EVA Reporting Framework

FINAL

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Authorised by:

Head of Finance

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AIRWAYS

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1. Objectives of Airways EVA Reporting

The overarching aim of EVA reporting is to provide an economic measure of performance and capital invested that is more closely aligned with the creation of shareholder value than traditional accounting frameworks (GAAP). It achieves this by providing a better measure of "cash returns on cash invested".

By developing and reporting against an EVA Framework, Airways intends to achieve the following objectives:

1.1. Provide a more relevant measure of return on the capital invested by the Shareholder

1.2. Provide reliable and relevant reporting to key Stakeholders

1.3. Provide reliable and relevant reporting and forecasting of both capital employed and performance, for the process of pricing regulated services, helping ensure a fair commercial return on these activities

2. Fundamental principles

In order to achieve the objectives set out above, the following fundamental principles have been adopted. They translate accounting measures of both performance and capital into a framework that better measures cash returns on cash invested:

2.1. Recognise Income and Expenditure at the time it is received or paid, effectively moving from an accrual to a cash basis for accounting

2.2. Measure Capital invested by the Shareholder at the full cost of that contribution and not at a level reduced by accounting provisions or unsuccessful investment decisions

2.3. Separate Operating activities from Financing activities in order to provide a relevant measure of economic performance for the underlying core business

2.4. Separate Operating activities from "Non-operating" or one-off activities in order to provide a more relevant measure of sustainable economic performance

2.5. Explicitly recognise the opportunity cost of the economic capital employed in Airways

3. Operational considerations

3.1. Simplicity is a key operational consideration. In order to ensure full transparency both within Airways and for all Stakeholders, the EVA Framework should be simple to apply, explain and implement. GAAP accounting currently forms the primary book of entry for Airways and as a result there needs to be a clear and easy-to-manage suite of adjustments to arrive at EVA based reporting.

3.2. Consistent with the Simplicity consideration, only material differences between GAAP and EVA measures will be adjusted for.

3.3. Consistent with the Simplicity consideration, adjustments will be determined for reporting purposes only and a full EVA ledger will not be maintained.

3.4. Specific adjustments will be reviewed on a semi-annual basis for relevance and materiality.

3.5. Any fundamental changes to the objectives or fundamental principles of the Framework will be approved by the Board.

4. Scope of application

4.1. EVA results are calculated for the regulated business only

All stakeholders for which EVA reporting is produced have a primary interest in Airways' regulated business i.e. the provision of ANS services in the NZ Flight Information Region (FIR). Consistent with Objective 1.2 and the operational consideration of Simplicity, reporting activities will be completed for the regulated business only.

4.2. Scope of reporting produced

EVA Reporting will be produced for the following purposes:

4.2.1. Periodic reporting to key Stakeholders
4.2.2. Business Planning (Primary Financial Statements)
4.2.3. Airways Annual Financial Report KPI table
4.2.4. Airways Interim Financial Report KPI table

For avoidance of doubt, the EVA component of the above reporting outputs will reflect the activities of the regulated business only.

5. General adjustments

As a result of the Fundamental Principles adopted, there are a number of adjustments to the GAAP results that will be made every reporting period to determine EVA and Capital Employed. These are:

5.1. Capital charge

5.1.1. The Capital Charge is the recognition of the opportunity cost of the capital invested in Airways, in line with Principle **2.5**. It is calculated by multiplying the capital employed by the capital charge rate (the calculation is covered in Section 6).

5.2. Exclusion of net interest costs from the operating result

5.2.1. Net interest costs consist of all interest charges less interest income on cash and cash equivalents. They reflect the return to the providers of debt financing and, consistent with Principle **2.3**, are excluded from NOPAT (i.e. operating result). The return to providers of debt finance is reflected through the Capital Charge adjustment.

5.2.2. The actual interest costs will generally differ to the assumed debt financing costs implicit in the Capital Charge. Any difference is effectively borne by the Shareholder.

5.3. Taxation

5.3.1. The GAAP taxation expense includes both tax payable to the IRD for the current year (current tax) and deferred tax elements. There is also a significant deferred tax balance on the GAAP balance sheet. Consistent with Principle **2.1**, the deferred or non-cash element of the GAAP tax expense is reversed to provide a cash tax charge equivalent to the tax payable to the IRD in respect of the current year. Any balance sheet deferred tax provisions (reflecting historic adjustments) are also reversed.

5.3.2. Where there is a material component of the above cash tax charge that relates to one-off or financing charges, these will also be reversed, consistent with Principles **2.3** and **2.4**.

5.4. Capitalisation of Operating Leases

5.4.1. Airways' has a number of long term leases that are categorised as operating under GAAP. Where these leases are long term and are for core Airways operating assets, the GAAP treatment represents off balance sheet financing. Consistent with Principle **2.3**, these leases are capitalised to recognise the financing implicit in the leasing arrangements, and the annual operating lease costs are substituted for interest and depreciation charges.

5.4.2. At the outset of the lease, a liability is recognised at the present value of the expected future lease payments, discounted at the current cost of capital. During the life of the lease, the lease liability is measured at amortised cost and an interest charge is recognised in the P&L as the liability is unwound. Note that under adjustment **5.2**, this interest expense is subsequently reversed and replaced by the Capital Charge.

5.4.3. In addition to the initial lease liability, an equal and offsetting capitalised lease asset is also recognised. This asset is depreciated over the life of the lease.

