ADDENDUM:	STATION ACCESS AGREEMENT
SUBJECT:	Glasgow Prestwick Airport AirTrain Access Agreement
PURPOSE:	Addendum to the Representations made by Glasgow Prestwick Airport dated 29 March 2006
DATE:	1 May 2006

Introduction

Our original proposal contends that the use of a Modern Equivalent Value is the most appropriate method of asset valuation for the purposes of determining an Access Charge for the Glasgow Prestwick Airport Rail Facility ('GPA Facility'). Our justification for the use of this method is best summarised by the following statement contained in ORR publication '*Framework for the Approval of Railtrack's Track Charges for Franchised Passenger Services*' under the heading '*Choice of Capital Value*';

> *In principle, all assets should be rewarded on the basis of their current economic value, in order to provide the correct economic signals about their continued use.*

In response to the consultation meeting held on 29 March 2006, the following discussion on Asset Valuation is offered by way of Addendum to the GPA AirTrain Proposal submitted to the ORR on 29 March 2006 and both documents should therefore be read in conjunction with each other.

Determining an appropriate asset valuation methodology is a fundamental component of calculating the appropriate Access Charge for the GPA Facility. It is also the only parameter of the *Section 17* application by First ScotRail where there is a fundamental difference of view between First Scot Rail ('FSR'), the train operator, and Infratil Airports Europe Ltd ('IAEL'), the ultimate owner of the GPA Facility.

Regulators in various industry sectors and across many jurisdictions have studied the issue of asset valuation at great length. Newly built facilities tend to be straight forward as all of the methodologies converge at the same value, the construction cost (except where there may be arguments over inefficiency in design or construction, or issues of allocation). Asset valuation is more problematic where assets are older.

In the case of the GPA Facility, complexity arises due to:

- the age of the facility;
- the unique nature of its ownership structure within the UK Rail Network;
- the existence of elements of grant funding; and
- its change of beneficial ownership.

Given these complexities special consideration needs to be given to the appropriate method of valuation for the GPA Facility. The methods that could be considered for valuing the station include:

- Sunk cost (ie zero)
- Indexed historic cost;
- Indexed purchase price (most recent transfer of beneficial ownership);
- Book value; and
- Modern equivalent value (or optimised replacement cost).

While the appropriateness of each method is explored in more detail below it should be noted that the treatment of the initial grants should be considered separately under each method.

Overriding Regulatory Principles

To determine the appropriateness of each of the methods identified above we are guided by *Section 4* of the *Railways Act 1993 ('Act')* where a duty is imposed on the Regulator to consider a series of overriding principles in the exercise of its power under this *Act*. As the Application by FSR is made under *Section 17* of this Act, GPA contends that of the list of considerations identified in *Section 4* specific attention should be placed on those considerations identified at:

Section 4(1)(a)	'*… to protect the interests of railway users'*
Section 4(1)(bb)	*'… to contribute to the achievement of sustainable development'*
Section 4(1)(g)	*'… to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance'*
Section 4(5)(b)	*'… to act in a manner which he considers will not render it unduly difficult for persons who are holders of network licenses to finance any activities or proposed activities of theirs in relation to which the Regulator has functions under or by virtue of this Part.'*

It is therefore IAEL's view that these specific considerations must be taken into account in the determination by the ORR of the appropriate method to use for the valuation of the GPA Facility and associated access charge. The application of these considerations would result in an Access charge that:

- Sends efficient signals for consumption (s4(1)(a));
- Sends efficient signals for future investment in the GPA Facility (s4(1)(bb));
- Establishes equity as between the parties;
- Ensures regulatory consistency, by not diverging from reasonably expected outcomes; and
- Ensures that the commercial viability of the facility to Asset owner is maintained.

IAEL contends that the proposal contained in the FSR Application fails to satisfy these considerations and therefore the underlying principles governing the application of the regulatory framework surrounding this Access Agreement. *Section4(5)(b)* (above) is of particular relevance to the GPA Facility. Under the current framework being proposed by FSR it is difficult to see how continuing to operate the GPA Facility would be commercially viable. As we will expand below, the marginal nature of the GPA business means that it is essential to obtain a commercial return from all of its assets. It is simply not a viable option for IAEL to operate a facility that only covers its costs, when the provision of this facility attracts passengers away from other modes of transport available at the Airport that do make GPA a commercial return.

Appropriate Method of Asset Valuation

Sunk Cost

It is generally recognised that sinking private sector capital is almost never a reasonable approach as it would send a signal to the market that would prevent future investment. This method has been used for public sector assets in some countries (such as for dams) where there is little need for any future investment and the alternatives produce socially unsustainable pricing signals.

