Financial and Corporate Sustainability Project

Kaikoura Airport

Airport Stocktake –

Interim Summary May 2019

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Contents

IMPORTANT: This document contains financial information that has been sourced from KDC staff and reports. We have been unable to convince ourselves that the information is sufficiently and consistently robust to rely on for the detailed analysis required to finalise our recommendations.

Therefore this report should be treated as indicative only until more robust information can be provided.

In addition the views expressed in this report are subject to formal legal confirmation

The Brief

Morrison Solutions was engaged to undertake a stocktake of the Kaikoura Airport and report on the following:

Stocktake of Current Position

- Operational compliance and H&S
- Council assets, deferred maintenance and future capital requirements to maintain current service levels for users and evaluated lease conditions
- Financial analysis – current and forecast

Growth Potential and Resilience

- Major operators views, plans and aspirations
- Growth potential and revenue capture mechanisms and charges
- Resilience and adequacy as a future emergency site and potential upgrade costs
- Financial sustainability and funding policies including possible third party contributions
- Outline next steps to optimise sustainable operations and revenues

The work was to be undertaken in two phases with Phase 1 being a review of available information for quality and usefulness and in discussion to determine the objectives in more detail and if possible derive a preliminary position.

In undertaking this review Morrison Solutions has relied heavily on information provided by Council and Airport Stakeholders.

1 – Stocktake Snapshot

Stocktake Snapshot(1)

Status

- KDC is an Airport Authority under the Airport Authorities Act and has all the prescribed responsibilities under the **A**ct
- Airport land is Crown and vested in KDC as a local purpose reserve under the Reserves Act – cannot sell but can lease
- PGF report concludes there is no commercial or resilience case for extending the runway
- No likely large growth in market but probably slow steady increase

Positives

- The Airport:
  - is a discretionary activity (i.e. not a significant activity under the Act)
  - captures good revenue data through AIMM system
  - managed the EQ aftermath pretty well
  - assets (runway, taxiway, etc) in generally good condition
  - has potential to make a limited economic contribution but probably not nearly as much as Port activities or SH1 rest stop traffic
  - has 3 embedded operators - Some would like more facilities

Stocktake Snapshot (2)

Negatives

- Being an Airport Authority requires KDC:
  - to run airport business as a commercial undertaking (ie make money), and
  - be capable of managing all the aspects of running the Airport
- Poor management and operational controls leading to direct risk to Council (and perhaps its senior employees):
  - Operator disharmony
  - Building issue (hangar non compliance with the Building Code)
  - Unpaid landing fees
  - Non compliance to CAA requirements - Only in the last month have things been done to conform with CAA requirements for its classification
  - No qualified staff managing Airport which leaves KDC highly exposed

Financial

- Information lacks robustness and no "single source of truth" meaning it is difficult to set fees and charges with any certainty
- Losing between $60 ~ $100k p.a. so subsidised by ratepayers despite 100% private good usage
- Leases need review but have to wait out term, short term revenue opportunities confined to landing fees
- Under the Reserves Act all profits from the airport land must be used on the airport and/or other Council reserves (not general revenue)
- Unclear about reason for future capital spend ($1m + on Terminal Building) with no clear increase in revenue
- Depreciation policy will prove to be unsustainable (funding renewals)
- Overall, risk not matching returns

2 – Airport Background

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History

- The Airport and grass runway was constructed by Council staff in 1964 - Cost 4000 pounds
- In 1995 the runway was sealed for increased traffic and to protect it from rabbit damage
- In 1997 KDC was appointed as an airport authority by an Order in Council under the Airport Authorities Act 1966
- Scheduled commercial flights have been intermittent with Sounds Air services to Wellington from 2004 to 2009 (stopped as not viable) and a temporary daily service to Blenheim and Christchurch in November 2016 (post earthquake) that was extended to late December 2017
  - *Source: Wikipedia*
- We are informed that:
  - The airport suffered only minor earthquake damage to the hangar (currently occupied by South Pacific Helicopters) and terminal building
  - The runways were unaffected
  - Overall the airport performed very well within its capacity during the time the town was isolated
  - The very high usage during the highway and rail reconstruction, especially by helicopters, has now stabilized at a lower level

Current usage

- Aircraft movements for January 2019 (high season) and June 2018 (low season) are compared below:

