



APPROVED BY:
JAMES YOUNG
CHIEF FINANCIAL OFFICER



EVA REPORTING FRAMEWORK

DOCUMENT NAME: EVA REPORTING FRAMEWORK
DOCUMENT OWNER: CHIEF FINANCIAL OFFICER

These materials are the confidential information of Airways Corporation of New Zealand Limited (Airways). They may not be used, reproduced or disseminated in any form except as agreed in writing by Airways.

VERSION: 1.0
EFFECTIVE DATE: JUNE 2019
NEXT REVIEW: JUNE 2021



DOCUMENT MANAGEMENT

Document Author, Owner and Approver

Role	Name and Position
Document Author	Financial Controller
Document Owner	Chief Financial Officer
Document Approver	Chief Financial Officer

Document Review

This policy document is to be reviewed every two years.

Record of Reviews and Updates

Version	Details of change made	Date of change
1.0	First release in new format	1/06/2020



CONTENTS

DOCUMENT MANAGEMENT	2
1 OBJECTIVES OF AIRWAYS EVA REPORTING	4
2 FUNDAMENTAL PRINCIPLES	4
3 SCOPE OF APPLICATION	5
4 OPERATIONAL CONSIDERATIONS	5
5 ADJUSTMENTS	6
6 CALCULATING THE CAPITAL CHARGE	9



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 for the activities covered by Airways’ Service and Pricing Frameworks (the ‘Core Business’):

- ▶ Provide a more relevant measure of return on the capital invested by the Shareholder
- ▶ Provide reliable and relevant reporting to key Stakeholders
- ▶ Provide reliable and relevant reporting and forecasting of both capital employed and performance, helping ensure prices are set at levels that deliver a fair, commercial return

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 SCOPE OF APPLICATION

3.1. EVA results are calculated for the Core business only

All stakeholders for which EVA reporting is produced have a primary interest in Airways' Core 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 Core business only.

3.2. Scope of reporting produced

EVA Reporting will be produced for the following purposes:

- ▶ Periodic reporting to key Stakeholders
- ▶ Business Planning (Primary Financial Statements)
- ▶ Airways Annual Financial Report KPI table
- ▶ Airways Interim Financial Report KPI table

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

4 OPERATIONAL CONSIDERATIONS

4.1. 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 accounting ledger 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.

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

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

4.4. Adjustments (refer Section 5 for details) will be reviewed on a semi-annual basis for completeness, relevance and materiality. Any changes to the list of adjustments, including the requirement for any one-off additions, will be approved by the Chief Financial Officer.

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

5 **ADJUSTMENTS**

As a result of the Fundamental Principles adopted, there are several 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 cost of capital (the calculation is covered in Section 8).

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.

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 6.2, 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.

5.4.4. From 1 July 2019, Airways will adopt the new GAAP standard on leasing (NZIFRS16) which will bring all leases on balance sheet. This standard will achieve the same result as the adjustments outlined in 5.4.1 and 5.4.2 above and, as a result, these adjustments will not be required once NZIFRS16 has been adopted.

5.5. Derivative contracts

5.5.1. 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.

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

5.6. Intercompany balances

5.6.1. The Core business operates an intercompany account with the various commercial business units, which do not have their own bank accounts. For the Core Business balance sheet, this results in an increasing liability as retained earnings from other business units accumulate. For GAAP purposes, this is



reported in working capital however it effectively represents funding from the commercial business units. To ensure the capital charge is calculated consistent with principle 2.5, the intercompany balance is transferred to debt funding.

5.7. Payroll provisions

- 5.7.1.** There are significant payroll provisions recognised on the GAAP balance sheet representing 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.
- 5.7.2.** 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.
- 5.7.3.** Movements in actuarially determined leave provisions are not considered operating costs and, consistent with principles 2.2 and 2.4 are reversed in determining EVA NOPAT.