Indexed historic cost

The main issues with using historic cost for older assets is the difficulty of identifying an appropriate index and the potential for changes in technology to result in historic cost being too high, or conversely, changes in construction requirements resulting in historic cost being below the cost that would be incurred in replacing the asset. The benefit is that it is often observable rather than an estimate.

RPI is not generally a good indicator of changes in construction costs. Indices that look at changes in the costs of materials and labour are more appropriate.

In the case of the GPA Facility, an historic cost of £2,307,000 is consistent with the MEV valuation of £3,534,000 if an index averaging 3.95% were correct over 12 years. Accordingly, it would appear that these methodologies are broadly producing the same outcome.

Indexed Purchase Price

If there has been a recent change in beneficial ownership, using the actual purchase price has the great advantage of being an accurate understanding of the owner's investment of capital and understanding of value at that time.

In the case of the GPA Facility, the purchase price of the station is generally, but not specifically, observable from the change of ownership of 100% of the share capital of Prestwick Airport Ltd as follows:

- 22/1/2001 67.3% £14.8 million
- 15/12/2003 10.0% £6.03 million
- 19/12/2003 22.7% £11.7 million

Because the acquisition by (ultimately) Infratil Ltd was of all the airport assets, the specific amount that relates to the station cannot be specifically determined. However, as part of the fair value exercise, performed in 2001, a value of £2 million was attributed to the station. This valuation was based on the depreciated replacement cost and supported by a discounted cash flow. Infratil contends that the value ascribed to the station must have been at least the amount included in the books

Discounted cash flow valuation

A discounted cash flow ('DCF') model was used by Infratil to arrive at a price that could be paid to the then owners of shares to acquire beneficial ownership of the airport. It can be argued that using the purchase price based on a DCF to value the station introduces the issue of circularity (i.e. the access charge is based on a value that is effectively derived using the estimated future access charge).

At the time of the valuation, the station was generating revenue for the airport based on a share of ticket revenues. Like all commercial contracts, the agreement had an end date and the DCF analysis had to make assumptions about the terms of any future arrangement. The most common approach, and the one used implicitly in this case, was to assume that the status quo would continue. This was done by linking the revenue of the station to the estimates of traffic growth, with the underlying assumption that around the same proportion of passengers would continue to use the station and the growing revenue stream would continue to be shared in equal proportions.

Infratil contends that this is an entirely reasonable valuation basis. If the regulator were to now ascribe a value that is lower than that reasonably assumed on acquisition, this would amount to a confiscation of private sector capital. The implications would be that Infratil would be required to write-off the difference in valuation to reflect the reduced DCF value. Under accounting standards, this is likely to be required to be taken through the profit and loss account of the airport. After interest, Glasgow Prestwick is currently not profitable. A write off of this magnitude would potentially reduce pre-interest earnings by more than half in the year of the write-off. This would clearly be a grossly inequitable outcome for a company that has invested in the infrastructure in good faith and is not currently earning a reasonable return on that investment.

Book Value

Book value tends to be aligned to one or more other valuation methodologies at particular points in time, as it is simply the recording of the value. Accounting standards require that the book value or carrying value be no more than the asset's recoverable amount. The recoverable amount is the higher of the amounts that can be obtained from selling the asset (i.e. its net realisable value) or from using the asset (i.e. it's value in use). Value in use is calculated by discounting the expected cash flows arising from the use of the assets at the rate of return that the market would expect from an equally risky investment. If the book value is found to be in excess of the recoverable amount then the asset value is impaired and this loss is recognised in the profit and loss account. The book value is therefore ultimately capped by a DCF analysis (refer issues above).

Infratil Airports Europe has a policy of revaluing it's assets every 5 years with an interim valuation in year 3. An independent valuation was performed in 2002 and in 2005 which

valued the Station at £2 million based on a prudent DCF performed on the station. The station therefore has a carrying value in the IAEL books of £2 million. If the company had a policy of historical cost accounting and depreciated the asset over an expected life of fifty years it's current carrying value would be £1,772,500. In order to compare the depreciated historical cost to the MEV you would be required to add back the depreciation and index the original cost – effectively the indexed purchase price (refer issues above).

At the current point in time, the book value is broadly equivalent to the valuation.

Modern equivalent value (or optimised replacement cost)

To overcome the drawbacks of other methodologies, and to give the best signals for consumption and future investment, many regulators have adopted a modern equivalent value (or optimised replacement cost) methodology for setting an asset base. The advantage of this approach is that it can be said to result in a price that would be identical to the price that an investor would need to charge if the asset was built today. Another way of looking at it is that it best emulates a competitive market. If someone were able and willing to build a competing rail station of equal amenity adjacent to the GPA Facility then this would require at least this asset base.