	January 2019	June 2018
Kaikoura Aero Club	995	413
South Pacific Helicopters	635	243
Christchurch Helicopters	55	335
Canterbury Aero Club	51	81
Others	154	178
Totals	**1890**	**1250**

- January Aircraft types comprised:
  - Aeroplanes 1422
  - Helicopters 300
  - Microlight 37
  - Unknown 21
- Landing charges were levied for 99.6% of total movements
- It is noted the Aero Club is disputing the landing fees and is currently not paying

**Source AIMM Reports*

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3 – Current Situation

Council assets

- The airport land is Crown owned and vested in KDC as local purpose reserve (2018 valuation of $600k)
- Council owns outright the improvements on the land such as the runways, terminal building, hangar, hard stand areas and carpark (2018 valuation of $630k)
- Both the terminal and hangar suffered some earthquake damage and need repair
- There is likely to be a requirement for additional facilities over time as justified by demand

	Condition	Deferred Maintenance /Upgrade	Other issues/comments
Land			Vested to KDC as local purpose reserve/Rural zoned/not designated 8.9Ha
Sealed Runway	Very good	Recently resurfaced	Deficient lateral width/clearances - 8000 m^2
Grass Runway	Good		Deficient lateral width/clearances
Taxiways	Very good	Recently sealed	1600 m^2
Terminal Bldg	Some EQ damage	Programmed	300 m^2 footprint and mezzanine 80 m^2
Hangar	Some EQ damage	Wind bracing required and programmed	Source of turbulence for aircraft – 300 m^2
Carpark	Sealed Good		1000 m^2
Perimeter	Not secure		

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Operational Compliance, H&S and Capacity

- There are a number of CAA non-compliances or safety issues identified in the Astral * report including:
  - Non-complying sealed runway dimensions
  - Non-complying grassed runway dimensions and prohibition of taxiing beside the grass runway
  - H&S issues including safety of public close to operational areas
  - New fuel facilities and CAA approvals required
  - Absence of secure areas
- These present a risk to KDC and need to be addressed immediately (some work is underway)
- We understand that the estimate for the physical works to remedy all the above is $250k ($150k loan and $100k material damage fund)
- We have a concern that this funding is contributing to a100% private good facility and should be reflected in KDC's return on its investment

* Source - CAA CONFORMANCE AND AERODROME DEVELOPMENT - Astral Report September 2018

The Commercialize Ltd Draft Report** to assess the case for funding of development from the Provincial Growth Fund (PGF) concluded that:

- There is no case for a commercially justified or resilience justified runway extension
- Some capital will be required for incremental airport development as demand is identified and recommends *"That KDC reserve the right to come back to the PGF in the future around growth driven airport asset development with a view to accessing debt financing to aid development that may not otherwise occur."*
- The report also noted that *"the immediate growth potential for the facility are not currently limited by the runway length or availability of take-off slots, they could comfortably handle greater volume than they do currently."*

- *** Source - Draft report* "Kaikoura Airport Development Feasibility Assessment" by Commercialize Limited

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Current Year Financial Performance 2018/19

Revenues	Budget $000	Latest Forecast $000	Comment
Landing Fees	90.0	61.2	KDC Forecast
Leases	30.0	62.0	KDC Forecast
Licence to Occupy	3.9		
Total Revenues	**123.9**	**123.2**	
Costs			
Maintenance	30.0	30.0	KDC Budget
AIMM Monitoring	19.1	13.0	21% of landing fees
Consultancy	70.0	43.6	May not continue at this level
Management & Overheads	59.4	64.8	Includes allowance for part time manager
Insurance	2.6	4.0	
Depreciation	15.0	0.5	Depreciation policy is lacking and will result in decrease in balance sheet value!
Interest	20.6	9.6	
Total Costs	**216.8**	**165.5**	
Surplus (Deficit)	**(92.9)**	**(42.3)**	**Deficit funded from rates**

Financial information supplied by KDC

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Normalised Financial Reports

- Robust normalised/BAU financial information is required to give ~~any~~ third parties interested in involvement with the Airport an indication of normal trading patterns
- Some work has been done on this but further and more detailed analysis of financial reports and forecasts is required before any final recommendations can be made
- We believe that KDC should appoint a temporary acting CFO to produce a 'single version of the truth' set of financials for the whole of Council and for its trading entities that have been developed from base data
- This would enable all parties to be able to have confidence in both the recommendations (of this study?) and in determining their own conclusions relating to the Airport
- Without robust financial data we are concerned that neither KDC nor Morrison Solutions will be able to determine the appropriate level of fees and charges with any certainty