5.8. Impairment of non-depreciated fixed assets

- 5.8.1.** Where non-depreciated fixed assets are impaired under GAAP, cash invested in the business is removed from the value of capital employed. Consistent with principle 2.2, these impairments are reversed.

This results in a credit to NOPAT and a debit to Capital Employed.

- 5.8.2.** For the avoidance of doubt, impairments of fixed assets which would otherwise be depreciated represent an early release of costs to EVA NOPAT. Where they are considered to represent operating costs, they are not reversed in determining the EVA result.

5.9. Capitalised interest

- 5.9.1.** Where assets are constructed over a period of greater than 1 year, borrowing costs incurred in funding the asset are capitalised.
- 5.9.2.** To avoid charging customers for this interest through the capital charge and then again through depreciation and inclusion in the capital base, an estimate of accumulated capitalised interest is reversed from the asset base on depreciation profile for pricing purposes.

6 CALCULATING THE CAPITAL CHARGE

6.1. Components of the Capital Charge

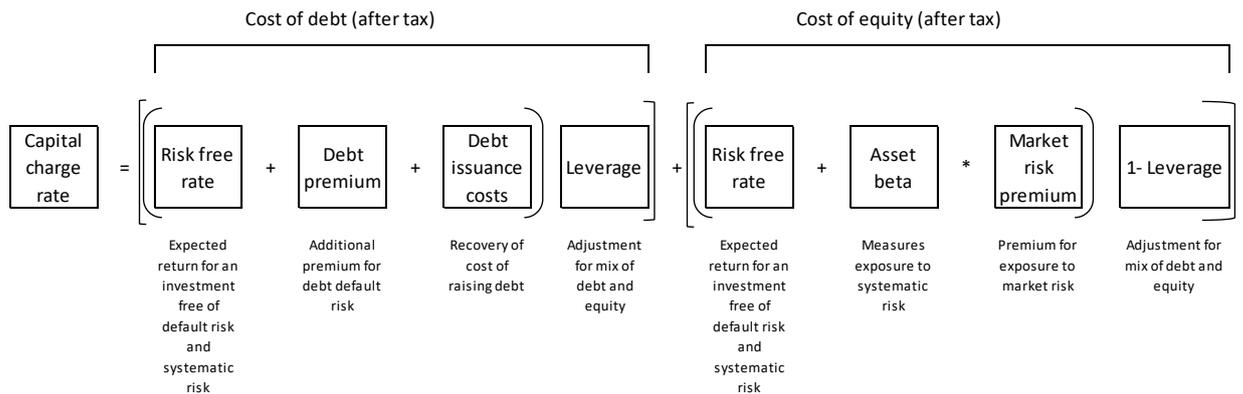
The Capital Charge is calculated by multiplying the Capital Employed on the EVA Balance Sheet by the Cost of Capital. The details of these two components are set out below:

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 adjustments set out above.

6.1.2. Cost of Capital

- ▶ Reflects the return investors require to compensate them for the risk of investing in Airways. It consists of the following:



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, debt premium, debt issuance costs and the Market Risk Premium are reviewed annually and updated where there are material changes, after review by external experts.



6.1.3. Use of point estimates

- ▶ There are several 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 67th percentile.

6.1.4. Gearing

- ▶ For planning and pricing purposes, gearing assumptions reflect long term target positions for Airways, bearing in mind standard industry gearing.
- ▶ For reporting purposes, gearing reflects actual gearing for the period.
- ▶ Gearing is calculated on an EVA rather than GAAP basis.

6.2. Operational considerations in calculating the Capital Charge

6.2.1. The Asset Beta, Equity Beta and Market Risk Premium will be assessed at the start of each financial year.

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, Equity Beta and market Risk Premium established at the beginning of the relevant financial year and the actual average Risk Free Rate described in 6.2.2.

6.2.4. In calculating the Capital Charge, the Cost of Capital will be applied to the average Capital Employed for the relevant period.

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