We are also guided by the approach taken in the 'Fair Deal' guidelines issued by the ORR where it identifies that the Modern Equivalent Asset Value ('MEA') was the basis upon which the calculation of the cost of capital and an appropriate return on capital was initially formulated.

The Regulator set the overall level of Railtrack's access charges in January 1995. He allowed for:

(a) the capital costs of Railtrack meeting its obligations in respect of renewal of stations in modern equivalent form and an appropriate return on capital. These costs were based on the modern equivalent asset (MEA) values of stations owned by Railtrack;

This is further supported by reference to the ORR publication '*Framework for the Approval of Railtrack's Track Charges for Franchised Passenger Services*' where is states under the heading 'Choice of Capital Value':

'*Under Railtrack's initial financial regime, its required rate of return is applied to the assessed net value of its renewable assets on a Modern Equivalent Asset Value basis……'* and

'In principle, all assets should be rewarded on the basis of their current economic value, in order to provide the correct economic signals about their continued use. In a profitable and competitive business environment, this economic value would be the replacement cost of the asset in modern form – since that is what the market would pay for ownership of that asset in order to enjoy the income stream which it would generate.'

Treatment of Grant Funding

The original construction of the GPA Facility was undertaken with the assistance of significant grant funding. FSR contends that this is relevant for determining the current asset base by claiming Infratil should receive no return on this capital. To be able to address the issue more logically, it is assumed here that FSR would concede that a return is at least reasonable on the then airport owner's capital contribution.

To understand the role of grant funding, the ORR should consider the investment environment that existed at the time the station was constructed. Prestwick Airport (as it was then known) had been acquired in an almost empty state from the BAA who had consolidated all international and domestic flights into the previously domestic only Glasgow and Edinburgh airports. The owners were committed to the future success of the airport. However, the risk profile of airport was extraordinary in any normal infrastructure sense. Various public bodies clearly recognised the damage that closure of the airport may cause to the future economic development of the region. These public bodies assisted through grant funding to support the development of the airport was being undertaken at enormous financial risk by its then owners.

It is understood that the grant funding did not entitle to public bodies to any ownership of the Station. Therefore, on completion, 100% of the asset was owned by the airport.

The agreement to share station revenues was a risk-free proxy for access/usage fees for the train operator. If the airport was not successful in attracting passengers, the airport would receive no revenue. If the current proposed access arrangements had existed, the train operator would have paid far more for access in the early years, even if the access arrangement at that time excluded grant funding from the asset base. Projecting forward to today, the train operator now contends that the revenue share agreement is too generous for the airport and sought its termination.

A substantial question the ORR needs to consider is whether the original airport owners had the right to sell the rail station along with the airport, given they did not fully fund it. The legal answer is clearly yes as the then airport owners had 100% ownership of the GPA Facility. The moral answer is also yes, as the then airport owners undertook an incredibly risky investment in an almost empty airport. Arguably the most likely outcome would have been those owners losing their investment (it was clearly BAA's view at the time there was no demand for an airport at Prestwick). The public backing has had a return on its investment many times over in the jobs, inward investment, tourism and business links that the airport has afforded the community.

The question then is whether the grant funding is now relevant for determining an asset base to calculate an access charge for FSR to the GPA Facility. Infratil, as 100% beneficial owners of the airport and the GPA Facility, has received no benefit from the grant funding as it has acquired the shares based on a fair value assessment of the assets. Therefore, it would be inequitable to effectively confiscate Infratil capital based on grants provided for the benefit of others when Infratil now has no recourse (or legal or moral logic) to be able to reclaim that capital paid to former shareholders.

FSR have argued that IAEL should, in effect, subsidise the cost of the rail operation due to the benefits it provides by bringing passengers to the airport. In response, Infratil

makes the following points:

- The economics of low cost airports rely on revenues from non-aeronautical activities to assist meet the very significant fixed costs of running the airport infrastructure.

- Low cost airport operators without market power are generally unable to charge airlines significantly more than marginal cost. This pricing is economically efficient and sustainable if there are other areas that revenue can be earned to meet fixed costs.

- Fees from ground transport access to the airport, including car parking, rental cars, taxis, buses and trains make up a significant proportion of the available funding to meet the fixed costs of the airport.

- Given this, the concept of aeronautical activities (or even other commercial activities) being able to cross-subsidise rail costs is absurd.

- The existence of the rail infrastructure provides an additional travel option for passengers and staff. As evidenced by the fact that no other Scottish airport has a rail service, rail is not necessary for an airport to operate as passengers are able to catch a bus, drive a car (private or rental car), be dropped off/picked up by others, catch a taxi or other private hire car etc, all of which generate a revenue for GPA.