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Future Forecasts - Capital

KDC Three Year Plan	2018/19	2019/20	2020/21
Taxiway Seal	$27k (completed)		
Airport Hangar	$190k		
Airport Terminal		$581k	$581k

- Capital expenditure of $1.38m over the term of the Three Year Plan:
  - Taxiway seal is an upgrade (not previously sealed)
  - Hangar work is to improve wind bracing (understood to be the subject of litigation against the builder)**
  - Terminal building works are understood to restore service levels and upgrade
- These capital upgrades do not appear to be linked to an opportunity to generate more revenue
- Thus all of the benefits from this expenditure of ratepayers' funds accrues to the private sector users of the airport

** We have no detail about this but expect the legal action will be very difficult to succeed in court.

KDC Management – Status Quo Pros, Cons and Risks

Pros

- Control of lease and landing fee revenues and response to economic development opportunities

Cons

- Costs of maintenance, future asset renewals and capital costs of upgrades of airport assets
- Airport operations and commercial management responsibility including debtors and sorting disputes
- Administration associated with CAA compliance and airport management
- Exposure to subsidising from rates if shortfall
- Challenging for Council to add value to this discretionary business

Risks

- Management and operational risks that could arise in the event that KDC as the Airport Authority does not effectively exercise its powers and responsibilities under the Airport Authorities Act 1966
- Includes potential responsibility for contribution to an aircraft event that could be fully or partly attributed to any deficiency in compliance with CAA requirements, maintenance or H&S practices
- Commercial risks with ratepayer's funds
- Not exercising sufficient hands on competent management to mitigate the above risks

Conclusions

- There are CAA non-compliance issues which are in the process of being addressed
- The business of the Airport Authority has not been run as a commercial undertaking as required by the AA Act
- KDC currently carries high financial risk and has been topping up the airport accounts from rates mostly for the benefit of a low number of private users
- Depreciation of the airport assets have not been funded in the past which is poor practice and can lead to increasing costs and/or reducing asset value
- KDC currently carries high operational risks as the Airport Authority
- The management of the airport has not been adequately resourced in recent times
- We have not been able to satisfy ourselves that the provided financial accounts are sufficiently robust for an accurate financial picture to be drawn
- However it is clear that the current revenues from leases and landing fees fall short of that required to provide a viable commercial outcome

4 – Growth Potential and Resilience

Operators Views and Aspirations*

Operational

- Fuel arrangements are not good and need an aggregated supply point with separate power supply, swipe card access and easy to locate for visiting pilots. Requirement for A1 jet fuel essential for search and rescue is noted
- Runways – A number of views including:
  - Sealed marginally short for Cessna Caravan which is the largest aircraft that can operate here
  - Sealed runway would be better closer to the beach
  - Repositioning the grass runway alongside the paper road and extending it
  - Potential to fell trees on Te Runanga o Kaikoura land to the north and level for emergency purposes
  - Future hangars would be better placed between the airport and camping ground as the current hangar between the highway and runways causes turbulence - better if it was removed
- From a resilience perspective the airport worked relatively well

Commercial

- Needs to be certainty around leases or availability of freehold sites to encourage investment
- There is confusion for passengers with shared use of the terminal causing operator tensions
- Some expected tourism growth but DOC Licences for whale watching are limiting activity
- Kaikoura is on a touring route so high end tourist market will visit Kaikoura without airport
- KDC should not be investing but terminal building remain a Council asset and be commercially available to operators
- Needs to be a company formed to manage the airport

** Source – "Future Wants and Needs Airport Consultation 2018" – Project Team lead by Danny Smith*

Financial Sustainability

- Financial sustainability must be addressed in the context of:
  - Council's policy that the airport is 100% a private good facility i.e. it is a discretionary commercial business that should be fully funded from revenues
  - Council has a considerable investment of publicly funded assets (valued at $1.23m) at the airport and we understand a further upgrade to the terminal at $1.16m is programmed but we are unsure of the future revenue increases this will produce
  - The real cost of this capital should be recognised in assessing the viability of the business – such cost of capital being assessed as the Council's cost of borrowing plus a reasonable margin for the commercial risks of owning and managing an operational airport
  - The airport assets will need renewal over time and depreciation funding tagged to the airport assets should be put aside for this in an airport reserve fund
  - There are loans in respect of both the terminal building and the hangar that must be serviced and repaid within the terms of the loans
  - Council does exercise some management input which should also be recognised together with any insurance and compliance costs
- Unless all these requirements are met the ratepayer will in reality be subsidising the private sector operators which is contrary to the requirements of the AA Act to operate a commercial undertaking and to KDC's 100% private good policy
- It is noted that under the Reserves Act any profits relating to the use of land are tagged to be used for reserves (including the airport land) and are not general revenues

