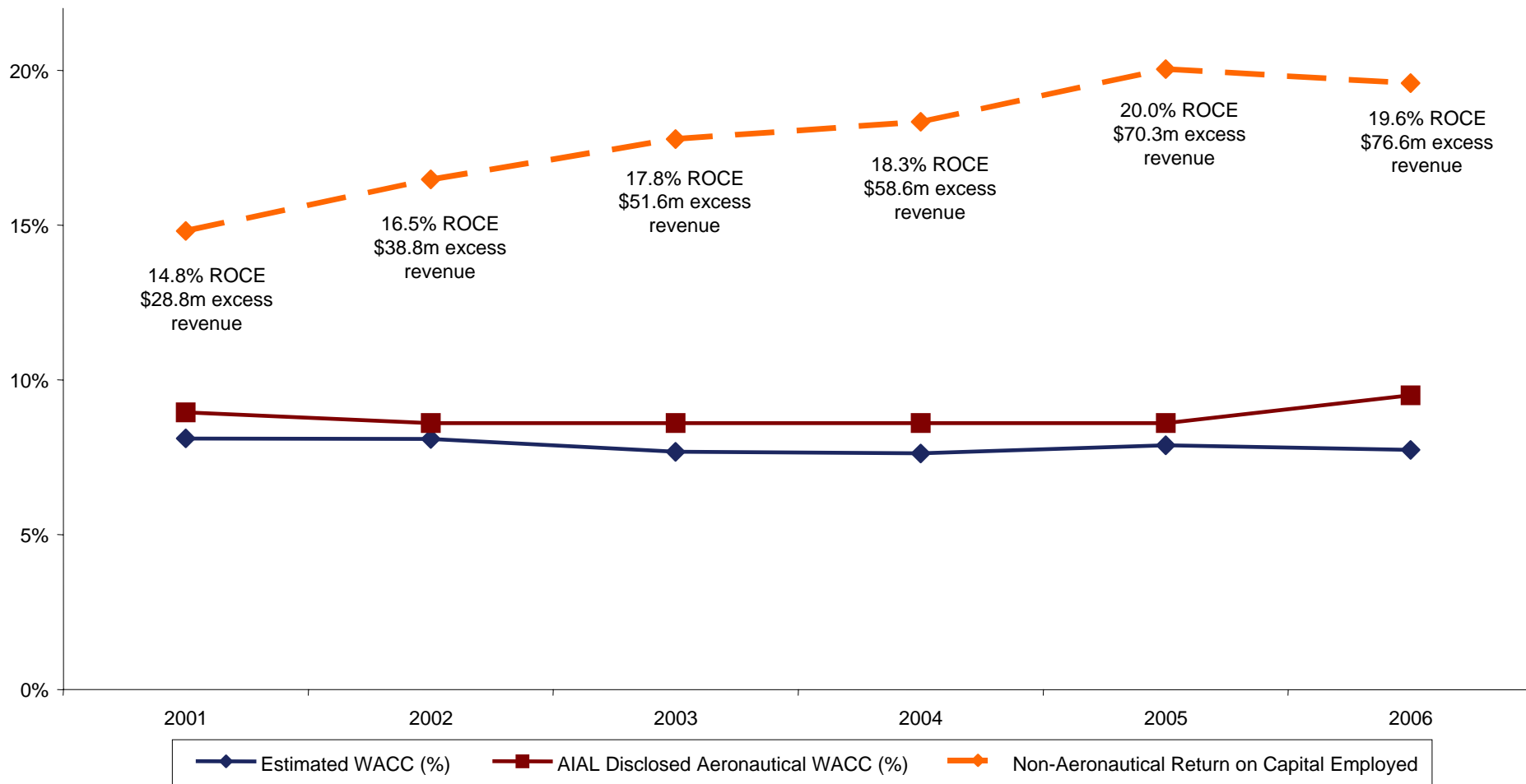
Estimation of AIAL's excess returns on non-aeronautical activities

- The determination of AIAL's return on capital employed for its non-aeronautical activities compared to the estimated WACC are displayed on the table below. The difference between ROCE and the estimated WACC represents the excess returns earned by AIAL.
- Non-aeronautical activities have earned returns well in excess of WACC from 2001 through 2006. If the non-aeronautical activities are, in fact, subject to competition then we would not have expected returns to have been this far in excess of WACC for such a sustained period.
- In competitive markets, competition would be expected to drive down prices such that returns approach WACC. The returns above cost of capital would not be sustainable and would fall over time as new entrants to the market price below AIAL to gain market share.
- Our analysis suggests that either:
 - the non-aeronautical till is not genuinely subject to competition; or
 - there are issues with the allocation of assets and costs between aeronautical and non-aeronautical tills.