- It is Infratil's view that the existence of the GPA Facility and services provided to that station by FSR does not materially add to the number of passengers using the airport. While around 20% of passengers do arrive and depart by train, the overwhelming majority of these passengers would transfer to dedicated bus services if the rail service were not available. The airport would expect to earn a return from bus services through commercial agreements with operators.

- FSR benefits heavily from the existence of the GPA Facility. The track and route would exist without the GPA Facility (linking Ayr and other towns to Glasgow), although patronage would be significantly lower. Accordingly, the marginal cost to FSR is low and the marginal return on revenue derived from the GPA Facility is accordingly high.

- The lack of train services that run at times to connect passengers to the early morning peak aircraft services and late night arrivals is evidence that FSR does not provide services for the specific benefit of airport users.

In view of the above, Infratil strongly contends that historic grant funding is not a reasonable justification for regulating a subsidy to FSR by setting prices below the efficient cost of the service. The efficient cost being (MEV x WACC) + Depreciation + Operating Costs.

Should the ORR make directions at all?

The Application submitted by FSR, is an attempt to 'game' the regulatory process by only seeking an access agreement when the terms of the 'at arms length' commercial agreement had started to be advantageous for the Airport. As the revenues that GPA derived from the AirTrain Facility were directly related to the passenger numbers departing and arriving at the airport, their low levels up to 2002 would have meant that the facility was operating at a significant loss to the airport. Annexure A provides a comparison of the estimated revenues from the three different types of Access agreement currently being reviewed, i.e. the continuation of the Travel Discount Scheme, the FSR Application and the GPA Airtrain proposal.

Annexure A highlights the fact that at the commencement of the Travel Discount Scheme (1999), GPA was likely to have received a Gross contribution from the AirTrain Facility of approximately £103,839. If this agreement had not been terminated by FSR it would represent approximately £1.9 million in 2016 (the expected termination date of the proposed Access Agreement). This figure compares sharply to the FSR proposal which would see Gross contribution peaking at £X (deleted). While the GPA proposal peaks at £668,957.

While it is clear that the ORR must play a role in the final approval of any Long Term Access Agreements, there is an argument that the ORR should not intervene in this case as it should be viewed as a commercial negotiation between the parties. The reasons for this would be:

- A competitive market exists for access to Glasgow Prestwick Airport. Trains compete with buses, taxis and cars. The other modes are not price regulated.

- The airport can operate without rail services, as evidenced by the prevailing situation at other busier Scottish Airports and the fact that not all flight times at GPA have connecting rail services (and Infratil provides bus services at these times).

- FSR contend that it is providing a valuable service to the airport. If this is the case, FSR should be able to reach agreement with Infratil without the intervention of a regulator.

- FSR also contend they do not make large profits from the GPA Facility, indicating that they should be largely indifferent to operating at the GPA Facility, therefore giving them a strong negotiating position.

- There has not previously been the need for the intervention of a regulator, and it was the termination by the train operator of a long standing revenue sharing agreement that has resulted in the dispute.

Accordingly if the parties are unable to reach a conclusion then it should be left to the commercial environment surrounding the interests of both parties to determine their ultimate response.

Conclusion

The purpose of this paper is to discuss the key issue of contention between FSR, the train operator, and IAEL, the ultimate owner of the GPA Facility being the determination of an appropriate asset valuation methodology. In the analysis above, the advantages and disadvantages of using the Sunk Cost, Indexed Historic Cost, Indexed Purchase Price, Discounted Cash Flow, Book Value and Modern Equivalent Asset Value methods have been discussed.

It is ultimately contended that the analysis above indicates that the Modern Equivalent Asset Value (or optimised replacement cost) approach best emulates a competitive market, thus best represents the fair value of the GPA Facility. Our analysis of the Indexed Historic Cost method indicate that indexing the historic cost of the station, adding back depreciation and taking into account the effect of construction price inflation results in a value greater than the value calculated by using the MEA method thus confirming the suitability of the Modern Equivalent Asset Value approach and confirms the ORR publicised statement that;

> *In principle, all assets should be rewarded on the basis of their current economic value, in order to provide the correct economic signals about their continued use.*

The appropriateness of the MEA method of Asset Valuation for the purposes of calculating an Access Charge for the GPA Facility is further supported by reference to the Overriding Regulatory Principles discussed above. The analysis of the MEA method contained in this document and the GPA AirTrain Proposal dated 29 March 2006 both suggest that this approach best satisfies those statutory considerations most applicable to the FSR Application.