Revenue Opportunities

- In 2019 the Commerce Commission set the weighted average cost of capital (WACC) for major airports at 6.3%.
- Given the size and nature of Kaikoura Airport and its owner, the high commercial risk and uniqueness of its local service offering, revenues should be set at reasonable market rates and a WACC of say 10%
- If this was achieved, then based on Council's valuation of the airport assets (land and improvements) in 2019 at $1.23m the airport should be producing returns of circa $123,000 before interest
- The current total revenues are well below the levels required to deliver anything like this sort of result
- The opportunities to increase lease revenues are limited in the short term by the currency of existing leases however should be considered within the framework of options considered in the longer term
- The best available source of increased revenues in the short term is from landing fees
- Based on a preliminary high level analysis using the supplied projected 2018/19 financial information landing fees would have to increase by about 180% to enable the airport to achieve a WACC of 10%
- The additional capital upgrades in excess of $1m planned for the terminal would increase the total asset valuation and justify an even higher increase in the order of 350% on current landing fees!

Landing Fees

Current and preliminary indicative commercial landing fees (including GST) assuming lease revenue is the same as at present

Kaikoura airport landing fees	Current	Commercial return 10% WACC
Up to 800kg	$7.00	$19.60
800-1500kg	$10.00	$28.00
1500-2000kg	$14.00	$39.20
2000-3000kg	$20.00	$56.00
3000-4000kg	$30.00	$84.00
4000-5000kg	$40.00	$112.00
Aerial spray contractors (per tonne)	$7.00	$19.60

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Preliminary based on current financial information provided by KDC

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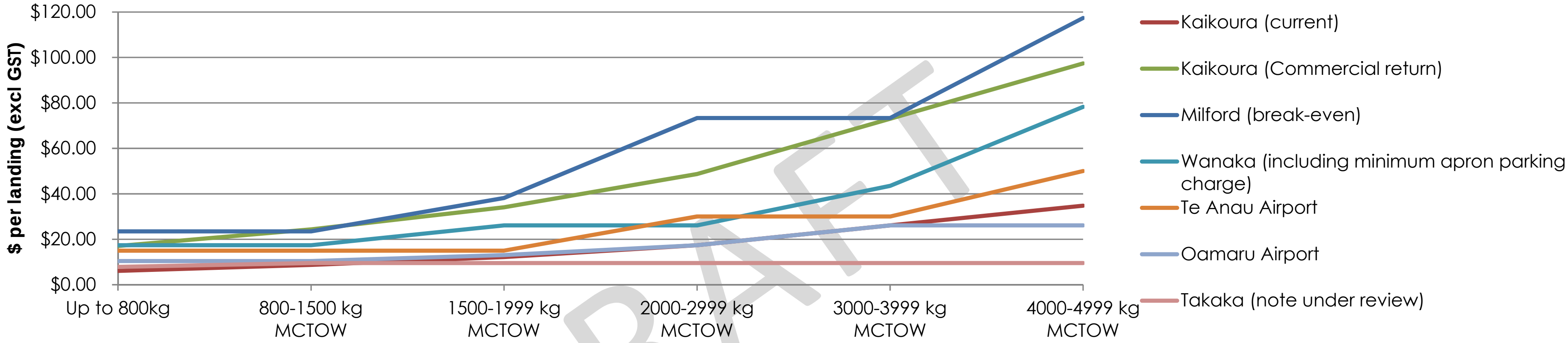
Landing Fees Benchmarked