AIAL – Estimation of Excess Returns Excluding Revaluations – Non-aeronautical						
(\$ in thousands, rounded)	2001	2002	2003	2004	2005	2006
Return on Capital Employed	14.8%	16.5%	17.8%	18.3%	20.0%	19.6%
Estimated WACC	8.1%	8.1%	7.7%	7.6%	7.9%	7.7%
Excess Return Over WACC (%)	6.7%	8.4%	10.1%	10.7%	12.1%	11.8%
Average Capital Employed	287,800	310,500	342,400	366,800	387,900	433,000
Excess Return	19,300	26,000	34,600	39,300	47,100	51,300
Excess Revenue (Pre tax)	28,800	38,800	51,600	58,600	70,300	76,600

AIAL's return on capital employed for non-aeronautical activities

AIAL's Non-Aeronautical Return on Capital Employed Compared to WACC (DHC Values)



Source: Company Reports, Public Information, PwC Analysis

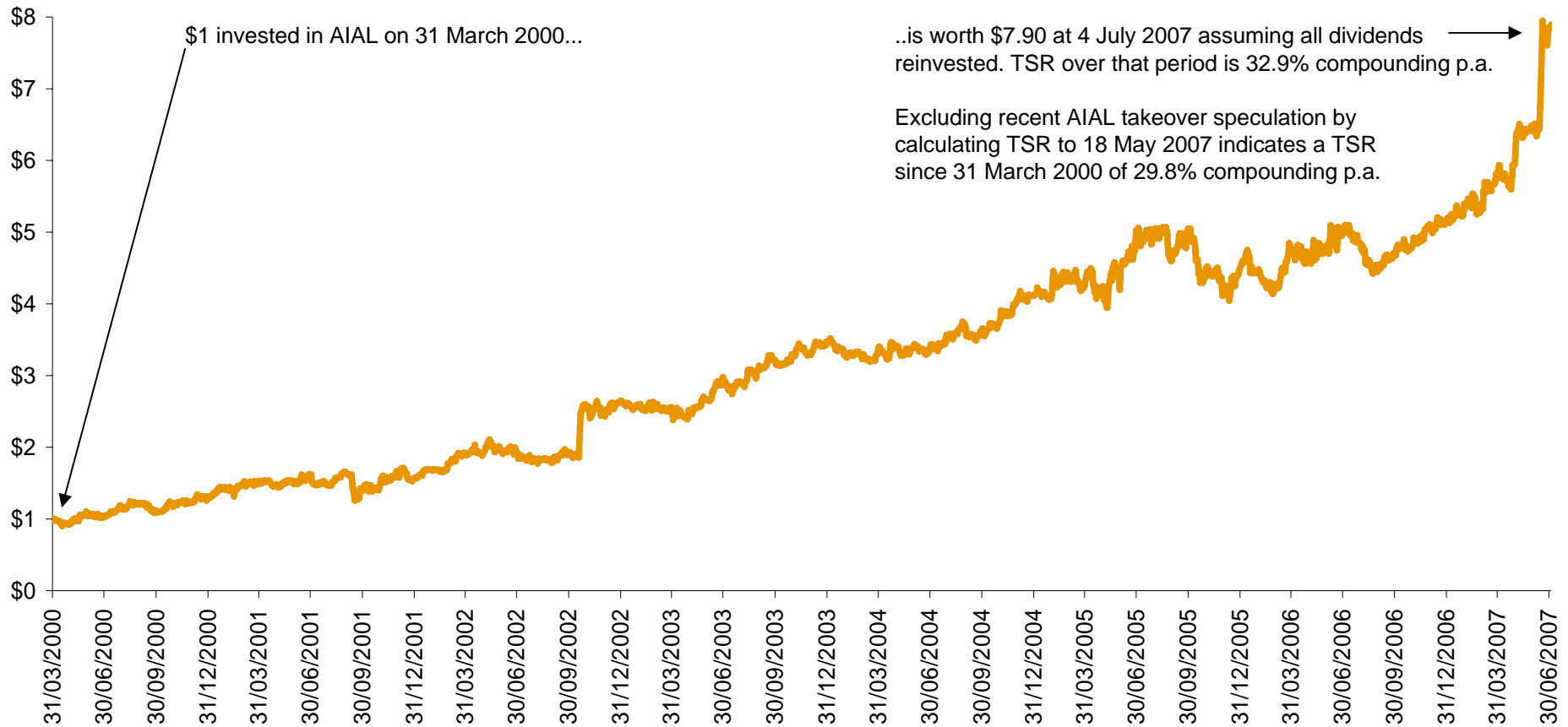
Section 4

AIAL Total Shareholder Return

AIAL Total Shareholder Return

- As illustrated in the chart below, AIAL's Total Shareholder Return (TSR) since 31 March 2000 has been high at 32.9% p.a.