5.5. Payroll provisions

5.5.1. There are 2 significant payroll provisions recognised on the GAAP balance sheet:

- 'At Risk' payments which are paid out after the financial year end
- The estimated future costs of long term employee entitlements, including annual leave, long service leave and retirement leave. These amounts are determined by payroll records and actuarial assessments.

5.5.2. While the employee entitlement provision contains both current and long term components, the current trend in leave usage has resulted in this provision increasing over time. As this is not an immediately reversing transaction, the provision is closer to an equity equivalent and, consistent with Principles **2.1** and **2.2**, is reversed, along with the At Risk provision.

This results in a credit to NOPAT (equivalent to the increase in the provisions in the current year) and a credit to Capital Employed (in the amount of the current portion of the provision).

5.6. Derivative contracts

5.6.1. Airways uses derivative contracts to hedge its interest rate and foreign currency risk. Under GAAP, this results in the recognition of assets and liabilities on the balance sheet and an equal and offsetting hedge reserve. The cash impact of these derivatives is recognised in NOPAT at the same time, and in the same NOPAT caption, as the underlying operating or financing cash transaction which they hedge. Consistent with principle **2.1**, the derivative assets and liabilities and the hedge reserve at the reporting date are reversed.

5.6.2. This results in a debit or credit to capital employed, depending on the position of the derivative contracts at the time of reporting.

5.7. Intercompany balances

The regulated business operates an intercompany account with the various unregulated business units which do not have their own bank accounts. For the regulated balance sheet, this results in an increasing liability as unregulated retained earnings accumulate. For GAAP purposes, this is reported in working capital however it effectively represents investment in the regulated business. To ensure the capital charge is calculated consistent with principle **2.5**, the intercompany balance is transferred to debt funding.

6. Calculating the Capital Charge

6.1. Components of the Capital Charge

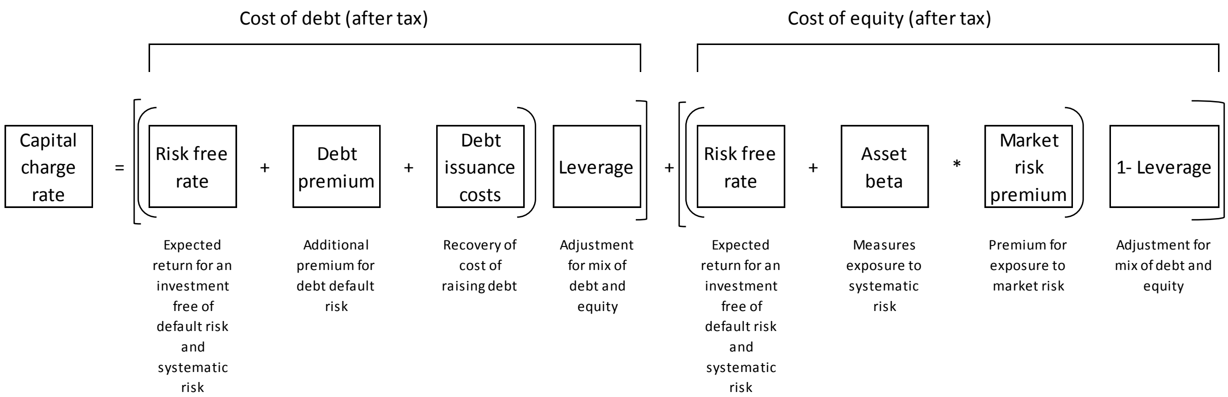
The Capital charge is calculated by multiplying the Capital Employed on the EVA Balance Sheet by the Capital Charge Rate. The details of these 2 components are set out below:

6.1.1. Capital Employed

- Reflects all capital invested in Airways including both debt and equity financing (including equity equivalents).
- This capital is used to fund Airways' asset base and can also be defined as total assets less current, non-interest bearing liabilities.
- For EVA purposes, it is determined by taking the GAAP capital employed and adjusting for the general and specific adjustments set out above.

6.1.2. Capital Charge rate

- Reflects the return investors require to compensate them for the risk of investing in Airways.
- The Components of the Capital Charge Rate are:



Where:

- The "risk free rate" is set at the Reserve Bank of New Zealand 3 year Government Bond rate. The 3 year rate has been chosen to reflect the term of Airways pricing arrangement with our customers.
- The Asset Beta for the Airways regulated business, debt premium, debt issuance and the Market Risk Premium are reviewed annually by the Airways Service and Pricing team and updated where there are material changes, after review by external experts.

- The debt premium is 1.86%, debt issuance costs are 0.35%, leverage ratio is based on Airways balance sheet, asset beta 0.6 and market risk premium 7%.

6.1.3. Use of point estimates

- There are a number of estimates within the capital charge calculation that introduce the potential for error between actual and expected returns.
- Recognising the asymmetric impacts of such errors on incentives to invest, Airways has set its capital charge rate at the 75th percentile which is consistent with the Commerce Commissions Input Methodologies.

6.2. Operational considerations in calculating the Capital Charge

6.2.1. The Asset Beta and Market Risk Premium will be assessed every three years.

6.2.2. The Risk Free Rate will be determined using the average over the period for which the Capital Charge is being calculated.

6.2.3. The Capital Charge will be calculated every six months, at the interim and annual reporting dates, using the Asset Beta and market Risk Premium established at the beginning of the relevant financial year and the actual average Risk Free Rate described in 6.1.2.

6.2.4. In calculating the Capital Charge, the capital charge rate will be applied to the average Capital Employed for the relevant 6 month period.

6.2.5. In calculating the Capital Charge, we will have regard to, but not be bound by, any relevant Commerce Commission pronouncements relating to Capital Charge calculations.