- Initial benchmarking of similar airports in the South Island shows that Kaikoura airport landing fees are currently amongst the lowest of the benchmarked airports
- Milford and Te Anau are considered most similar in type of usage to Kaikoura Airport
- All airports shown are council owned, with the exception of Milford Airport (operated on a break-even basis by Department of Conservation)
- It should be noted that Tasman DC has provided clear guidance to users that the Takaka Aerodrome charges are under review and *"the emphasis will be on ensuring that these activities are financially self-sustaining. This is likely to result in an increase in fees and charges as these businesses move to funding depreciation and any rates funding is removed."*

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Landing fees affordability

- Such an increase would place Kaikoura's fees at the higher end of the benchmarked airports but should be seen in the context of operator charges, such as current whale watching flights which range from $120 to $895 per person (not per landing) and introductory flight lessons which start at $120 per person
- All of the operations out of Kaikoura (with the exception of emergency services) are profitable businesses
- Interestingly, the Kaikoura Aero Club Inc. Annual Report for March 2018 posts a net profit of $186,060 which, when related to their net assets of $992,000, represents a ROI of 18.8%
- Their results for March 2017 record a net profit of $239,394 and net assets of $808,757 yielding a ROI of 29.6%
- By way of comparison KDC's airport forecast for the current year shows a ROI of –3.4% on net assets of $1.23m

Stakeholder investment possibilities

- Given the airport's private good standing it should be possible to generate interest in current and future stakeholder operators to take positions in the current airport and its future development, thereby reducing Council's funding liabilities and risks
- In the interviews conducted with stakeholders, there were indications of interest in changes that would stimulate development and give greater certainty of long term tenure
- While there was ongoing support for Council continuing to own the airport, the prospect of a different management arrangement or partnership was raised by both operators and Councillors, however no preferred option was described

5 – Maximising Council's Position

Legal Constraints and Opportunities (Summary)

- **Reserves Act 1977**
  - KDC cannot sell the airport land as it is Crown land vested in KDC for airport purposes
  - KDC could lease the airport land to an operating entity but note that any lease revenues would be tagged for reserves and not available as general revenues. This however may allow a reduction in rates expenditure on KDC's overall reserves that it administers under the Reserves Act.
  - Leasing revenues from improvements on the land (such as terminal, hangar etc) are likely to be treated as general revenues
- **Airport Authorities Act 1966**
  - KDC can continue to be the Airport Authority or form and transfer its undertaking as an Airport Authority to an Airport Company in which it holds shares alone or in association with other investors
  - KDC cannot transfer the airport land to the Airport Company but can lease it
  - The business of the airport must be operated and managed as a commercial undertaking
- **Local Government Act 2002**
  - KDC can continue to manage and operate the airport
  - KDC can form an Airport Company (CCTO or CO) and lease the land and improvements to it on terms KDC determines
  - KDC can maintain an overriding level of control through the terms of the leases

Disclaimer: Subject to legal confirmation

Suggested Objectives for KDC

To optimise KDC's position we suggest possible options be tested against the following objectives:

- Objective 1: Enables **flexibility to contribute to economic development as required** (including being able to ensure there is good citizen control on current and future users and operators to avoid monopoly control)
- Objective 2: Delivers **adequate and consistent returns on investment** and has the ability to benefit from future development that provides returns and contributes to economic development without exposure to high risk and potential ratepayer subsidies
- Objective 3: **Minimise or extinguish KDC's exposure to airport management and operational risks** including:
  - Airport activities and CAA compliance
  - Commercial management
  - Fees and charges setting and collections
  - Operator disputes

Opportunities – Economic Development

Objective 1 – Flexibility to contribute to economic development as required :

- KDC should optimise opportunities for any growth in economic returns to its community
- Some operators/stakeholders have some desire to increase facilities and this needs to be accommodated/facilitated
- There may be other operators/suppliers who would like to have a presence at the airport
- KDC must have levers to ensure that future users are able to use airport facilities when warranted
- KDC needs to retain the ability to influence tourism growth to align with its economic development strategy
- Where needed, KDC through its powers can remove constraints where possible or provide environments that allow further development through such things as zoning changes, open access to markets etc while creating entities or commercial contracts/leases that are flexible and allow responsiveness