AIAL Total Shareholder Return



Appendix 1

Weighted Average Cost of Capital

Calculation of WACC

- The Weighted Average Cost of Capital (WACC) for a company is typically determined by the following formula:

$$\text{WACC} = R_d(1-T_c) * (D/V) + R_e * (E/V)$$

Where:

R_d	=	Pre-tax cost of debt
R_e	=	Cost of equity
T_c	=	Marginal corporate tax rate
D	=	Market value of debt
E	=	Market value of equity
V	=	$D + E$

- Under tax regimes where dividends carry imputation credits, a company's WACC is relatively stable under a range of gearing assumptions, until the level of gearing rises to a level that borrowing costs increase to reflect the increased risk of default.
- The cost of equity (R_e) is typically calculated using the Capital Asset Pricing Model (CAPM). The CAPM is based on the theory that a prudent investor will price assets so that the expected return is equal to:
 - the risk free rate of return; plus
 - a premium for risk.
- The measure of volatility of an investment to general market movements (that is its relative 'riskiness') is called its beta.

- The simplified Brennan-Lally specification of CAPM calculates the cost of equity using the following formula and inputs to allow for the effect of investor taxes and the presence of a dividend imputation system:

$$R_e = R_f (1 - T_i) + \beta_e (\text{MRP})$$

Where:

R_f	=	Risk free rate of return
T_i	=	Investor effective tax rate on dividend income and capital gains. PwC has undertaken studies which indicate that the average effective tax rate on dividends and capital gains for investors in the New Zealand market is 28%.
β_e	=	A measurement of riskiness of a company relative to the returns of a market overall. The equity beta is influenced by the level of gearing within a company. The selected equity beta is the asset beta (β_a) "re-gearred".
MRP	=	Market Risk Premium - Expected return on a market portfolio of equity investments. Empirical studies undertaken by PwC indicate that the New Zealand MRP is approximately 7.5%.

WACC Inputs

Set out below is the range of inputs utilised by AIAL in the calculation of its aeronautical WACC as provided from its Disclosure Statements together with the inputs we have used to derive the “Estimated WACC” for this analysis. The “Estimated WACC” is calculated using the WACC specification described on the previous page.

		2001			2002			2003		
		Per Disclosure Statements		Estimated WACC	Per Disclosure Statements		Estimated WACC	Per Disclosure Statements		Estimated WACC
		Low	High		Low	High		Low	High	
β_a		0.40	to 0.50	0.45	0.40	to 0.50	0.45	0.40	to 0.50	0.45
Market Risk Premium		9.0%	9.0%	7.5%	8.0%	to 9.0%	7.5%	8.0%	to 9.0%	7.5%
R_f		6.97%	6.97%	6.38%	6.12%	6.12%	6.36%	6.12%	6.12%	5.76%
Debt Margin ($R_d = R_f + \text{Margin}$)		1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
D/V		40%	40%	40%	40%	40%	40%	40%	40%	40%
WACC		8.5%	9.4%	8.1%	7.5%	9.7%	8.1%	7.5%	9.7%	7.7%

		2004			2005			2006		
		Per Disclosure Statements		Estimated WACC	Per Disclosure Statements		Estimated WACC	Per Disclosure Statements		Estimated WACC
		Low	High		Low	High		Low	High	
β_a		0.40	to 0.50	0.45	0.40	to 0.50	0.45	0.60	to 0.80	0.45
Market Risk Premium		8.0%	to 9.0%	7.5%	8.0%	to 9.0%	7.5%	7.0%	to 7.5%	7.5%
R_f		6.12%	6.12%	5.69%	6.12%	6.12%	6.07%	6.20%	6.20%	5.87%
Debt Margin ($R_d = R_f + \text{Margin}$)		1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
D/V		40%	40%	40%	40%	40%	40%	25%	35%	30%
WACC		7.5%	9.7%	7.6%	7.5%	9.7%	7.9%	8.5%	10.4%	7.7%