Opportunities – Return on Investment

Objective 2 – Adequate and consistent returns on investment

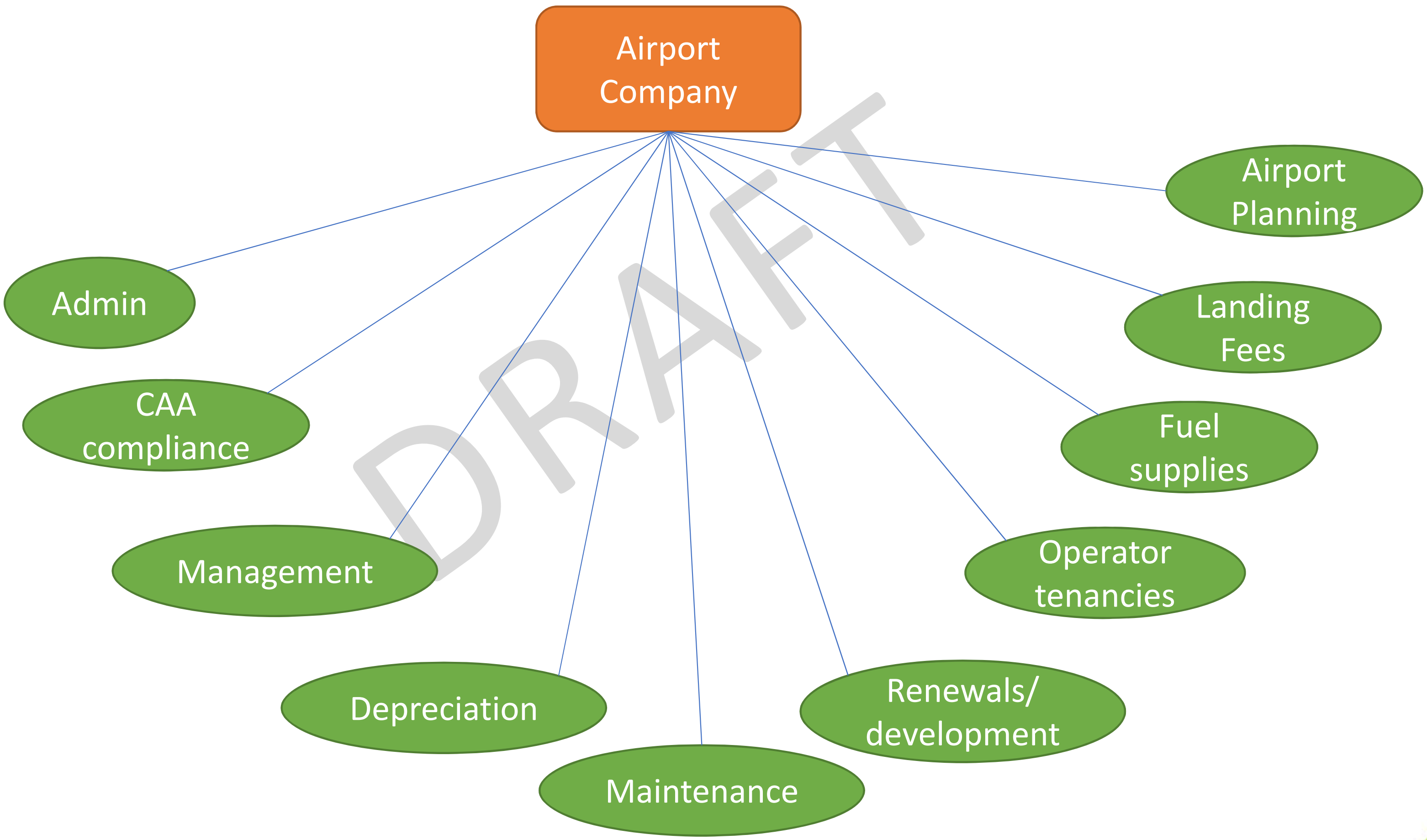
- With its relatively low risk and stable portfolio of land and buildings KDC could receive adequate returns on existing investment and permit operators to grow where they see increased opportunities
- Can't sell the land but can lease it with profits tagged to be spent on reserves
- Can sell or lease the buildings and other improvements (including the runways, taxiways etc) and use surpluses as KDC desire
- Leases are a very efficient way to control behaviour of lessees
- The airport is a discretionary activity entirely provided for private good purposes to successful and profitable operators
- Revenue has to be set at a level that recovers all costs including depreciation and provides a reasonable return on physical assets utilised (ie; including the land) and the operations structured so that other parties fund some or all operational costs
- Landing fees can be changed relatively easily, leases are reliant on the termination dates to be able to change
- Low usage growth is the most likely scenario, therefore once a reasonable return is achieved at current usage levels returns are unlikely to increase much
- KDC should not consider providing its own funding for future developments with anything but minimal risk
- KDC must make the airport into an overall positive contributor to its financial position and performance

Opportunities – Minimise Risk

Objective 3 – Minimise or extinguish KDC's exposure to airport management and operational risks:

- KDC does not have expertise in airport management and operations, and there are others that could execute this role more effectively while making an adequate return
- KDC should consider options to transfer management and operational activities/functions to other parties that have greater ability to perform these activities to reduce risk profile
- KDC can form a CCTO (≥50% control) or CO (<50% control) within the constraints of AA Act and LG Act
- An Airport Company must have the capability to competently handle the activities on the following slide to become an Airport Authority

Conceptual Model - Airport Activities



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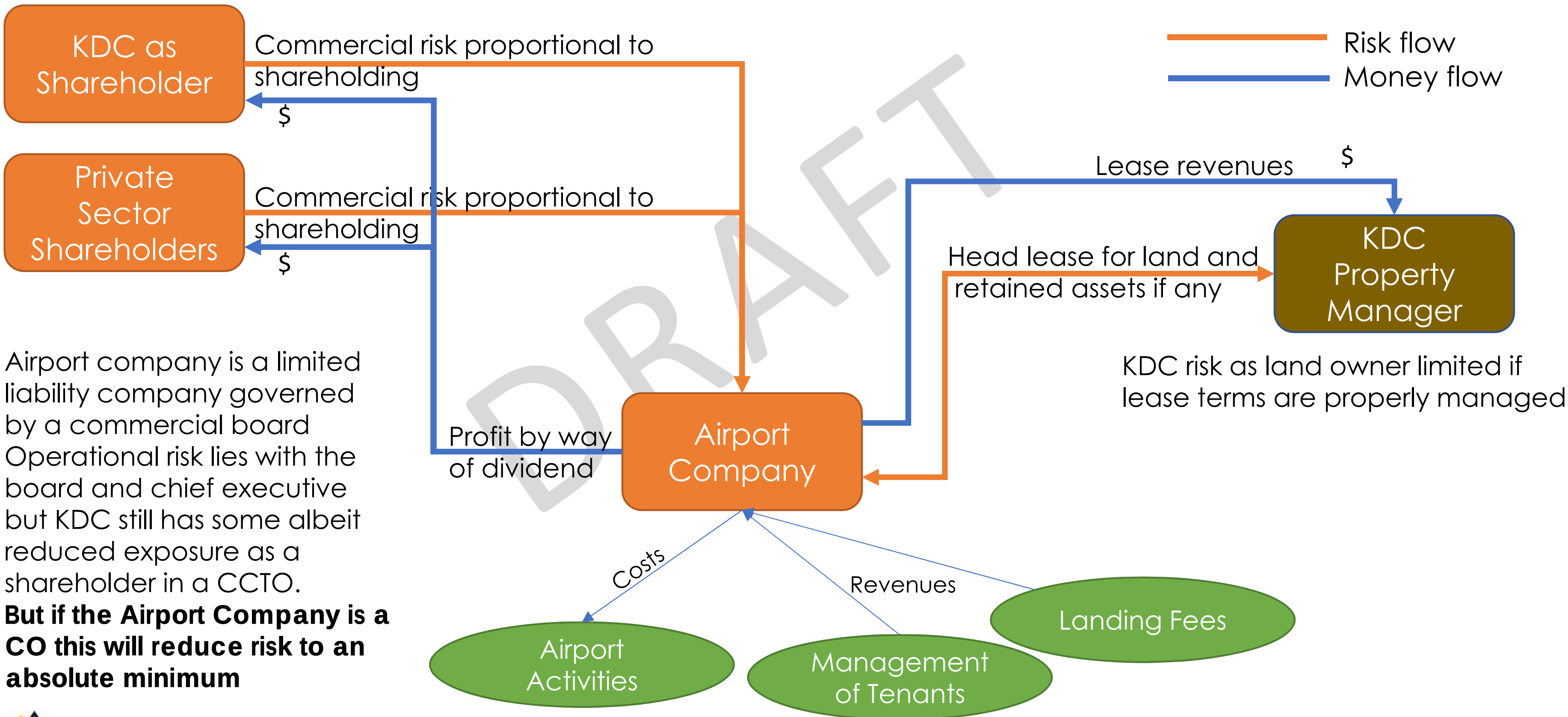
Conceptual Model – The risk and the money



- Airport company is a limited liability company governed by a commercial board
- Operational risk lies with the board and chief executive but KDC still has some albeit reduced exposure as a shareholder in a CCTO.
- **But if the Airport Company is a CO this will reduce risk to an absolute minimum**

Summary comparison of options

	Department Status Quo	CCTO Lease	CO Lease
Control of local purpose reserve	Direct	Via lease terms and governance	Via lease terms
Land Ownership	KDC	KDC	KDC
Asset Ownership	KDC	Airport Company or KDC	Airport Company or KDC
Commercial drivers	Profit	Profit	Profit
Operational Risk to KDC	High	As lessor if lease terms not enforced Medium due to governance control	As lessor if lease terms not enforced Minimised in governance but some by association
Commercial risk to KDC	High	Medium as commercial entity will better control Lease revenues secure	Lower exposure and commercial control Lease revenues secure
Attractiveness for potential partners	NA	Low due to image perceptions and lack of control	Medium/high
Achievability	Yes	Yes subject to consultation	Yes if private participant(s) found

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Comparison Against Objectives

	Department Status Quo	CCTO Lease	CO Lease
Obj 1: Economic Development	√√√	√√	√√
Obj 2: Return on Investment	X	√ Leasing to itself really	√√√ Primarily leasing to others
Obj 3: Minimise Risk	X	√	√√√

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6 – Preliminary Recommendations

Disclaimer: The following recommendations are an interim position pending receipt of robust normalised financial accounts and further analysis to confirm the optimum way forward for KDC.

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Preliminary Recommendations

1. KDC compiles robust financial and operational information and projections for the Airport Authority's future sustainable business
2. KDC facilitates forming an Airport Company (Company) that is intended to become the Airport Authority. A CO is preferable to a CCTO as CO reduces KDC's risk the most and uses more of other parties money. Given this, the Company needs to be formed jointly with other parties who have a vested interest in the airport's sustainability and with KDC interest of less than 50%. The shareholders elect the Board etc
3. Ensure the Company has access to the capability to undertake the role of an Airport Authority
4. Transfer the undertaking (business) including the Airport Authority undertaking to the Company at a price to be determined
5. Lease:
   a) the airport land to the Company
   b) the infrastructure (common area) assets (runway etc) to the Company
   c) the building assets directly to the current operators who occupy them
   d) should be based on a WACC of ~~somewhere~~ around 10%
6. Form a tenancy management agreement between KDC and the Airport company

Disclaimer: Subject to receipt of robust normalised financial accounts and further analysis

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Preliminary Recommendations

8. The Company develops its financial plans and determines the fees and charges for all users
9. Sell the majority of the Company to others (most likely the current operators or their parent organisations) while maintaining the minimum shareholding possible in the Company

Note: The size of the shareholding will not have a significant bearing on KDC's overall return as KDC's sources of income include the leases, but the smaller the shareholding the less risk to KDC and the more attractive it will be to other potential shareholders

Plan B;

- Sell building assets into the Company and beef up Land Lease to the Company to cover good citizen and building maintenance and renewals etc. (Don't want the Company coming back to KDC for money like Eden Park)

Outcome:

- **Our recommendation is to form an Airport Company that would be a CO (<50% control) removing KDC from the inherent significant risks and responsibilities contained in the ~~for~~ management and operations of the airport, and yet still provide essential controls through ~~its~~ KDC's leases of the land (and facilities if still owned by KDC) while providing a low risk and stable return on ~~its~~ investment**

Recommended Next Steps – Phase 2

1. The compiling of robust normalised accounts and operational data for the airport is an essential baseline from which future projections may be based and is a precursor to further analysis. This is needed for the detailed financial analysis to test viability including determining whether the combined revenues from landing fees and tenant management fees can outweigh the costs of managing and operating the airport while paying KDC's lease costs.
2. Subject to this baseline being available it is recommended that Phase 2 further evaluate and report on:
   - Opportunities for increased revenues in support of achieving a viable business outcome
   - Each of the two Airport Company options (CO and CCTO) be further evaluated in regard to:
     - Governance
     - Financial structure and sustainability
     - Potential investor interest
     - Establishment process and cost
     - Legal compliance

- Report presented to Council for its decision

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